RDM 1st Quarter Market Update

January 14, 2020

Key Takeaways

- The U.S. and China have finally agreed to a Phase One trade deal.
- Equity and fixed income markets (here at home and overseas) posted solid returns in 2019 as financial markets climbed a wall of worry.
- Recent events in Iran are a reminder of the geopolitical risks that investors will have to live with in the months ahead.
- The U.S consumer appears to be on pretty solid footing, but business and capital equipment spending have slowed down.
- After cutting rates in 2019, the Federal Reserve Bank is likely to remain on hold this year.
- We continue to believe the odds of recession remain a low probability over the next few quarters (for now).
- Overseas, equity markets have lagged considerably in recent years, but we are watching for signs that foreign markets may start to improve.
- After a strong year like 2019, it's hard to expect a repeat performance. We remain moderately constructive for 2020 but expect a bit more volatility along the way.

It has been said that markets climb a "wall of worry." Well, last year there were plenty of things to worry about ranging from a trade war with China, weak economic growth overseas, an inversion of the yield curve, a slowdown in corporate profits and questions about Brexit. At one point during the year, there was approximately $17 trillion in negative yielding global debt outstanding. Despite these concerns, we are happy to report that whether you focus on equities or fixed income, U.S. or foreign markets or the 11 sectors within the U.S. equities market, last year was a good year for most investments.

At the start of 2020, the U.S. carried out a mission that killed the top general in Iran. We don't want to dismiss recent events in Iran and the potential that things may widen into a larger military conflict. However, history shows (looking back at several decades of military and terrorist acts), that financial markets tend to shrug off geopolitical conflicts after a period of time (more on this in the market report below).

Looking back at last year, the U.S. consumer continued to help support economic growth while business spending slowed as a result of uncertainty caused by the trade war and weak economic growth overseas. Housing activity (which had previously slowed) started to improve in 2019 due to a drop in interest rates and provided a moderate tailwind for the economy.

One of the main factors that helped support financial markets last year was the big change in policy by the U.S. Central Bank. Heading into 2019, we were concerned that the Central Bank would continue to raise interest rates and threaten the economic expansion. However, in early 2019 the Federal Reserve Bank officials changed its policy stance and ended up cutting rates three times last year. This, along with a decision to purchase $60 billion per month in U.S. Treasury Bills to offset pressure on the short- term REPO markets, provided liquidity (i.e. fuel) that helped send equity markets higher in 2019.

After rising double digits in 2018, corporate profits slowed considerably and barely grew in 2019. Based on current estimates, earnings per share (EPS) for the S & P 500 are currently forecast to grow just 0.2% for all of last year. Importantly as we look ahead, the current forecast is for EPS to increase 9.4% in 2020 with 5 out of 11 S & P 500 sectors forecast to generate double digit growth. We believe these numbers are likely too optimistic and that when all is said and done, EPS will likely come in somewhat below the current consensus forecast but still improve from 2019's lackluster numbers.

Outside the U.S., economic growth was fairly weak across a number of countries last year. The global manufacturing index (source: FactSet) moved sideways in December (the latest reading available) after having improved somewhat in November. While manufacturing data in emerging markets improved further last month, this was offset by weaker data in developed foreign markets and the U.S. (where the latest monthly manufacturing report declined to the lowest reading since June, 2009).

2019 was the best year for stocks since 2013 and the 11th best year since 1928 (source: Strategas Research). Some may think that if stocks advance strongly in one year, that this may lead to weak or negative returns the following year. However, since 1950, looking at the 13 times that equities rose 30% or more in a given year (on a total return basis), the average return in the following year was nearly 15% with only two negative years which both occurred during recessions (source: LPL Financial). Election years have also historically generated solid returns although there is likely to be plenty of uncertainly between now and the upcoming election on November 7, 2020.

This year we are moderately constructive in our market outlook. A combination of low interest rates and inflation, a Phase One trade deal with China (likely to be signed this week), continued support from consumer spending along with an eventual pickup in corporate profits, business spending and global economic growth could lead to moderate equity market gains in the year ahead. Unlike last year where rising price to earnings (P/E) ratios did the heavy lifting, we will need to see a rebound in corporate profits to help generate additional stock market gains in 2020.

One thing that has distinguished the current decade long economic expansion is that the economy has generated a lower growth rate versus prior economic cycles. Compared with a GDP growth rate of 3.4% from 1960 – 2000, GDP growth has registered about half that throughout the current 10 year plus economic expansion (source: CSFB U.S. Equity Strategy, January 2, 2020). One benefit of this slower growth rate is that the economy has not built up the kind of imbalances that typically derail economic expansions. Looking ahead, the consensus forecast is for GDP growth of 1.8% in 2020 followed by 1.9% in 2021 (compared with estimated growth of 2.3% in 2019) – source: FactSet.

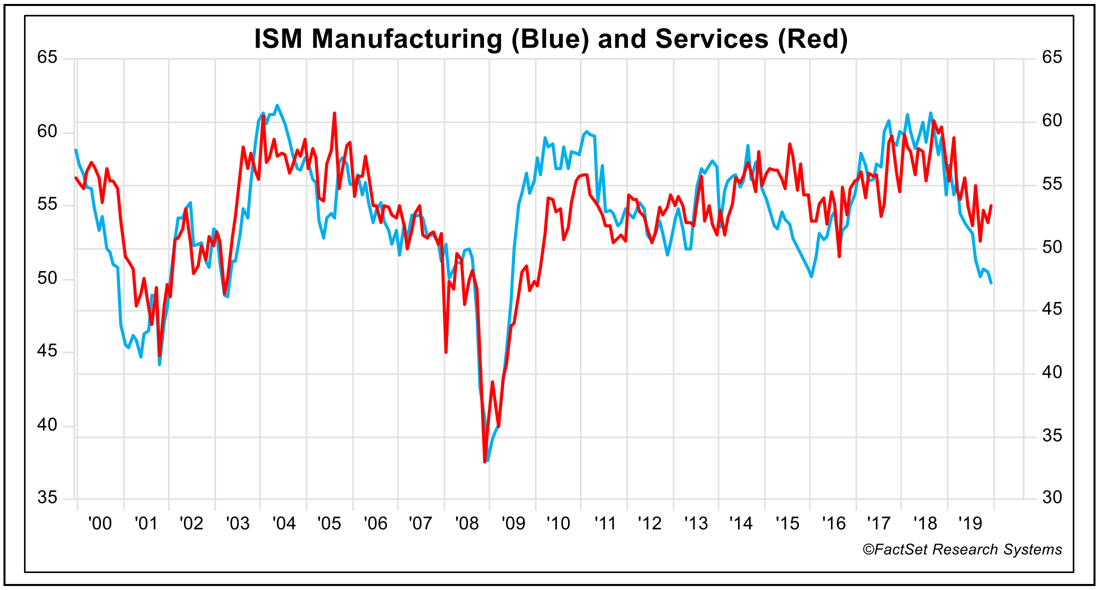
Despite our moderately constructive outlook this year, we want to point out that on average, equity markets have experienced 3 pullbacks of 5-10% per year and one correction of 10-20% per year (source: American Funds). It has always been challenging to accurately time the market (note: you have to pick the right time to get out and the right time to get back in) so this is something we have historically avoided.

In terms of the various headwinds that we see, debt levels here in the U.S. and overseas continue to rise, recent events in Iran are a reminder that geopolitical risks are a constant concern for financial markets, we need to see a rebound in corporate profits and business spending some time this year and it will be important for the U.S. and China to work together to help promote a pickup in the global economy. Lastly, the Federal Reserve Bank and Central Banks around the world have provided a significant amount of liquidity for financial markets. Should that start to reverse itself, that could lead to a pickup in volatility down the road.

The U.S. Economy

For most of the current expansion, the strongest and most consistent part of the U.S. economy has been the U.S. consumer. For reference, U.S. consumer spending represents about two thirds of the overall economy. Based on a number of different metrics including monthly payroll data, weekly jobless claims, wage growth, household balance sheets, savings rates and consumer confidence levels, we believe that the outlook for the U.S. consumer remains relatively positive heading into 2020.

The latest employment report came out on January 10, 2020 and showed that the economy created



145,000 jobs last month (versus estimates of 160,000), the un-employment rate remained at a 50 year low of 3.5% and average hourly earnings (i.e. wages) rose 2.9% year over year (down from 3.1% the previous month and the lowest rate since July, 2018). Job growth was led by an increase in the retail, leisure, hospitality and healthcare sectors while manufacturing jobs fell 12,000. Overall, job growth rose for the 10th straight year and the unemployment rate continued to fall in 2019 (down 0.4% for the full year). Both job and wage growth appear to have slowed somewhat at the end of last year (which could be a reflection of the trade conflict with China) but overall, the trend in employment remains mostly supportive for growth in early 2020.

Reflecting a healthy consumer, the monthly ISM Services Index was released last week and rose modestly to a level of 55. As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. This month's reading compares with a three-month average of 54.5 and a cycle high of 60.8 last August.

Unlike the ISM Services Index, the latest ISM Manufacturing report declined 0.9 points to a reading of 47.2 and manufacturing activity remained below 50 (indicating a slowdown) for the fifth straight month (see chart above – source: FactSet). Weakness in manufacturing was broad based in the latest report as new orders fell to 46.8 versus 47.2 the prior month, production fell to 43.2 versus 49.1 the prior month and employment fell to 45.1 versus 46.6 the prior month. The index peaked at 60.8 back last August but has fallen sharply as a result of the trade war with China, weak economic growth overseas and a pullback in U.S. CEO confidence levels. Now that a Phase One trade deal between the U.S. and China has been agreed to (note: it is expected to be signed this week in Washington), this may help lift business sentiment and provide a boost for the manufacturing sector and global economy as we head through 2020.

Geopolitics

The recent killing of a top military leader in Iran is a stark reminder that geopolitical risks are something investors will have to learn to live with in the months ahead. Equity and fixed income markets have been roiled by a number of military and terrorist attacks over the past several decades. At least historically (based on a list of 20 such incidences dating back to Pearl Harbor – Source: S & P / CFRA) the S & P 500 fell an average of 1.2% on the day of the first attack, declined an average of 5% from peak to trough and bottomed an average of 22 days later. Markets then regained all of their losses an average 47 days later. It is difficult to forecast how events may unfold this time around and we will continue keep an eye on upcoming developments.

Selected Military & Terrorist Market Shocks Since WWII

Market Shock Events	Event Date	% Change One Day	% Change Total	Calendar Days to Bottom	Calendar Days to Recovery
Saudi Aramco Drone Strike	9/14/19	(0.3)	(4.0)	19	41
North Korea Missile Crisis	07/28/17	(0.1)	(1.5)	14	36
Bombing of Syria	04/07/17	(0.1)	(1.2)	7	18
Boston Marathon Bombing	04/15/13	(2.3)	(3.0)	4	15
London Subway Bombing	07/05/05	0.9	0.0	1	4
Madrid Bombing	03/11/04	(1.5)	(2.9)	14	20
U.S. Terrorist Attacks	09/11/01	(4.9)	(11.6)	11	31
Iraq's Invasion of Kuwait	08/02/90	(1.1)	(16.9)	71	189
Reagan Shooting	03/30/81	(0.3)	(0.3)	1	2
Yom Kippur War	10/06/73	0.3	(0.6)	5	6
Munich Olympics	09/05/72	(0.3)	(4.3)	42	57
Tet Offensive	01/30/68	(0.5)	(6.0)	36	65
Six-Day War	06/05/67	(1.5)	(1.5)	1	2
Gulf of Tonkin Incident	08/02/64	(0.2)	(2.2)	25	41
Kennedy Assassination	11/22/63	(2.8)	(2.8)	1	1
Cuban Missile Crisis	10/16/62	(0.3)	(6.6)	8	18
Suez Crisis	10/29/56	0.3	(1.5)	3	4
Hungarian Uprising	10/23/56	(0.2)	(0.8)	3	4
N. Korean Invades S. Korea	06/25/50	(5.4)	(12.9)	23	82
Pearl Harbor Attack	12/07/41	(3.8)	(19.8)	143	307
Averages	**20**	**(1.2)**	**(5.0)**	**22**	**47**

Source: CFRA, S&P DJ Indices. Past performance is no guarantee of future results.

Leading Indicators

Each month we monitor a number of different economic indicators to try and determine the strength and outlook for the economy and financial markets. Here is a short list of some of the indicators we track each month:

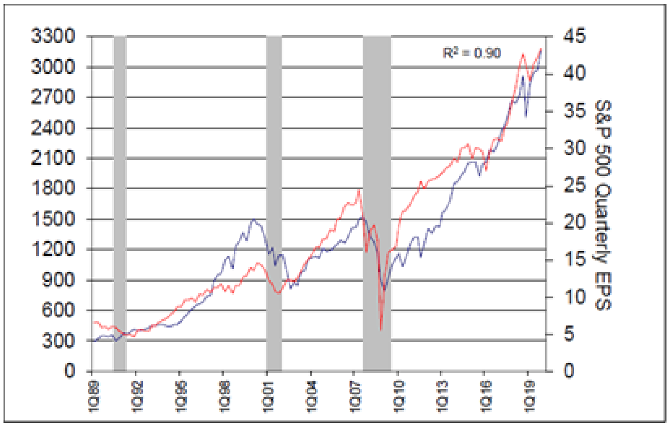
- The Conference Board's Leading Economic Index (LEI) - trending sideways near cycle highs but positive momentum has slowed
- Weekly Jobless Claims - currently not too far from multi-decade lows
- Manufacturing New Orders - has been quite weak in recent months
- Consumer Confidence – remains close to cycle highs
- Credit Spreads – near multi-decade lows
- Housing Starts - have been improving the past few months
- Corporate profits – weak in 2019 but forecast to start rising again in 2020
- The Fed's Quarterly Senior Loan Survey - remains healthy
- Real rates – historically low indicating monetary policy is accommodative

Looking at the list above, a majority of indicators continue to remain positive although there are a few reports that bear watching.

Corporate Profits

We believe it's important to monitor the direction of corporate profits because stock prices tend to follow the direction of corporate profits over time (see chart below which tracks the S & P 500 versus quarterly EPS for the S & P 500 – source: Citi Research: Monday Morning Musings Jan 3, 2020). After a strong year in 2018 where we saw 23% growth (source: FactSet) in earnings per share

(EPS), profits slowed significantly in 2019. As of 1/10/20, the S & P 500 is currently forecast to post EPS growth of minus 2.5% for the fourth quarter of last year (which would be the fourth straight quarter of negative year over year EPS growth).



On a more positive note, the current forecast for 2020 is for 9.4% full year EPS growth with 5 out of 11 sectors in the S & P 500 forecast to generate double digit growth. We believe this is encouraging and could provide a tailwind for equity markets in 2020. However, due to below trend economic growth heading into this year, when all is said and done, we would not be surprised if EPS in 2020 comes in somewhat below current estimates.

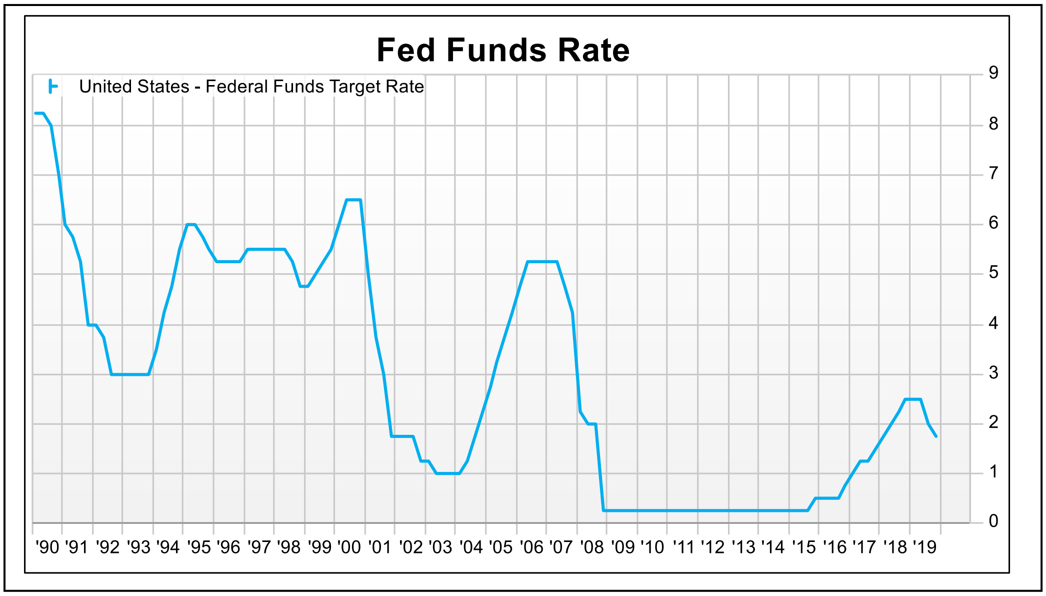
The Fed and Interest Rates

Heading into 2019, the Federal Reserve Bank continued to raise rates and it looked like the Central Bank might drive the U.S. economy into recession. Following a sell-off in equity markets during the fourth quarter of 2018, the Central Bank changed course abruptly and reduced rates by a quarter point at three straight meetings in 2019 (see chart below – source: FactSet). Monetary policy is currently accommodative with short term rates below the rate of core CPI inflation. With economic growth weak, inflation low and benefits from the Phase One trade deal with China still uncertain, the Central Bank is likely to keep short-term rates on hold throughout 2020.

Looking back at past interest rates cycles, there are two possible outcomes from here. Historically, when the Central Bank has cut rates a limited amount of times such as during the mid-1980's or mid 1990's (often referred to as a mid-cycle adjustment) investors respond favorably as the economy starts to recover before too long, corporate profits start to rebound and stock prices once again move higher. On the other hand, if the Central Bank were to cut rates several more times (after having already cut rates by a few times to help stabilize economic growth), financial markets have historically not responded well because additional rate cuts signal a weaker economy. For now, we are in the mid-cycle slowdown camp, but acknowledge that this could change based on developments as we head through the next few quarters.

Overseas

Looking around the world, economic growth has been much weaker outside the United States in recent years. Since the start of the current expansion, there have been multiple times when investors worried about growth outside the United States. For example in 2011 – 2012 investors feared that the European Union might not survive and that Greece might get kicked out of the EU. In 2016, Brexit concerns arose (and are still unresolved) and several times over the past few



years, investors worried about weak growth and high debt levels in China and Japan. The trade war with China did not help matters and actually made things worse.

According to recent data from the Federal Reserve, uncertainty from the trade war with China subtracted around 1% from global GDP between mid-2018 and mid-2019 and caused corporate executives to postpone capital plans. This helps explain why global growth in many countries around the world has been so weak over the past 6-12 months. We have started to see a few "green shoots" in various countries around the world (mainly in emerging markets so far) but these signs are somewhat tentative so far. We are hopeful that the recent de-escalation in trade talks between the U.S. and China and the signing of a Phase One trade deal may set the stage for an eventual pickup in global growth in the quarters ahead. Corporate profits for the MSCI Emerging Markets Index and MSCI Europe Index are currently forecast to increase 15% and 9% respectively in 2020 (source: Morgan Stanley – 2020 Outlook).

Looking ahead, we will continue to keep an eye overseas for signs that economic growth and equity markets may be on the mend after years of underperformance.

Summary

2019 was a good year for both equities and fixed income as financial markets climbed a wall of worry. While the S & P 500 was up more than 30% on a total return basis in 2019 (somewhat less for foreign markets and small capitalization stocks), it's important to point out that at RDM Financial, our goal is not to beat a specific index. Instead, it is to achieve a certain rate of return to help each RDM client meet his or her long-term investment goals. We will always be somewhat diversified because that helps smooth out the inevitable ups and downs in various markets that we invest in over time.

Looking ahead to 2020, we are moderately constructive in our outlook. Based on a Phase One trade deal between the US. and China, rate cuts by multiple Central Banks around the world and a gradual pick up in corporate profits and business spending, we believe that some additional stock market gains appear likely in the year ahead. However, unlike last year when market gains were largely driven by P/E expansion and liquidity (due to three rate cuts by the U.S. Federal Reserve Bank), market gains this year will need to come from a rebound in corporate profits.

We remain overweight the U.S. versus foreign markets (although we are taking a closer look at equities 0verseas), we remain over weight large versus small capitalization stocks (due to the length of the current expansion) and we are moving closer to the middle in terms of growth versus value (except in the RDM Income Model which is more dividend and yield oriented). In a low inflation world with continued uncertainty, we believe the Federal Reserve Bank is likely to remain on hold for the year.

A de-escalation in the trade war with China is definitely a positive and could help reignite global growth over the next several quarters. In terms of risks, many of the risks we spoke about in 2019 remain on our radar. They include rising debt levels (both at home and abroad), weak economic growth overseas, the fact that valuation levels are not cheap and that there are a number of geopolitical hot spots around the globe. Recent events in Iran are a reminder that the world can be a dangerous and volatile place.

Looking further down the road, if the Federal Reserve Bank were to start raising rates again at some point (too aggressively), that could lead to a rise in market volatility and have a negative impact on economic growth and corporate profits. Lastly, corporate profits slowed significantly in 2019 (following double digit growth in 2018). While the current forecast is for a rebound to 9.4% EPS growth in 2020, if profit growth fails to meet estimates, that could lead to some disappointment as we head through the year.

As always, we welcome any comments you may have.

Respectfully,

Michael Sheldon

Michael Sheldon, FRM, CFA®

Executive Director & CIO

Disclaimer:

S&P 500 Index: A popular benchmark for US large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

MSCI Emerging Market Index: The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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