PRIVATE WEALTH SERVICES GROUP

Our Thinking

Quarterly | Q4 2019

Overview

At the start of 2019, our positive outlook on the economy and capital markets was anchored on resolutions of some of the stresses that prevailed in 2018, including: Federal Reserve (Fed) policy, recession fears, and the U.S.-China trade war. Throughout the year, these three themes drove markets to record highs, but with intermittent volatility.

In an effort to prolong the economic expansion, the Fed effectively shifted its hawkish stance, and for months, telegraphed its first rate cut since the 2008-09 financial crisis. While at the start of the year, many expected the Fed to hike rates three times, ultimately it cut rates three times in 2019.

While some sectors of the U.S. economy weakened, manufacturing in particular, the overall U.S. economy showed resilience. The unemployment rate remains at historic lows, but more generally, employment growth has slowed, consistent with a tight labor market. This, in turn, has led to continued wage gains and robust consumer spending. For example, as of December, wages were up 2.9%, and consumer spending is estimated to have increased 2.6% year over year.

With 2019 defined by the resolution of some key geopolitical risks and supportive monetary policy surprises, we see a shift in 2020 to fundamentally driven growth and the possibility of further fiscal policy support. One significant geopolitical risk – the uncertainty of the 2020 presidential election – which will drive volatility and direction. The consensus is currently forecasting 1.8% GDP growth for 2020, and our view of the economy is also constructive. Our base case (*2020 Outlook: A Decade of Productive Competition*) reflects a modestly positive outlook for next year. We believe that economic growth may slow further but continue, allowing room for earnings growth. Central banks will remain data dependent, but their toolkit is more limited. We, in turn, expect some fiscal impulse to provide an incremental boost to the global economy.

Our portfolio recommendations continue to be anchored in our long-term outlook, with a focus on diversification both across and within asset classes. We will remain on our core tenants of investing for and with our clients: invest when the market presents opportunities to do so; lean in to higher rates when the goal is cash flow; and be mindful of value through the process.

Within equity, we're defensively positioned with a continued lean to high quality, dividend paying, large cap stocks. For clients investing outside of the U.S., we lean toward non-U.S. developed markets with an overweight to Europe. In fixed income, we continue to invest in A- or AA-rated municipal bonds, and prefer to hold to maturity. We currently invest in short to intermediate maturities, buying longer bonds only when we find the yield compelling.

The U.S. Economy

The U.S. economy is estimated to have grown 2.3% in 2019, above the Fed's longer-term estimate of 1.8%-2.0%, but slower than the 2.9% growth in 2018. The economy grew at an annualized 2.1% in the third quarter following a 2.0% expansion in the second quarter. The rise in GDP reflected positive contributions from consumer spending, federal, state, and local government spending, residential investment, and exports.

Our view is that GDP will grow 2.0%-2.25% in 2020, led by consumer spending, housing, and capital expenditure. As of January 3, the Atlanta Fed's GDPNow estimate for the fourth quarter of 2019 stood at 2.3%.

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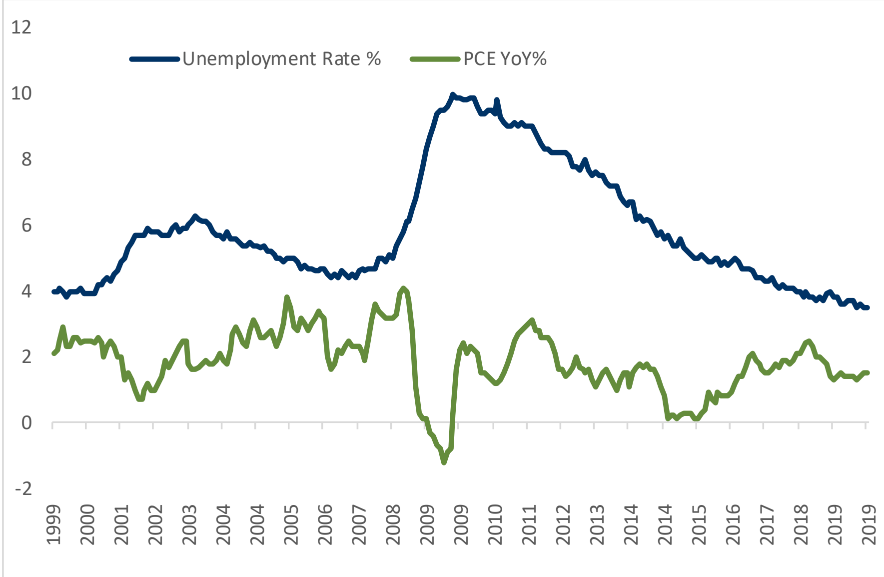
Inflation:

The core personal consumption expenditures (PCE) price index, which excludes food and energy, is one of the Fed's preferred measures of inflation. Inflation rose during the quarter, but still remains below the Fed's long-term target of 2%. In November, core PCE rose 0.2% from October and 1.5% from last year. The Fed's forecast for core PCE is 1.6% for 2019 and 1.9% in 2020. Inflation may drift higher due to the three rate cuts in 2019 and late-cycle pressures, but we believe it will remain close to the Fed's target and likely keep the Fed on hold.

Figure 1. Unemployment and Inflation



Source: Stifel Investment Strategy as of January 14, 2010

Employment:

The unemployment rate remained at 3.5% in December, and the participation rate stayed at 63.2%. Nonfarm payrolls rose 145,000 in December, contributing to a three-month average of 184,000. In 2019, nonfarm payrolls totaled 2.11 million, down from 2.68 million in 2018. More generally, there has been a slowdown in employment growth, consistent with a tight labor market. This has not led to wage gains. In December, the average hourly earnings increased 2.9% year over year compared to year-over-year increases of 3.1% in November.

Consumer:

Consumer spending, which accounts for more than two-thirds of U.S. economic activity, remains robust. After rising just 0.2% in September, spending increased 0.3% in October and 0.4% in November. Within goods and services, spending on new automobiles and healthcare were the leading contributors for November's increase. Personal income surprised to the upside in November, along with a 0.1% upward revision to the October number. Personal income rose 0.5%, and the personal savings rate, savings as a percentage of disposable income, was 7.9%. The consumer's strength is one reason we continue to have a modestly positive outlook on the economy.

Consumer confidence remains relatively strong, but the Conference Board Consumer Confidence Index decreased slightly in December, following a slight increase in November. The index now stands at 126.5 versus 126.6 at the end of 2018. The Present Situation Index, based on the assessment of current business and labor market conditions, rose to 170.0 from 166.6. The Expectations Index, based on consumers' short-term outlook for income, business, and labor conditions, fell to 97.4 in December from 100.3 in the previous month. The measures remain within their range over the past 12 months, suggesting that consumers should continue to support the current economic expansion.

Manufacturing and Services Sectors:

As mentioned, the manufacturing sector weakened both in the U.S. and globally in 2019. A reading below 50 indicates contraction. The ISM Purchasing Managers' Manufacturing Index December reading was 47.2%, the lowest level since June 2009, and below the 48.1% reading in November. The index has now been below 50 for the past five months. As a reference, the index was at 54.3 at the end of 2018. The contraction is, in part, attributable to the trade uncertainty that increased throughout the year, and the softening economic growth outside the U.S. Manufacturing represents about 12% of the U.S. economy, so we believe these mixed results alone are not yet something to worry about. The Non-Manufacturing Index stands at 55.0 as of December and grew for the 119th consecutive month. As a reference, this index was at 58.0 at the end of 2018.

Housing:

New single-family home sales, considered a leading indicator of the housing market, were at a seasonally adjusted annual rate of 719,000 in November, a 1.3% increase from October and a 16.9% increase from the prior year. October new home sales were also revised downward to 710,000 from 733,000. The median sales price of new houses sold in November was $330,800.

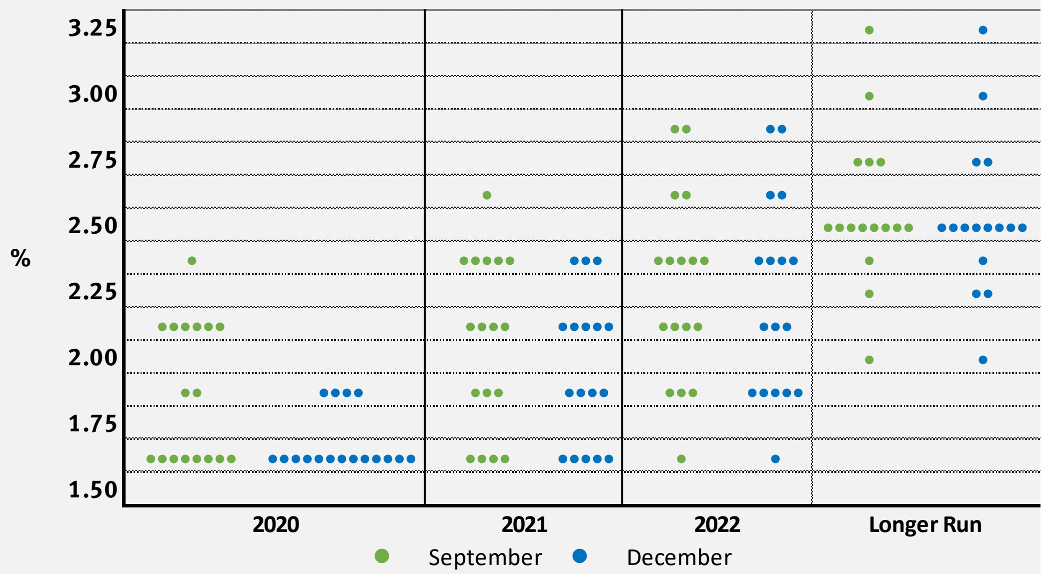
Existing-home sales fell 1.7% in November from October, reflecting an inventory shortage. Overall sales were up 2.7% year over year according to the National Association of Realtors. The median existing-home price, $271,300, increased for the 93rd consecutive month, up 5.4% year over year in November.

November permits rose 1.4% to 1,482,000 from October and rose 11.1% from last November. October was revised upward to 1,461,000. Permits usually foreshadow future starts. Strong builders' confidence, low mortgage rates, and high levels of employment have led to an increase in mortgage applications and refinances, helping the housing sector break out of its slump.

The Federal Reserve and Interest Rates

The Federal Open Market Committee (FOMC) met twice during the quarter (October and December), electing to only lower the federal funds rate by 0.25% to a range of 1.50%-1.75% in October and leaving rates unchanged in December. In the October press conference, Fed Chair Jerome Powell said he views the current stance of monetary policy as "likely to remain appropriate" and that a "material reassessment of our outlook" would be needed to change monetary policy. He reiterated that Treasury bill purchases were technical and not a change in policy.

Figure 2. Fed Dot Plot



Increments on y-axis are 0.125%.

Source: Stifel Investment Strategy as of December 11, 2019.

The December FOMC statement was little changed from the November statement. It did, however, acknowledge weak exports and business fixed investment. The Fed also published its Summary of Economic Projections. The Fed kept its real GDP growth forecast for 2019 and 2020 at 2.2% and 2%, respectively. It adjusted its 2020 unemployment forecast from 3.7% to 3.5%. Our takeaway: the Fed is not forecasting a recession during the forecast range of 2019-2022.

The dot plot, which represents each Fed official's best judgement of the appropriate target range for the federal funds rate at the end of the calendar year, shows a fairly united committee in the short term. Just four of the 17 members see the fed funds rate rising by 25 basis points in 2020. The median outlook is for rates to remain at their current level and rise in both 2021 and 2022. An important point: no Fed official has projected a fed funds rate that is lower than the current level through 2022. The information in the dot plot, taken together, is consistent with a positive outlook for economic growth.

The spread between the 2-year and 10-year Treasuries narrowed over the past year and turned briefly negative in August for the first time since the financial crisis before widening. An inversion in the spread between the 2-year and 10-year Treasuries has historically been a good indicator of recessions and market downturns. Shorter maturity yields moved lower as a result of the rate cut in October, but longer rates also rose as trade tensions and investor concerns about the global growth outlook eased. The 10-year Treasury yield fell to as low as 1.47%, and the 30-year hit a record low before rallying in September on account of reduced uncertainty. By year end, the U.S. and China moved to de-escalate trade tensions by agreeing, in principle, to a Phase One deal, and the UK passed the Brexit bill through parliament. All of this led to a rise in yields.

Equity Earnings

For the third quarter of 2019, 76% of S&P 500 companies reported earnings that were better than consensus, or a positive earnings surprise. On the surface, this is a powerful outcome, but the result remains in line with average results over the last year (74%) and last five years (72%). We see a similar result for revenue, with 60% of the companies reporting a positive revenue surprise, also in line with the one-year result (59%) and five-year result (59%).

For the third quarter of 2019, the blended earnings decline for the S&P 500 was -2.1%, its third consecutive quarterly decline. The last time the index reported three straight quarters of year-over-year earnings declines was fourth quarter 2015 through second quarter 2016. The forecast for the fourth quarter is another decline of -1.5%. Companies with the majority (>50%) of revenues coming from inside the U.S. have performed better: year-over-year quarterly growth in earnings was positive 0.6%, and year-over-year quarterly growth in revenue was 5.1%.

For those companies with the majority (>50%) of revenues coming from outside the U.S., the year-over-year quarterly growth in earnings was -7.3%, and the year-over-year quarterly growth in revenue was -2.1%. So non-U.S. exposure matters.

With three quarters of results in, the consensus is for earnings to be flat for all of 2019, growing at only 0.2%. In many ways, we can interpret 2019 to be about absorbing the strong growth of 2018. On a combined basis, the average for 2018 and 2019 is 10%. And looking forward to 2020, the consensus earnings growth estimate is 9.8%, which would be in line with the two-year average.

Investment Themes

Asset Class		View	Comments
EQUITY	**U.S. Large Cap**	■	Global economic growth stabilization is likely to provide a boost to large cap company earnings. A tight labor market and rising cost pressures may challenge profit margins. Even though valuations have risen, they are not at excessive levels. Note, our neutral is within U.S. equity and relative to U.S. small cap.
	Large Value vs. Large Growth	▲ ▼	We have a preference for value over growth due to value's more defensive nature during the late stages of the business cycle.
	U.S. Small Cap	■	U.S. economic growth may slow further, but it's likely to continue. This is supportive of small cap company earnings. However, a tight labor market and rising wage pressures may especially challenge company profit margins. Note, our neutral is within U.S. equity and relative to U.S. large cap.
	Small Value vs. Small Growth	■	We recommend a diversified approach investing in both small cap value and growth.
	Non-U.S. Developed Markets	■	Developed economies are expected to continue their economic growth. We continue to recommend non-U.S. exposure as part of strategic asset allocation to provide added diversification to an investor's portfolio.
	Europe vs. Asia	▲ ▲	Europe's economic growth has decelerated, but we think the region has the tools to stimulate growth. The European Central Bank remains accommodative and countries with a budget surplus could provide a fiscal boost. Political concerns related to Brexit and tariffs have receded. The Bank of Japan is also accommodative, valuations remain attractive.
	Emerging Markets	▼	We are very measured investing in emerging markets, which alone can be quite volatile.
FIXED INCOME	**Duration**	▼	We expect rates will continue to rise, albeit at a slower pace. We recommend maintaining a shorter duration than the benchmark.
	U.S. Investment Grade	■	We have a preference for shorter duration. Note, our neutral is within fixed income and relative to U.S. high yield.
	Corporates Gov't/Agency MBS	■	We favor a diversified, market type approach that balances the allocation to corporates, government/agency, and mortgage-backed securities (MBS).
	Inflation Protected	▲	Inflation is modest and around the Fed's 2% target. Other inflation measures, such as trimmed inflation, show inflation is picking up. Short-dated TIPs offer protection if inflation accelerates.
	U.S. Municipals	▲	Municipal bonds are our core exposure in fixed income. We typically invest in A- or AA-rated bonds, and prefer to hold to maturity. We currently invest in short to intermediate maturities, buying longer bonds only when we find the yield compelling.
	U.S. High Yield	■	Economic data remains positive. Default rates are low, and after modestly rising recently, they have stabilized. We believe spreads will be stable. Consider higher credit quality.
ALTERNATIVES	**Private Assets**	■	For investors interested in Alternative Investments and able to handle illiquidity, exposure to some combination of private equity, private debt, and/or private real estate can be considered as part of a diversified portfolio.
	Hedge Funds	■	For investors interested in Alternative Investments and able to handle less liquidity who have conviction about manager skill, exposure to hedge funds can be a helpful part of a diversified portfolio. This is especially true in volatile, low return environments.

▲ overweight ▼ underweight ■ neutral

Capital Markets Recap

The fourth quarter of 2019 was in stark contrast with 2018. Equity markets rose during the quarter, some setting new all-time highs, bonds were flat, and commodities rose.

Equity

A solid expected earnings season, accommodative policy from major global central banks, including the Fed, and a Phase One deal between the U.S. and China led to positive returns for U.S. equity markets.

U.S. equity markets traded higher as some of the economic data pointed to a bottoming in the manufacturing sector and political risks receded. The S&P 500 had 20 all-time highs during the quarter and was up 9.1%. The Russell 1000 Index was up 9.0%. For the quarter, large cap growth stocks outperformed value stocks, up 10.6% versus 7.4%. Cyclical stocks staged a strong rally during the quarter as investors grew optimistic on a global growth rebound. Information technology stocks performed best, up 14.0%, while real estate and utilities stocks performed worst, down -1.4% and 0.0%, respectively. For the year, information technology stocks were up 48.0%. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps, up 9.9% in the fourth quarter.

Non-U.S. markets also had positive returns, but generally weaker than those of U.S. equities. Political risks receded as the U.S. decided not to impose tariffs on European Union autos, and Brexit was headed for resolution. For the quarter, the MSCI EAFE Index, representing non-U.S. developed markets, was up 8.2%. Economic data in the Eurozone remains mixed with the manufacturing PMI below 50, indicating contraction in that sector.

Emerging markets, as measured by the MSCI EM index, were up 11.8%. A weaker U.S. dollar and the Fed's forecast for no interest rate hikes in 2020 provided a boost for emerging market indices.

Fixed Income

As mentioned above, the 10-year Treasury yield declined this year and fell below the 2-year Treasury yield briefly on August 14. As a reference, the 10-year was at 1.68% on September 30 and ended the year at 1.92%. The spread between the 2-year and 10-year Treasuries was 34 basis points at the end of the year versus 16 basis points at the start of the year.

The Bloomberg Barclays U.S. Aggregate Index, representing investment-grade taxable bonds, returned 0.2% for the quarter and 8.7% for the year. The Bloomberg Barclays U.S. Municipal Index, representing investment-grade municipal bonds, returned 0.7% in the quarter and 7.5% for the year. High-yield bonds, as measured by the Bloomberg Barclays Corporate High Yield Index, were up 14.3% in 2019, correlated with the positive equity performance.

Commodities

West Texas Intermediate continued its ascent, rising 10.68% to $61.06/barrel in December. The benchmark started the year at $45.41/barrel. Oil prices were supported by resolution to U.S.-China trade uncertainty, rising tensions in the Middle East, and ongoing supply cuts by OPEC and other major producers. The U.S. dollar (USD) fell in December against a basket of currencies, closing the month at 96.39 versus 98.27 the prior month. As a reference, the USD began the year at 96.17. Gold prices rose to 1,517.27/oz., up 18.3% for the year.

Market Returns					
Equity	**MTD**	**QTD**	**1 Year**	**3 Years**	**5 Years**
S&P 500	3.0%	9.1%	31.5%	15.3%	11.7%
Russell 1000	2.9%	9.0%	31.4%	15.1%	11.5%
Russell 2000	2.9%	9.9%	25.5%	8.6%	8.2%
Russell 3000	2.9%	9.1%	31.0%	14.6%	11.2%
MSCI All Country ex U.S.	3.5%	9.0%	26.4%	12.4%	8.5%
MSCI EAFE	3.3%	8.2%	22.0%	9.6%	5.7%
Fixed Income					
Bloomberg Barclays U.S. Aggregate	-0.1%	0.2%	8.7%	4.0%	3.1%
Bloomberg Barclays U.S. Municipal Bond	0.3%	0.7%	7.5%	4.7%	3.5%
Bloomberg Barclays Corporate High Yield	2.0%	2.6%	14.3%	6.4%	6.1%
Other					
S&P Goldman Sachs Commodity	7.0%	8.3%	17.6%	2.4%	-4.3%
Wilshire U.S. Real Estate Securities Index	-0.6%	-1.1%	25.8%	7.9%	7.2%

Source: Stifel Investment Strategy via Bloomberg as of December 31, 2019.

All periods greater than one year are annualized. Past performance is not a guarantee of future returns.

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One of the founding partners of the Private Wealth Services Group, Michael O'Keeffe, provides investment management and strategy to the team as Stifel's Chief Investment Officer.

Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. Indices are unmanaged, do not reflect fees or expenses, and are not available for direct investment. Past performance is no guarantee of future results.

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Asset Class Risk

Bonds – Bonds are subject to market, interest rate, and credit risk. Prices on bonds and other interest rate-sensitive securities will decline as interest rates rise. Municipal bonds may be subject to state and alternative minimum taxes, and capital gains taxes may apply. High yield bonds have greater credit risk than higher quality bonds. Yields and market values will fluctuate, and if sold prior to maturity, bonds may be worth more or less than the original investment.

Equities – Portfolios that emphasize stocks may involve price fluctuations as stock market conditions change. Small and mid capitalization stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.

International/Global/Emerging Markets – There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries.

Alternative Investments – Alternative investments involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing tax information, are not subject to the same regulatory requirements as more traditional investments, and often charge high fees, which may erode performance. An investment is appropriate only for investors who have the capacity to absorb a loss of some or all of their investment. Alternative investments may include, but are not limited to: Real Estate Investment Trusts (REITs), Commodities, Futures, and Hedge Funds. Real Estate – When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance. Commodities and Futures – The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains. Hedge Funds – Investors should be aware that hedge funds often engage in leverage, short-selling, arbitrage, hedging, derivatives, and other speculative investment practices that may increase investment loss. Hedge funds can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and often charge high fees that can erode performance. Additionally, they may involve complex tax structures and delays in distributing tax information. While hedge funds may appear similar to mutual funds, they are not necessarily subject to the same regulatory requirements as mutual funds.

Index Descriptions

The Standard & Poor’s 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $11 billion, and the median market capitalization is approximately $3.5 billion.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $490 million, and the median market capitalization is approximately $395 million.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The average market capitalization is approximately $4 billion, and the median market capitalization is approximately $700 million.

The MSCI World ex USA All Cap Index captures large, mid, small, and micro cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States). With 8,138 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

The MSCI EM (Emerging Markets) Europe, Middle East and Africa Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East, and Africa.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related, and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and nonagency). Provided the necessary inclusion rules are met, U.S. Aggregate-eligible securities also contribute to the multicurrency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt.

The Bloomberg Barclays U.S. Municipal Index covers the U.S. dollar-denominated, long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The Bloomberg Barclays U.S. Credit Index measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals, and local authorities.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Wilshire U.S. REIT Index is a float-adjusted market capitalization-weighted index that measures U.S. publicly traded real estate investment trusts (REITs), excluding mortgage REITs, net-lease REITS, real estate finance companies, home builders, large landowners and sub-dividers, hybrid REITS, and companies that have more than 25% of their assets in direct mortgage investments.

The Wilshire ex U.S. Real Estate Investment Trust IndexSM (Wilshire ex U.S. REIT) measures global publicly traded real estate investment trusts, less all U.S. securities. The Wilshire ex U.S. REIT is a subset of the Wilshire ex U.S. Real Estate Securities IndexSM (Wilshire ex U.S. RESI).

The S&P GSCI Crude Oil Index is a sub-index of the S&P GSCI Commodity Index. The production-weighted index reflects the returns that are potentially available through an unleveraged investment in the West Texas Intermediate (WTI) crude oil futures contract.

Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

This is the opinion of Private Wealth Services Group and not necessarily of Stifel.