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2019 Year-End Review and Forecast

23 January, 2020

The Year in Review

Investment markets generally had an outstanding year in 2019, and especially the US stock market. About this time last year, I wrote that I expected to have a decent 2019 after what had proved a challenging 2018 for stock markets. I thought that much of the downturn in 2018 had been caused by news events rather than fundamentals and that I expected news events such as the US-China trade dispute, the Brexit issues, and so on, to reverse or to already be baked in so that there was potential for good news to drive markets higher in 2019.

This forecast proved largely correct although I certainly didn’t expect the extent to which markets bounced back this year, with the S&P500 leading the way with an almost 30% increase, as can be seen in the chart below. I also wrote at the beginning of 2019 that I thought the May to October period might not be as good for investment returns, and this too proved correct.

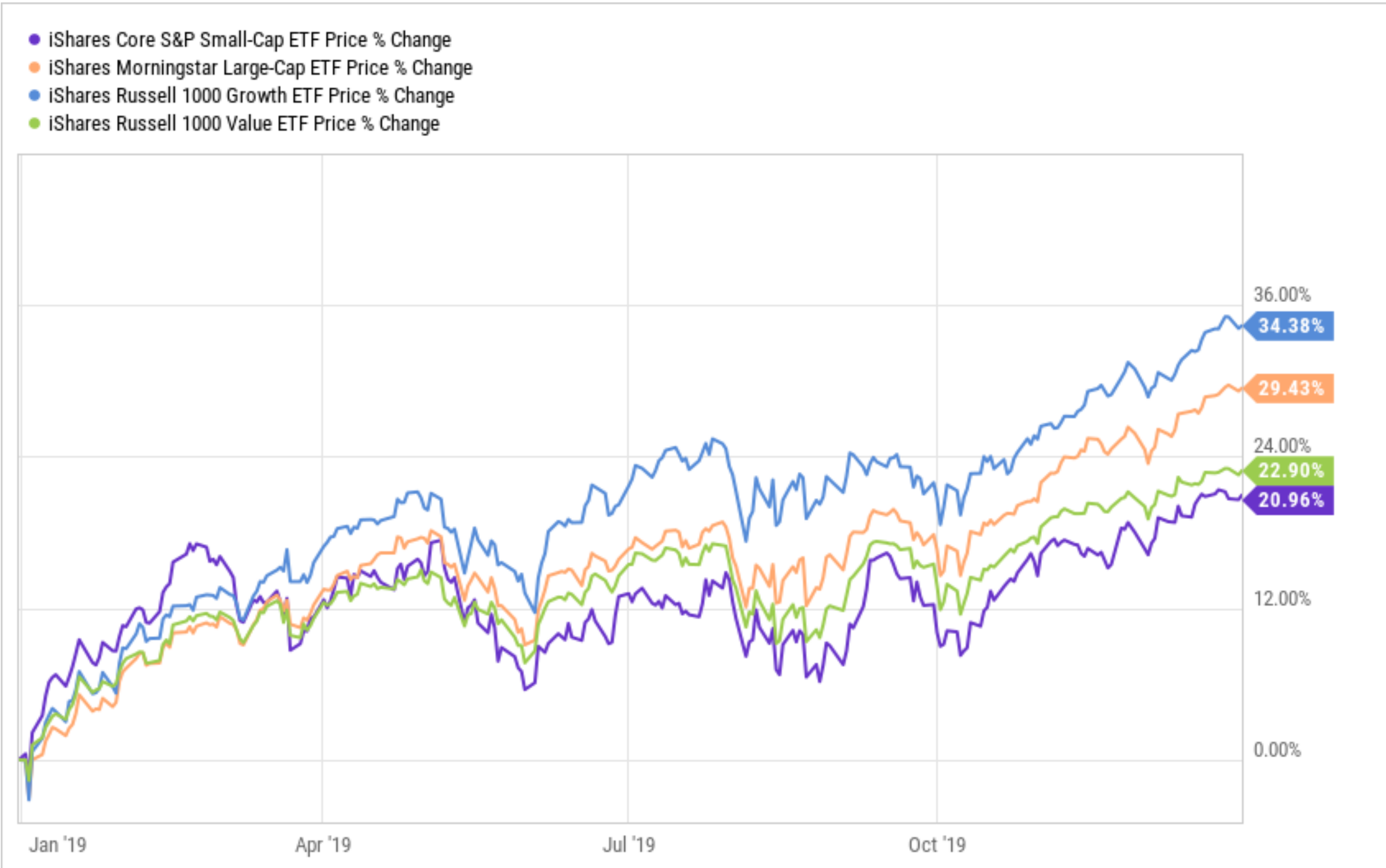

SPDR® S&P 500 ETF Trust Price % Change
iShares MSCI EAFE ETF Price % Change
iShares MSCI Emerging Markets ETF Price % Change
iShares Core US Aggregate Bond ETF Price % Change
30.00%
28.79%
20.00%
18.14%
14.87%
10.00%
5.52%
0.00%
Jan '19
Apr '19
Jul '19
Oct '19

I didn’t get everything right though – I thought that after April we might see a rotation out of some of the companies that had been leading the way in investment returns for many years, mostly US info tech companies like Apple, Google, Amazon, and so on. This proved incorrect as these companies, and what we call “growth” companies in general, continued to outperform “value” companies.

A traditional classification system for shares of companies groups them into “growth” or “value” and “small-cap” or “large-cap”. Growth companies are firms that are characterized by significant earnings per share growth but often paying low (or no) dividends and having high price/earnings ratios. Sometimes these companies are not even profitable yet since they are spending most of their free cash on re-investing into growing the business and perhaps even borrowing to do so. Value companies are more established firms that have a stable business but perhaps aren’t growing that quickly but they usually pay good dividends and tend to have lower volatility stock prices.

The chart below shows how US growth companies did relative to value companies in 2019 and also large-cap vs. small-cap company returns. Large-cap companies are generally ones where the value of the firm is measured in billions of dollars and small-cap stocks are ones valued at 1-2 million on average. As you can see, US large-cap stocks outperformed small-cap by about 9% in 2019. The Russell 1000 Growth and Value ETFs represent large-cap growth and value stocks and the spread between the two in 2019 was about 11.5% in favor of growth firms.

These are quite large spreads in performance compared to historical values, however this significant outperformance of growth companies has now been with us for three years. We usually see growth and large-cap outperform towards the end of a business cycle and so perhaps we should be on the lookout for events that could cause a downturn in the US economy – although presently US economic indicators are still broadly positive, as they have been for many years.


iShares Core S&P Small-Cap ETF Price % Change
iShares Morningstar Large-Cap ETF Price % Change
iShares Russell 1000 Growth ETF Price % Change
iShares Russell 1000 Value ETF Price % Change
36.00%
34.38%
29.43%
24.00%
22.90%
20.96%
12.00%
0.00%
Jan '19
Apr '19
Jul '19
Oct '19

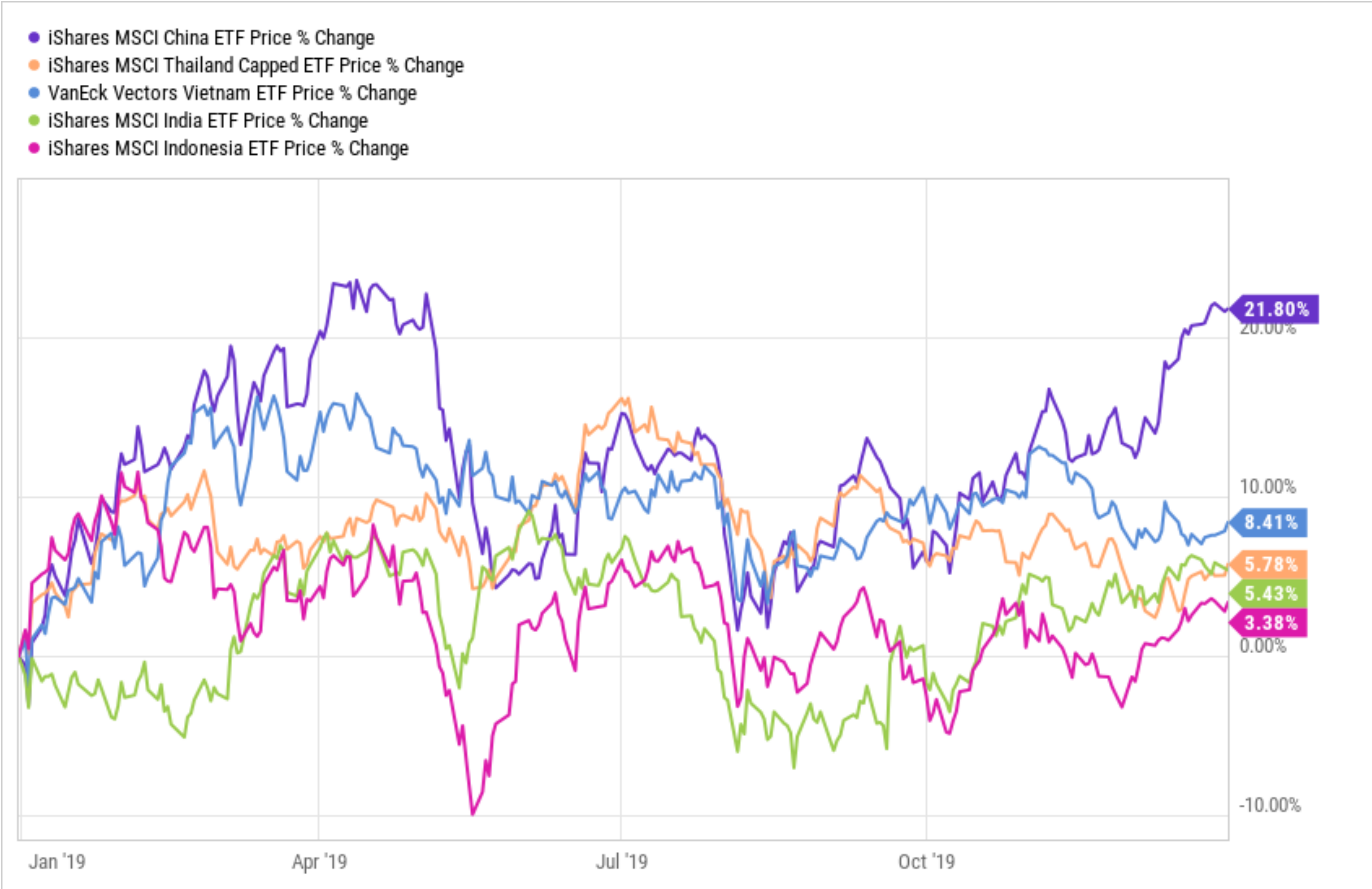
The economic indicators in Europe are another matter altogether though. These have been broadly negative now since beginning of 2019; the German indicator for two years, and the UK indicator since the Brexit vote in 2016. Nevertheless, as can be seen by the chart below, European markets still did well in 2019, with French and Italian markets leading the way.

We shouldn’t forget that stock market returns are in fact one of the data sets that go into the index of leading economic indicators of a country; so we are never going to be able to time stock market tops and bottoms by looking at leading indicator indices, but if we see indices trending lower over a number of months then we should be on the lookout for a possible recession and for more pronounced and sustained negative stock market returns.

Currency movements were not a big factor in developed countries’ stock market returns in 2019, with most major currencies ending the year within a few percent of where they started relative to the USD. The British pound was one of the more volatile currencies as the Brexit situation played out. Sterling was down about 7% vs. the USD by mid-August but rebounded in the latter half of the year to finish slightly higher, as Boris Johnson seemed to receive a stronger mandate to deal with the Brexit situation.

Commodities also performed well in 2019, with gold and silver up 18% and 15% respectively and the price of oil up about 25%. A broad index of commodities, as represented by the iPath Bloomberg Commodity ETN that includes agricultural as well as so-called “hard” commodities, was up 7.6%. The good performance of gold prices is perhaps somewhat surprising since gold typically does well in an inflationary environment or as an alternative to the stock market during times of market stress.

I was surprised at the performance of certain emerging markets, especially those in Asia. I thought at the beginning of 2019 that some of the US/China trade issues might be resolved, which would have been positive for the Chinese market. However, as the year went on, things actually got worse, and so I would have expected that Chinese markets would have suffered and perhaps those of neighboring countries that are perceived as alternatives to Chinese manufacturing, might have done well. However, as can be seen by the chart below, the Chinese market far outperformed markets such as Thailand, India, Indonesia, and Vietnam in 2019.



iShares MSCI China ETF Price % Change
iShares MSCI Thailand Capped ETF Price % Change
VanEck Vectors Vietnam ETF Price % Change
iShares MSCI India ETF Price % Change
iShares MSCI Indonesia ETF Price % Change
21.80%
20.00%
10.00%
8.41%
5.78%
5.43%
3.38%
0.00%
-10.00%
Jan '19
Apr '19
Jul '19
Oct '19

Finally, there was also some excitement in US bond markets. In January of 2019 the Federal Reserve decided to stop raising interest rates after three years of slow but steady increases that took the target rate from 0% to 2.25%. Then, in June, the Fed reversed course and lowered rates to 1.5% over a three-month period. This was one of those rare events that we could actually see coming and were able to take advantage of in more conservative accounts by buying long-dated Treasury bonds in April.

Looking Ahead

I find it especially difficult to make projections for 2020. After such a spectacular year in the US stock market, I would expect a correction at the beginning of the year, however, as I write this in the third week of January this has not come about. We shouldn't let the fact that we had a good year last year scare us into thinking that this year must be poor. In the USA there have been three other 20%+ return years in the last ten and two of them were followed by returns of 13% and 15% the year following.

Economically speaking the USA seems in good shape – low interest rates, low unemployment, low inflation, consumer confidence at very high levels, and consumer spending robust. There seems no reason to underweight US equities at this time, although perhaps some of the companies that have had such a spectacular run-up in share prices recently might take a bit of a breather and so some rebalancing of gains might be a good idea.

Europe, it seems, continues to face challenges, although as the Brexit process grinds forward with greater clarity this could be positive for the British pound, which has decreased substantially in value since the Brexit vote in 2016. This decrease in the value of Sterling could make UK products more competitive internationally and so perhaps an allocation to large British exporting companies might be an interesting investment. I would think that the recent strikes in France would be negative for that economy.

It seems as though there is now positive news regarding the US/China trade issues, with a recently signed “phase 1” agreement. If the two countries continue to move forward with further accords then this should be positive for markets in general. Recent economic stimulus in China may also further boost these markets as well as those of countries, such as Germany, that export to China.

An interesting wild card on the global scene is the on-again / off-again conflict between the USA and Iran. The recent US assassination of a top Iranian General and the so-far limited response to this from Iran suggests that this conflict could bubble up over the next year. This would likely be positive for oil and perhaps gold prices (gold tends to increase in value during times of stress), however this is a difficult investment theme since it is hard to know what, if anything, might come of this situation.

I think there are opportunities to take positions in companies that should benefit from long-term trends and this is where we are looking for value and investment opportunities. The aging Baby Boomer generation and the increase in medical services in China could be broadly positive for medical device and pharmaceutical firms. It seems like renewable energy and the electrification of the auto industry are also long-term trends. Tourism should continue to do well, specifically tourism oriented at older people, such as the cruise ship industry. The internet of things is also something that is happening as we speak and a trend likely to continue.

In general, I would expect an "average" year for investments barring an external shock such as an escalation of the Iran-USA issue. I would suggest some rebalancing from growth investments that have performed well recently to value investments, which are possibly better value these days.

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