Making Sense of Finance

Karagosian Financial Services | 1/16/2020 | Volume 23, Issue 1

Fourth Quarter 2019 Review

STOCK MARKET

The stock market finished off the year and the decade on a high note. After an innocuous third quarter with a small gain, the S & P 500 index rose almost in a straight line in the fourth quarter with a return of 9% for the quarter (29% for the year). Other major stock indexes followed suit with increases last quarter of 12% and 6% for the Nasdaq Composite and Dow Jones Industrial Average respectively. This was in stark contrast to the previous year's stock market meltdown in the final quarter. (To illustrate how bad 2018 ended, the S & P 500 actually gained just 11% over the 15-month period beginning prior to the fourth quarter of 2018 through the end of 2019). Stock price gains for the quarter and the year were driven primarily by price/earnings (P/E) multiple expansion rather than by actual earnings growth. The S & P 500 trailing P/E at the end of the year was 22.6, higher than the historical average. Revenue growth and stock buybacks by corporations offset lower margins which has led to slight earnings per share growth this past year. Increases in stock buybacks were fueled by foreign earnings repatriation the last couple of years. Stock valuations rose as investors chose riskier assets, unable to find decent investment returns elsewhere. The Federal Reserve proved to be a driving influence in the 2019 stock market gains as they cut the Fed Fund target rate for the third time in the year last quarter. This has caused a drop in short-term rates, which typically influences the interest rates you will receive at the bank and from money markets. In addition, since US tariffs on Chinese exports that were scheduled to be in place on Dec. 15th (the Penalty Tariffs) did not occur and the previous 15% tariffs that were invoked were cut to 7.5%; this helped assuage investor anxiety that ebbed and flowed throughout the year.

One can call it the quarter and the year of technology stocks as they outpaced every other market sector by a large margin. Apple's stock was one of the best performing technology stocks as its price gained 31% in the fourth quarter and 86% for all of 2019! (In keeping with the overall market, its stock price increase was primarily driven by multiple expansion not earnings.) It is also a stock that is represented in many market weighted indexes and played a large part in their extraordinary gains in those time periods. Another sector which did better than the overall market last quarter was healthcare, although it lagged the market for all of 2019.

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Everyone and their neighbor have an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Laggards in the last quarter were real estate investment trusts and utility stocks as these sectors are considered bond proxies and as such mirrored the performance of bonds in the fourth quarter, basically flat returns. Energy stocks failed to keep up with the benchmark indexes during the fourth quarter and throughout 2019. Although oil as a commodity increased 34% last year, energy stocks could not match that gain.

During the fourth quarter, foreign stock market performances started closing the gap with the U.S. market. The MSCI EAFE Index which measures developed country markets in US dollar terms increased 8% last quarter, nearly the same as the S & P 500 index, though still behind the S & P 500 index for all of 2019. France and Germany were among the better performing markets in this group. A flattish US dollar and global accommodative monetary policies (more than 15 central banks cut interest rates in 2019) were beneficial to Emerging Market countries as their respective stock markets outperformed last quarter. The MSCI Emerging Market Index, measured in US dollar terms, increased over 11%. With all the troubles made known about the Chinese economy, the Shanghai Composite still managed to gain over 22% in 2019. Brazil had also one of the better performing stock markets last year.

BOND MARKET

Bonds were up very slightly in the fourth quarter, as measured by the Bloomberg Barclays Aggregate Bond Index. The yield curve (3 Month Treasury Bill/10 Year Treasury) ended the year no longer inverted as short-term rates declined when the Federal Reserve cut another 25 basis points on the Fed Fund target rate. Longer term rates increased and therefore long-term bond prices decreased. The 10 Year Treasury ended the year at 1.92% after starting the fourth quarter at 1.68%. In general, longer term bonds did not fare well last quarter and short-term bonds benefitted and rose due to the aforementioned Fed rate cut. High yielding (low quality) corporate bonds and emerging market debt performed the best among fixed income investments last quarter due to the increased desire for riskier assets as investors started to feel better about the global economy.

For all of 2019, bonds had a good year along with stocks which is not that common. The previously mentioned Aggregate Bond Index had a total return over 8% last year. US Treasuries still attract a lot of global investors as many interest rates in other developed markets are negative. Of note is Switzerland, the 10-year government bond is -0.56% and even if you go out to 50 years, the yield is still negative at -0.11%. In the U.S., home borrowers have benefitted from the low rates, with most mortgage rates under 4%, which historically is a very attractive rate to borrow long term. However, this does not compare to Denmark where mortgage rates are negative, meaning you pay back less than you borrow!

OUTLOOK

We remain in uncharted territory. Usually, history is our guide; however, when was the last time we saw economic growth for 11 years (the longest in US history), near zero interest rates and low inflation? In our previous newsletters, we cited the weak economies of Japan and Germany. Germany has since shown some tepid growth which may help bolster US trade and Japan continues to grow mildly. Our view is that the world is at a balancing point where a really good or really bad event could swing the pendulum either way. The U.S. remains the most stable and attractive economy for investment, in our view. One portion of the economy that we continue to have worries about is the manufacturing sector which has contracted for five straight months. Even so, the US economy has a greater emphasis on the service sector which has allowed the overall economy to sustain growth in aggregate.

As we have stated for the past decade; we manage your money based on a bottom up method, meaning based on the fundamentals of the companies we invest in, not based on macro-economic assumptions. Despite the strong stock market gains in the past year, stocks remain the most attractive long-term asset, in our opinion. Real estate and bonds remain the second and third most attractive asset classes as interest rates remain a large component of its return characteristics, and simply, there isn’t much more you can go past zero for interest rates. Even so, our low interest rates of 1.8% for the 10 Year treasury is among the highest among developed economies, making the U.S. debt attractive to others around the world. Progress with trade between the U.S. and China could help kickstart stronger exports, as well. With a Presidential election looming, we will most likely see more volatility in the markets relative to the current steady returns we have been currently experiencing.