MATRIX
PRIVATE CAPITAL GROUP

MATRIX PRIVATE CAPITAL GROUP

Can the Momentum Continue?

First Quarter 2020 Outlook

After a very strong fourth quarter to finish an already successful 2019, can the markets continue the "melt up" in 2020? We discuss the current strength across asset classes and examine both the positive data points that are in focus and those that are telling a different story.

Matthew Rubin
Chief Investment Officer
mrubin@matrixpcg.com

Ryan Tunnell, CFA
Director of Investments
rtunnell@matrixpcg.com

2019 in Review

2019 turned out to be a very good year for investors, after the late-stage collapse of market performance in 2018. The S&P 500 was up 31.5%, but strong performance was not limited to equities. Bond indices were also higher, including the Barclays U.S. Aggregate, which was up 8.7% in 2019. Real estate had a big year, with the S&P United State REIT index up 24.5%.

Major U.S. equity indices outperformed major international equity indices, such as the FTSE Developed ex-U.S. index and the MSCI Emerging Markets index. Those benchmarks were up 22.6% and 18.9%, respectively, in 2019[1].

In addition to strong performance, 2019 was characterized by relatively low equity market volatility. The largest peak to trough decline in the S&P 500 during the year was approximately 7%[2]. For the volatility that did occur, much of it was attributed to headline risk pertaining to the trade war with China. At the time of this writing, there is a signing ceremony scheduled on January 15th for a "phase one" trade deal.

Market Momentum Strong to Start 2020

The markets are starting 2020 at a time when there has been strong upside momentum. Investors have focused on positive factors such as the strong labor market, consumer sentiment, progress toward a U.S. – China trade deal, and accommodative central banking policies around the world and shrugged off risks like high valuations, deteriorating credit quality and protections, negative geopolitical events, uncertainty around the 2020 presidential election, declining manufacturing activity, and declining CEO/CFO sentiment.

With consensus earnings growth estimates for 2020 in the mid-to-high single digit range, we believe companies will need to minimally achieve the high side of this range to keep the S&P 500 well into positive territory for 2020. According to a recent report from FactSet, the forward 12 month price-to-earnings ratio of the S&P 500 is 18.3. This is higher than both the 5 and 10 year ratios of 16.7 and 14.9, respectively. Since market prices change in anticipation of what will happen in the future, it seems that investors are expecting solid corporate earnings in 2020 and that these investors were willing to bid up stocks in 2019 based on this assumption. If earnings disappoint, the investors that bought stocks at higher-than-average valuations may find themselves questioning why they didn't exercise more patience in waiting to buy at cheaper valuations.

Maintaining a Disciplined Approach to Balancing Risks

At Matrix Private Capital Group, valuation is always in focus when constructing investment portfolios. As part of prudent long-term risk management, we continue to advocate for realizing some gains in growth-oriented assets that have performed well in what is now an almost 11 year bull run in equities. The deployment of gains from risk assets into other assets varies depending on each client's unique situation, but since long economic cycles typically become more and more difficult to sustain, we have emphasized using proceeds from the sale of growth assets to reallocate to other areas of the market that can reduce total portfolio volatility. For some clients, this means adding to lower growth but higher dividend yield stocks. For others, this may mean adding to cash positions, certain parts of the bond market, MLPs, core real estate, and/or alternative assets.

New York (HQ)
400 Park Avenue, 6th Floor
New York, NY 10022

Chicago
155 N. Wacker Drive, Suite 4242
Chicago, IL 60606

Los Angeles
10250 Constellation Boulevard
Los Angeles, CA 90067

Palm Beach
101 Northpoint Parkway
West Palm Beach, FL 33407

Pittsburgh
409 Broad Street, Suite 200
Sewickley, PA 15143

212.254.4876
info@matrixpcg.com
matrixpcg.com

MATRIX
PRIVATE CAPITAL GROUP

Sources:
1. Addepar
2. Yahoo! Finance

For many investors, it can be difficult to embrace risk management during periods of time when riskier assets have performed very well. We at Matrix view risk through the lens of understanding that long-term market exposure serves most investors well, while also understanding that, at times, markets can be struck by too much optimism/greed or pessimism/fear. In recent months, the rhetoric surrounding the marketplace has shifted toward more optimism. Some of this talk is justified. One can understand why people are speaking positively about the strong labor market, low corporate tax rates, and accommodative monetary policy. However, with conversations moving beyond analysis of fundamentals and toward the idea that the recent rally has been driven by investors fearful of missing out on returns, we must consider that greed may be overtaking fundamentals to some degree. By gradually taking some risk off the table, we can better protect in down markets. This also means that if there is a market correction, we can reenter riskier assets at better prices.

Risk reduction does not mean risk elimination. We have already mentioned some of the positive data points for the market, and, in particular, we are wary of "fighting the Fed." Looser central bank monetary policy means that the cost of borrowing is reduced, which typically pushes up the prices of riskier assets. This is not a new concept, but it is worth repeating. Our focus is not so much on the fact that monetary policy is currently loose, but that the Fed seems to have set a fairly high bar for tightening up that policy going forward. While we believe the Fed is not looking to cut rates anytime soon, we think the requirements for a cut are lesser than those that would instigate a raise. In particular, we think the Fed would need to see sustained inflation well over 2% before considering a rate hike.

Phase One and Done?

The recent announcement of the phase one deal with China is a step in the right direction and is helpful for ballasting the market's current momentum. While neither country's volume of trade with the other accounts for an extensive percentage of GDP, the inability up until this point to get any major resolutions in place has had an outsized effect on investor sentiment. According to the Wall Street Journal, this step in the deal will remove planned tariffs entirely on $156 billion of Chinese goods and cut the tariff rate to 7.5% from 15% on another $120 billion of goods. Although a positive first step in improved trade relations between China and the United States, the deal does not remedy the extraction of intellectual property from U.S.-based firms by China. We have stated numerous times in the recent past that this is arguably the single largest problem that needs to be resolved and that a resolution is needed to justify the cumulative negative effects of the negotiating tactics employed by the Trump administration.

Consumers Optimistic, CFOs Not So Much

A divergence in sentiment between consumers and CFOs has taken shape. The Commerce Department reported numbers for November 2019 that showed consumer spending is up 2.4% on a year-over-year basis[3]. These numbers coincide with stronger numbers from the University of Michigan consumer sentiment survey in its most recent reading. We have discussed the importance of consumer spending in previous editions of our investment outlook, and the solid numbers have supported bullish views of the market.

New York (HQ)
400 Park Avenue, 6th Floor
New York, NY 10022

Chicago
155 N. Wacker Drive, Suite 4242
Chicago, IL 60606

Los Angeles
10250 Constellation Boulevard
Los Angeles, CA 90067

Palm Beach
101 Northpoint Parkway
West Palm Beach, FL 33407

Pittsburgh
409 Broad Street, Suite 200
Sewickley, PA 15143

212.254.4876
info@matrixpcg.com
matrixpcg.com

MATRIX
PRIVATE CAPITAL GROUP

Sources:
3. https://www.wsj.com/articles/u-s-consumer-spending-rose-0-4-in-november-11576854094

On the other hand, the December 2019 results of Duke's Fuqua School of Business CFO survey are painting a very different picture. The survey found that 52% of U.S. CFOs believe that the United States will have begun a recession by Q4 2020 and a whopping 79% of Asian CFOs believe that a recession will have started in their respective countries by the time that 2020 is finished. In our view, this is one of the most bearish indicators right now, given that these corporate insiders are privy to the most detailed aspects of their firms' financial outlooks. In fact, one of Matrix's preferred small cap fund managers places special emphasis on the insider buying trends of CFOs during its decision-making process about which small cap stocks to buy or sell.

And We're Off...

Given the mix of positive near-term data and less favorable mid- to long-term indicators, we expect much more volatility in 2020 than what investors experienced in 2019. As mentioned earlier, valuation is a key concern, as is what we see as a challenge for positive data points to trend in an even more positive direction. If these positive indicators simply plateau, then we would expect modest positive performance in 2020. However, a confluence of weaker data would likely result in sharper downside moves, given the higher-than-average forward P/E ratio currently reflected in the market.

As always, if you have questions about anything contained in this outlook or want to discuss your portfolio, please contact your financial advisor.

New York (HQ)
400 Park Avenue, 6th Floor
New York, NY 10022

Chicago
155 N. Wacker Drive, Suite 4242
Chicago, IL 60606

Los Angeles
10250 Constellation Boulevard
Los Angeles, CA 90067

Palm Beach
101 Northpoint Parkway
West Palm Beach, FL 33407

Pittsburgh
409 Broad Street, Suite 200
Sewickley, PA 15143

212.254.4876
info@matrixpcg.com
matrixpcg.com