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Driven up the Wall

Todd Asset Management US Market Commentary and Outlook

	4Q 2019	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	9.1%	31.5%	15.3%	11.7%	14.7%	13.6%
Russell 1000 Value	7.4%	26.5%	9.7%	8.3%	12.2%	11.8%

* *Annualized Total Returns.*

Investors worried about so many things last year. All the anxieties were legitimate, and concerning. Most strategists looked at the concerns and immediately concluded the equity market was going nowhere. As concerns were alleviated, the market caught fire and produced the best returns in years. The markets drove bears up the wall (of worry) as it climbed last year. We believe the pundits are still looking in disbelief at the market returns, and stand by our call that most worries are likely to be addressed and worldwide economic growth is likely to accelerate this year. Markets may be a little ahead of themselves early in 2020, so we expect a period of consolidation followed by a resumption in the equity market advance.

As always, there are a number of summary points to remember when reviewing 2019 and looking forward to 2020, including:

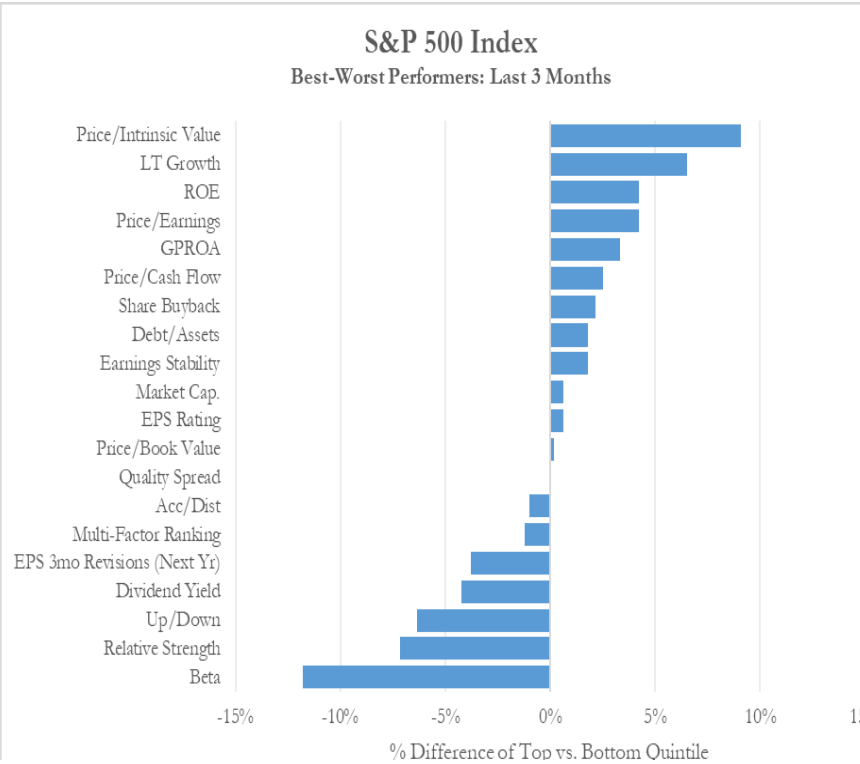
- We think the outlook for investing and the economy are good. The last six times the S&P gained more than 30%, the following year was always positive and gains averaged 19%. Additionally, real GDP accelerated each time over the following year.
- The US consumer remains strong, while manufacturing has been a soft point. Last year's manufacturing slowdown was caused by central bank tightening in 2018 and trade war concerns. Central banks are now easing, and trade war concerns are easing as well.
- The worldwide economy has gone through three mini recessions since the Great Financial Crisis, in 2012, 2016 and 2019. In each instance manufacturing weakened, concerns about a new recession grew and rates declined to 1.5% on the US 10 year. We believe the market is recovering from the third slowdown. In the prior recoveries, the 10 year yield climbed above 3% over the following years, markets did well and oil rose.
- The US President is working to give the economy a boost during an election year by reducing economic tensions. We expect continued easing of tensions globally this year. Deals have already been reached with Mexico, Canada, China, Korea and Japan, reinforcing this notion.
- As trade strains ease and investors adjust to lower Fed rates and a larger US Budget deficit we would expect the dollar to weaken after the safety trade driven strength since the beginning of 2018. This should help US exporters, allow international stocks to outperform US stocks and prompt a rotation to cheaper stocks to occur as confidence grows.

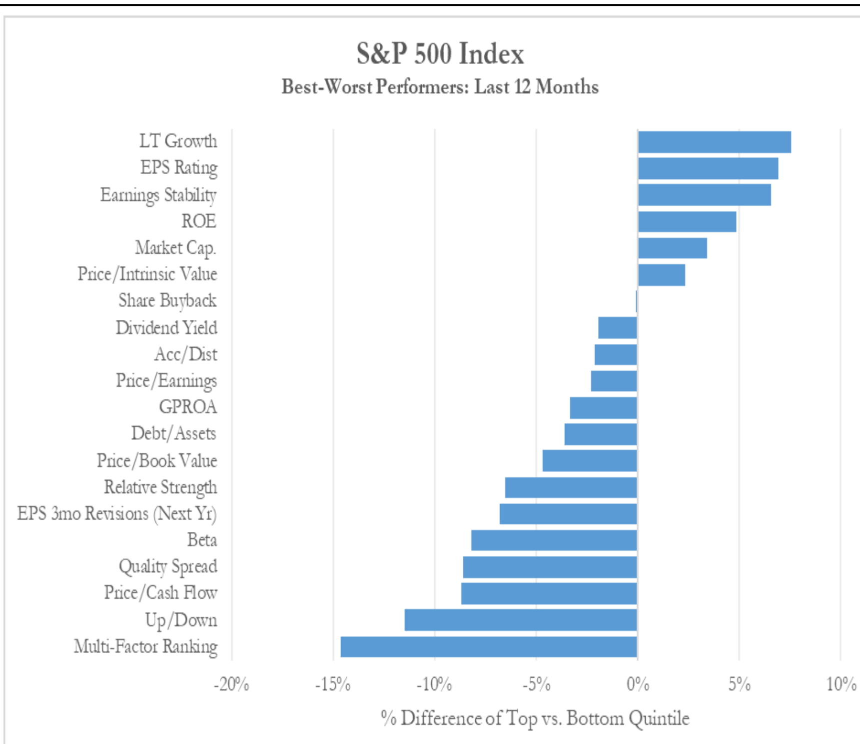
Early in the year, concerns centered on a US Government Shutdown and the Parliament's failure to approve Theresa May's Brexit deal. Those concerns did not sidetrack the market, and after a difficult fourth quarter of 2018, the S&P rose 15% from January 1 through early May as some hope of a US/China trade deal emerged. When those hopes dissolved and the US instituted tariffs on $250B in imports from China, the market gave back about half of the year to date gains in May. Following that, the market seesawed for most of the next six months, working through a Chinese devaluation, inverted yield curve in the US, a new British Prime Minister (with unmistakable hair), a Japanese Value Added Tax and an on again off again relationship between the US and China on trade. Against this backdrop, global manufacturing went into recession and most investors started to whisper about an broad scale recession.

That narrative changed in August. The Fed lowered rates for the first time since 2008 after they overtightened during 2018. The ECB and most other central banks started (or continued) to lower rates to spur economic growth. Fiscal stimulus began being discussed in Europe, and France complemented business tax cuts they had implemented over the past two years with personal tax cuts to quell the yellow vest movement. China pursued economic stimulus and lowered bank reserve requirements. The US announced additional tariffs to be implemented on China in early September, yet the market rose. As the fourth quarter played out, we saw the British population reject socialism and re-elect the conservatives. This gave clarity to how Brexit is likely to play out. The pressure of the tariffs prompted renewed trade negotiations and we saw the US and China announce a Phase One trade deal. Concurrent with those developments, central banks shifted to reduce rates and stimulative fiscal policies began to work on worldwide economies. A nascent recovery in growth seems to be unfolding. Markets have risen in anticipation of this, but it is probably not fully reflected yet.

The question for investors now is what to expect once we are over that "wall of worry". We believe the outlook for equity markets remains constructive, though bonds may have a more difficult go of it. The stock market has had a significant run up recently, so a modest pullback over the short term would not surprise us. If that materializes, we would urge investors to realize it is setting the stage for continued rotation in to the cheaper names and (in all likelihood) International stocks as well.

Factor Analysis



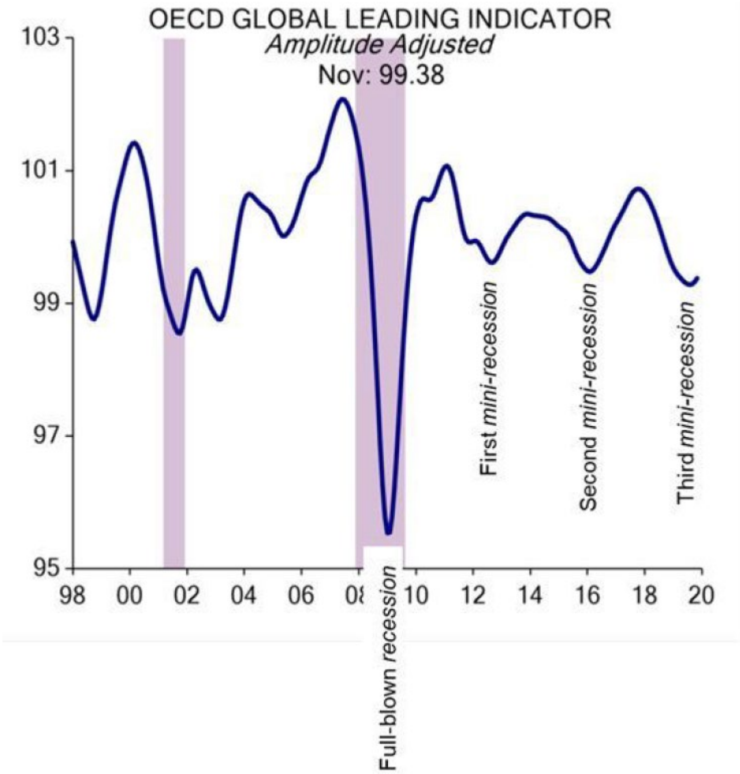


Source: Bloomberg, William O'Neil + Co and Todd Asset Management

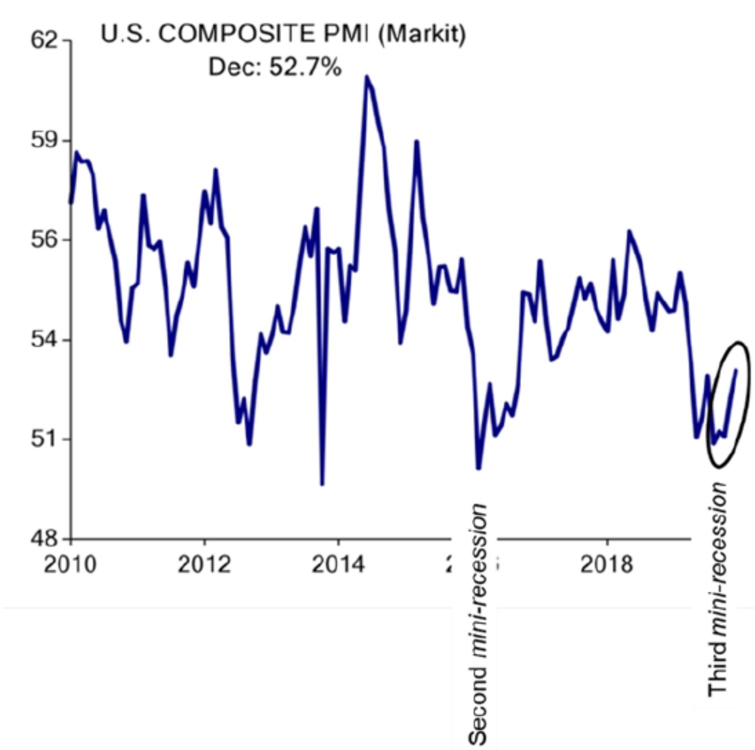
Since the Federal Reserve lowered rates in August, the factors favored within the market have shifted. These two charts are our customary analysis of the factors that are hurting or helping performance within the S&P 500. For most of the year, we found that value factors were firmly planted at the bottom of the list. In the fourth quarter, that began to change, and you can see that Price to Intrinsic Value added the most value. Price to Earnings and Price to Cash Flow also saw recoveries. The laggards were generally factors favoring volatility, momentum or safety.

We believe this shift to Value is likely the beginning of a regime shift as Growth factors have trounced Value factors while economic tensions have risen over the past 2 years. As those tensions ease, investors should be more comfortable buying Value stocks.

Interesting Charts We Saw This Quarter



The chart to the left, compliments of Evercore ISI, highlights how Leading Economic Indicators have performed over time. Since the Great Financial Crisis, we have seen three mini-recessions. Economic recoveries followed the last two episodes and we think a recovery will occur this time as well.



The chart to the left, compliments of Evercore ISI, shows how economic activity performed around these mini-recessions. In 2012 and 2016 activity recovered in response to easier rates and stimulative policies. The third recovery appears to be starting now as central banks ease and stimulative policies are occurring.

S&P Surges of 30% or More Since WWII

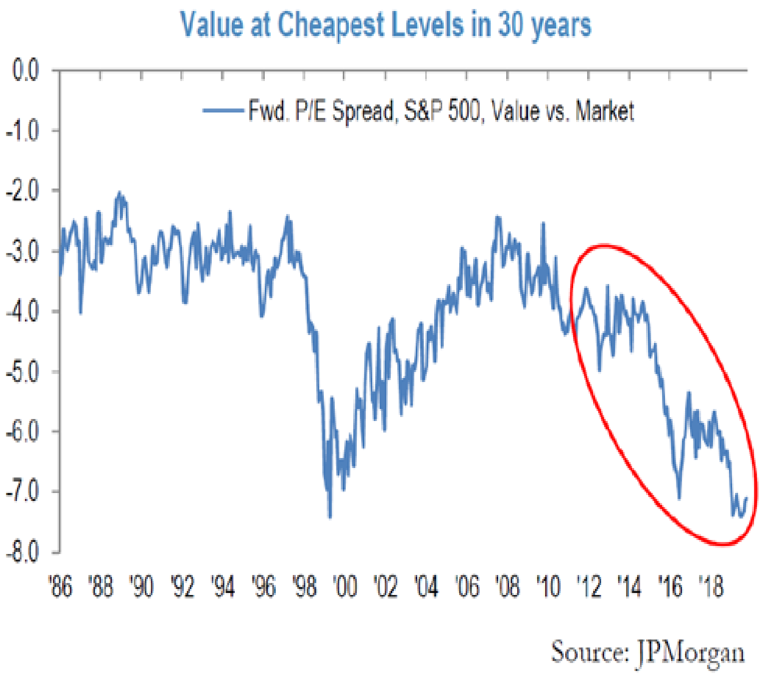
	S&P Y/Y %		Real GDP Y/Y %	
	Last Year	Next Year	Last Year	Next Year
1954	45	26	2.7	6.6
1958	38	8	2.7	4.6
1975	32	19	2.6	4.3
1995	34	20	2.2	4.4
1997	31	27	4.5	4.9
2013	30	11	2.6	2.9
Average	**35**	**19**	**2.9**	**4.6**
2019	29	?	2.4 e	?

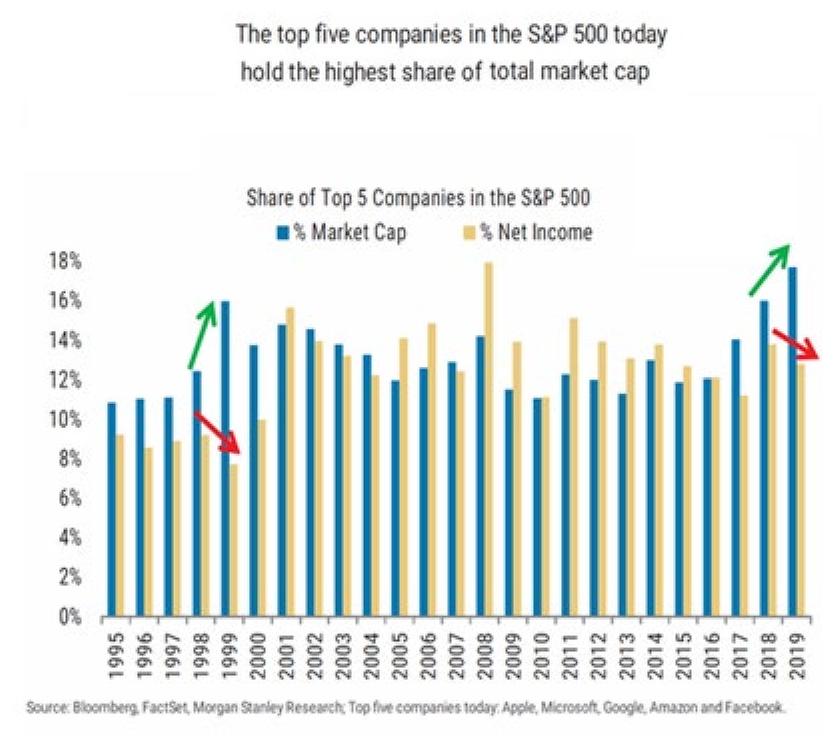
Source: Evercore ISI

Many strategists forecast small market gains and no economic acceleration in 2020 for the US. This flies in the face of history. Historically (table left) when the S&P gains 30% in a year, the next year typically returns 19% AND the economy accelerates. Our sense is 2020 could be better than most strategists expect.

Source: ISI

The amount of money in retail money funds has gone parabolic according to the chart to the left. When we hear that sentiment is frothy and extended, we look at this chart and it suggests any frothiness is not from Retail investors. This would indicate more fear than greed to us.

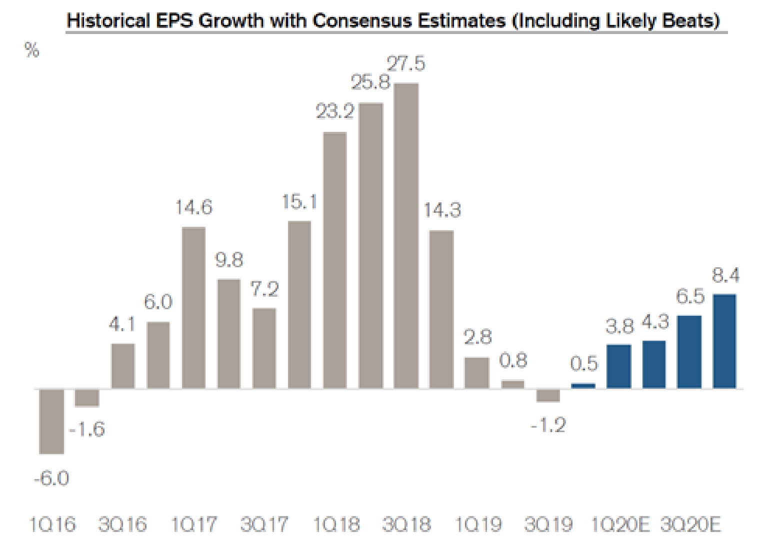




The two charts on this page are intricately related to each other. The top chart shows how extreme the discount is for value stocks versus the S&P 500 and we see the discount rivals the prior record of 1999. We believe this suggests that a rebound should occur.

The lower chart shows the percent of the market capitalization and earnings within the S&P 500 that are from the five largest names. The top five names are all growth stocks, and have the highest concentration of market cap weighting since at least 1995.

Both of these measures being at extremes indicates that the large cap growth stocks sucked all the air out of the room and caused the value underperformance. The extremity of these moves suggest that there should be a turn at some point. This also suggests that the recent passive outperformance over active should reverse when the relationship moves back to historical norms.



Note: Estimates based on consensus. Likely Beat calculated based on 2011–17 historical trends
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

The chart to the left shows the year over year earnings comparisons for the S&P 500. Like the mini-recession of 2016, earnings turned negative during the third quarter of 2019. Following that, economic growth and tax reform prompted good earnings comparisons for two and a half years. We believe getting the trade deal, coupled with more accommodative central banks and stimulus programs should allow for a similar recovery this time.

Summary

Most of the worries investors cited for being bearish last year have been alleviated. Trade tensions are simmering down as we get better clarity on the Brexit situation. Manufacturing seems to be bottoming and starting to recover. Central banks have shifted to an easier policy stance as well. The markets are recognizing this and acting well. Markets have had a good run over the short term and may be due for some consolidation. We believe they should act better later this year, especially if we get to a consensus that we are back in globally synchronized growth without prompting central banks to raise rates. That's a tightrope they can walk as long as inflation stays low, so we remain optimistic for the year ahead.

As always, if you need any additional information, please feel free to contact any of us.

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01/21/2020
S&P 500 – 3321
Russell 1000 Value – 1360

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

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S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.