January 5, 2020

Overview

Equities finished the year exuberantly.

The S&P's 500 rose **3.02%** while the US Small Cap index progressed **2.88%** and the Nasdaq Composite **3.63%.** Internationally, the USD declined and made it possible for most indices to rise, sometimes spectacularly. The EPAC BMI (developed economies) rose **3.47%.**

In emerging markets the MSCI EM raced upward **7.46%** while the Frontier 100 Index rose a solid **3.15%.**

In the US fixed Income markets performance was more contrasted. The long bond declined **2.87%** while high yield bonds rose about **2%** and other sectors barely moved above the flat line.

As is often the case when the USD weakens, international equities tend to perform well. The chart below illustrates this point.

The orange line is that of VWO, our preferred emerging market equities ETF. The vertical line marks the beginning of December. The blue line represents the performance of USDU, an ETF that tracks the performance of the USD vs. a basket of major currencies. VWO went up 7.01% in December as USDU was declining about 2%.

In December, our client portfolios rose between 1.00% and 1.84%. This compares to a monthly performance of 1.70% for a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy).
For the whole of 2019, our portfolios are up from 15.36% to 19.63% (net of fees) vs. 17.52% for our benchmark.

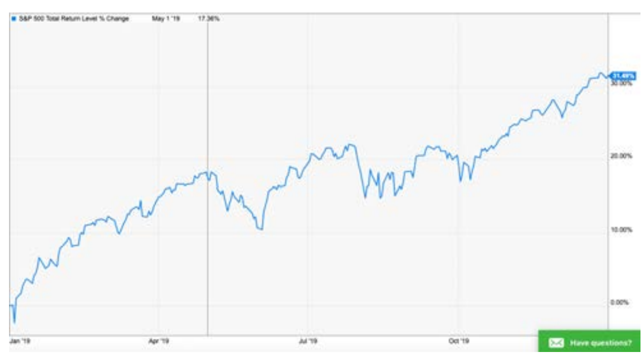
As a reminder, the equity allocation in our clients' portfolios ranges currently from 30% to 60%, depending on risk profiles.

Market developments

The month of December started on a rather sour note with the White House announcing new tariffs on Brazilian steel, Argentinian aluminum and agricultural commodities and indicating that the much-heralded China-USA trade agreement (phase I) may not be signed for a while. This poor market tone was not to last though. Conditions started to improve on December 12, when UK electors gave Boris Johnson a solid parliamentary majority, reducing in the process the chances of a disorderly Brexit.

A significantly reduced Brexit risk together with the lifting of the threat of additional tariffs on Chinese goods, shortly afterwards, contributed to pushing equity indices upward. From that point on, reduced market liquidity and a relatively uneventful economic calendar helped most equity indices set new records as the year-end holiday season started.

The S&P's 500 finished 2019 up 31.45% on a total return basis. The chart below shows how that spectacular performance was connected to the Federal Reserve's announcements and decisions during the year.



In early January 2019, the Fed announced that it was open to reversing its tightening stance (from pushing rates up to pushing them down). That propelled the S&P's 500 straight up 18% through mid-April (vertical line). During the next five-six months the index meandered. While the Fed delivered twice on its promise to lower interest rates during the summer, equities were unable to move decisively forward due to soft industrial production numbers and fears of escalating trade tensions with China. All these headwinds evaporated in the last quarter of the year.

First, the Fed eased again in early October. Then, a fairly good third quarter corporate earnings season reassured investors. Finally, the announcement of an agreement on trade with China added to the positive momentum. All of this contributed to pushing the S&P's 500 up another 10%.

Tilts and Allocations

As mentioned in previous newsletters, I added to our equity exposures gradually in October and November, taking advantage of a positive market momentum. In December though, other than for some tax-optimization buying and selling, I kept investment decisions to a minimum, and left clients' portfolios mostly unchanged.

When I had to deploy new cash, I prioritized investments in international developed and emerging market equities. The reasons for this go from my belief that the USD should decline in 2020, pushing performance upward for non-USD denominated equities to technical reasons that point to a likely reduction of the significant annual performance gap between US equities and the rest of the world.
The annual performance gap between US and non-US equities has averaged 5% to 10% in favor of the US for more than ten years now, depending on which international market one looks at. This is amazing. At some point, trends reverse.

Conditions for this reversal may be developing currently, with an improving political environment in Europe, an easing of trade tensions globally, expectations of a weaker USD, and the possible use of growth-enhancing fiscal policies around the world, outside the USA.

Concluding Remarks

2020 is unlikely to bring about as much satisfaction to equity investors as 2019 did. To be fair, no one would have expected such a spectacular performance at the end of 2018. So, is it possible for 2020 to bring about another year of outsized performance? Yes. Is it likely? No. The Fed will not push rates down three times in 2020 unless we enter a recession. The tensions with China are unlikely to ease for long and market ructions will ensue. 2020 is an election year and with it, politically induced volatility is likely to erupt, on and off, as campaigns gear up.

Let's therefore prepare for a volatile year. In terms of performance, we should ready ourselves for a return to a more pedestrian annual performance range of -5% to 10%, absent a recession and major geopolitical disturbances.

Thank you for your trust,

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