BUCKHORN INVESTMENT ADVISORS

Fourth Quarter Market Review and Comment
January 2020

Updated Market Performance

Returns	4th Quarter 2019	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**9.07%**	**31.49%**	**15.27%**	**11.70%**	**13.56%**
DJIA	**6.67%**	**25.34%**	**15.73%**	**12.59%**	**13.40%**

Performance: October began right where September left off notching a return of 2.17%. November continued October's trend posting a 3.63% increase. December ended on a positive note, up 3.02%, but not without anxiety of a repeat of last year. This December was much different than last year. Last year we just wanted it to end. This December was so good we were hoping for a few extra days. This was the best December since 2010 when the S&P 500 posted a return of 6.68%. The net result for the quarter was 9.07%. The best quarter since 2011's 11.73%. We ended a great year with the S&P 500 up 31.49% after dividends, the best year since 2013's 32.39% return.

After the 3rd quarter with the S&P 500 up 1.72% the 4th quarter of 2019 brought a sigh of relief after a volatile 4th quarter 2018, the S&P 500 (SP500) posted a 9.07% return in the 4th quarter that just ended on December 31, 2019. The Dow Jones Industrial Average (DJIA) trailed the SP500, posting 6.67% over the same period. For the previous twelve months the SP500 has returned 31.49%, handily outpacing the DJIA which returned 25.34% over the same period. The annualized three-year returns are not as impressive than near term returns, with the SP500 posting 15.27%, while the DJIA is running at 15.73%. Over the last five years the annualized returns are running above historical norms (around 10%), with the SP500 returning 11.70% and the DJIA posting 12.59%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 13.56% vs the DJIA which turned in 13.40%.

Breaking down the returns for the Q4 2019, we note that there were three outperforming sectors and eight underperformers. **The best sectors were Technology (14.40%), Healthcare (14.37%) and Financials (10.47%)**. **The losers during the quarter were Real Estate (-0.54%), Utilities (0.75%) and Consumer Staples (3.51%).** The clear winners the last twelve months were Technology (50.29%), Communication Services (32.69%) and Financials (32.13%). Bringing up the rear were Energy (11.81%), Health Care (20.82%) and Materials (24.58%).

The DJIA continued its rise in the 4th quarter as the we received confirmation of a phase 1 trade deal with China. Trade tensions continue to be visible, but with a phase 1 trade deal with China completed on January 15th trade tensions have eased for now. Economic growth forecasts have started to increase. Although they are still below historical norms, thoughts of a recession have receded into the distance. Global trade and global economic growth are important since more than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

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Economy: Economic growth for the 4th quarter 2019 and 1st quarter 2020 are expected to remain below average but have increased from the lows before the phase 1 trade deal with China was announced.

The third estimate of 3rd quarter Gross Domestic Product (GDP) is 2.1% according to the report released at the end of December by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter increased by ~0.1% compared to the 2nd quarter 2019 when GDP was running at a rate of 2.0%. Overall, the economic recovery has continued through the end of 2019 and into the beginning of 2020 following growth of 2.9% in 2018 and 2.2% in 2017. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future as we continue to have low interest rates and muted inflation, although there continue to be vulnerabilities. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted 2019 Q4 GDP growth at 1.11% and 2020 Q1 GDP growth at 1.24%. By comparison, China says their GDP grew at 6.4% in the 4th quarter of 2019. China's 2018 GDP was 6.6% compared to 6.8% in 2017. Trade pressure from the US, slowing global demand, and off-balance-sheet borrowings by local governments continue to hinder China. China continues to implement policy driven stimulus to increase and maintain growth, which is not sustainable in the long-term. Growth rates for the European Union (EU) and the Euro Area were 1.4% and 0.2% respectively in the 3rd quarter 2019. For 2018, GDP rose 1.9% for the EU and 1.8% for the Euro Area. This is down from the 2.4% growth both achieved in 2017 giving continued evidence to the slowing of global growth.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, December unemployment remained at 3.5%. Unemployment for 2019 came in at 3.67%, the last time the unemployment rate maintained an average of 4.0% or lower other than 2018 was in the late 1960s. Job growth continued to trend up in healthcare and retail trade, while mining jobs trended down. The labor force participation rate was 63.2% for December unchanged for the month and has been in a narrow range over the last 12 months.

Inflation is still below historical averages. After averaging ~1.76% in the 3rd quarter, inflation as measured by the Consumer Price Index (CPI) increased to an average of 2.07% in the 4th quarter. The average rate of inflation for 2019 was 1.82% and continues to be subdued by historical standards (~2.50% over last 30 years). December came in at 2.30%, an increase of 0.2% from November's reading.

Consumption is an important driver of the economy as it represented 68% of 3rd quarter 2019 nominal GDP. The U.S. Census Bureau announced in December that retail sales for November 2019 were up 0.2% compared to October but were up 3.3% above November 2018. Non-store Retailers were up 11.5% from November 2018, while food services and drinking places were up 5.1% from last year.

Manufacturing economy contracted in December. Economic activity in the **manufacturing sector** contracted for the fifth consecutive month in December, with the Purchasing Managers Index (PMI®) registering 47.2, a decrease of 0.9 from November reading of 48.1. The PMI®'s continued contraction has reached nine straight months of softening. Two of the six big industries expanded, while the other four contracted. The **overall economy** grew for the 128th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** ***Report on Business®***. Based on historical relationships between PMI and GDP, a PMI of 47.2 corresponds to a 1.3% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continue to rise. According to the S&P Case-Shiller Home Price Indices home prices rose in October with the S&P CoreLogic Case-Shiller National Home Price Index rising 3.3% over the last 12 months. Phoenix, Tampa and Charlotte had the largest year over year increases of 5.8%, 4.9% and 4.8% respectively. Fundamentals indicate renewed housing demand. According to the National Association of Realtors, the year over year change in existing home sales was positive in November for Single family homes above $250,000 and housing supply continued to remain tight since peaking in June.

Markets: Last year was a great year for market appreciation. Too bad most of the returns came from multiple expansion. We still have a trade war (Even though a phase 1 deal has been signed),

Impeachment proceedings, slowing manufacturing and an upcoming election to cast uncertainty into the market. The Fed is still dovish and ready to step in when needed. If everything stays NABAF (Not as bad as feared) we should have another positive year, although not as generous as last year.

- **Earnings growth for the SP500 is expected to decline -2.0% for the 4th quarter 2019. If actual growth comes in as estimated, it will be the first time the index has reported four straight quarters of year over year declines in earnings since Q3 2015 through Q2 2016.** According to FACTSET, of the SP500 companies that have reported earnings as of 10 January (Approximately 20), 84% reported earnings above the mean estimate and 74% have reported sales above the mean estimate. **Earnings guidance has been skewed to the downside with 73 companies issuing negative EPS (Earnings per Share) guidance and 34 issuing positive EPS guidance**. Estimated earnings for the quarter fell by -4.7% from the end of Q3 2019 through the end of Q4 2019. This percentage decline was larger than the 5-year average decline of -3.3%. Looking at future quarters, analysts see an increase in earnings growth in the first half of 2020 between 4.5% and 6.5%.

- **After last year's multiple expansion, stocks are rich.** ***Valuation expansion accounted for 92% of the appreciation in 2019 according to Goldman Sachs. It doesn't look like we will receive any meaningful earnings growth until early to mid-2020.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 18.2. The long term (20 Year Average) PE for stocks is 15.5, so we don't see a lot of room for valuations to move higher without growth or lower interest rates. There is no room for PE expansion now, so to get continued appreciation we will need an increase in earnings and/or widening profit margins.
- **Global trade tensions continue to persist. After the announcement and signing of a phase 1 trade deal with China, the mood has lightened and given more confidence of a more substantial future agreement.** There continues to be a cloud of uncertainty in the market around the pursuit of protectionism. With trade concerns still in the news often, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures continue to be present. We are seeing the tariffs flowing through in the manufacturing sector and don't be surprised if we continue to feel the pain when purchasing goods.

- **Falling interest rates.** The Federal Reserve decided to leave the target range for the federal funds rate unchanged at 1.50%-1.75% during its December meeting. This comes after a .25% cut in October. The decision to keep rates unchanged was predicated by the current stance of monetary policy being appropriate to support sustained expansion of economic activity, maintain strong labor market conditions, and to keep inflation near the Committee's symmetric 2 percent objective. In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. The market is currently pricing in at least 83.9% chance of a .25% rate increase at the 29 Jan 2020 Fed Meeting according to the CME FedWatch Tool.

Forecast: It will be hard to have another year like last year, but there is renewed hope of another positive year. Given the strong performance of US equities in 2019, we want to remember that historically when the S&P returned greater than 30% over a one-year period, 85% of the time the subsequent year also saw positive returns.

What risks are out there that might disrupt the recovery?

- **Global Conflicts**. Recently we have had renewed conflicts with Iran. This temporarily made oil spike and shot some uncertainty into the market. This has slowly quieted down for the time being, but if this were to reignite it could increase uncertainty and permeate into other areas of the market.

- **The Fed raising rates**. Given the continued low inflation and low unemployment, we think the risk of rate increases by the Fed is low. After a rate cut in October the Fed decided to pause in December. It is currently looking like there will be no rate increases this year. However, we are starting to see some chances of a rate increase. **Nine of the last eleven recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**

- **Global trade tensions.** We are continuing to see trade tensions which will continue to hold back business and consumer spending, leading to slower economic growth. If we continue to explore protectionist economic policy, we will have subdued growth while higher prices for goods and services are digested.

- **Election Year.** It is that time again. Election years bring policy uncertainty, which usually translates into higher market volatility. The last 23 election years since 1928 the S&P 500 was only negative 4 times. Historically if the S&P 500 rises between July 31st and October 31st in an election year, the incumbent candidate (current holder of office) wins 80% of the time. On the other hand, if stocks fall, the incumbent loses 88% of the time.

We think the biggest threat to the stock market is the uncertainty presented by slowing economic growth as well as rising corporate debt levels. This uncertainty will persist as long as we continue to explore protectionism and continue to maintain a low interest rate environment. It will also depend on the amount of economic stimulus injected globally to spur growth. After the rally last year, it will not take much negative market sentiment and fear to get the market to head to the downside. We also have the added uncertainty of a presidential election. We think the SP500 will end the 1st quarter between 3,350 and 3,400. At this juncture, we venture a guess that stocks will end up somewhere between 8%-10% for the year.

For the next six to nine months, the Federal Funds rate should remain at its current range of 1.50%-1.75% with a possible increase to between 1.75%-2.00%. **The 10-year Treasury which is currently priced at ~1.79% should remain in a range between 1.75%-1.85% through the end of the 1st quarter.** ***Any economic shock or increased uncertainty could cause the 10-year to drop down to around 1.50%. Also, any surprise in growth or reduced economic uncertainty could cause the 10-year to spike to 2.00% or above.***

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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