MALVERN CAPITAL MANAGEMENT

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Fourth Quarter Commentary and 2020 Market Outlook

January 2020

The Fourth Quarter 2019 Review

In the fourth quarter 2019, we experienced a "market melt up" as all major equity averages posted substantial gains. Sellers went on a quarter-long holiday and stocks moved up virtually unimpeded. This was in stark contrast to the fourth quarter 2018 where the S&P 500 lost 13.5%. Investors seemed to take advantage of the additional liquidity pumped into the system by the Federal Reserve and ran with it. The gains in the fourth quarter added onto the already impressive gains for the year 2019. The tech heavy NASDAQ 100 Index outpaced all other indices by advancing nearly 13% in the quarter and 39.46% for the year. Much of the gain in this index is attributable to the performance of just a few stocks namely Apple, Facebook and Microsoft. These stocks make up a significant weighting in the market cap weighted NASDAQ 100 Index.

Other indices were impressive as well. The S&P 500 Index moved up 9.07% in the quarter. Small-cap stocks tacked on additional gains of 9.94% and Mid-caps moved forward by just over 7% in the quarter. Growth stocks continued to outperform value stocks, a trend we have seen for the past few years.

High quality investment grade bonds were flat for the quarter as interest rates ticked up. The yield on the 10-year U.S. Treasury Note was 1.644% at the start of the quarter and ended the quarter at 1.919%. The Bloomberg Barclays U.S. Aggregate Bond Index was up just 0.18% for the quarter. Junk or high yield bonds fared better but there is a concern that yield "spreads" have really narrowed between U.S. Treasury bonds and high yield bonds suggesting that there is less room for junk bonds to squeeze out further gains.

Index Performance

Category	Representative Index	Dec. 2019	4th Qtr 2019	2019	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	1.87	6.67	25.34	15.73	12.59	13.40
Broad US Large Companies	S&P 500 Index	3.02	9.07	31.49	15.27	11.70	13.56
US Small Cap Companies	Russell 2000 Index	2.88	9.94	25.52	8.59	8.23	11.83
US Mid Cap Companies	Russell Mid Cap Index	2.29	7.06	30.54	12.06	9.33	13.19
Largest 100 NASDAQ Companies	NASDAQ 100 Index	3.99	12.99	39.46	22.88	16.91	18.07
Developed International	MSCI EAFE Index	3.25	8.17	22.01	9.56	5.67	5.50
Emerging Markets	FTSE All Emerging Markets	6.96	11.76	20.11	11.19	5.62	3.82
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-0.07	0.18	8.72	4.03	3.05	3.75
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	2.00	2.61	14.32	6.37	6.13	7.57
Commodities	Bloomberg Commodity	5.04	4.42	7.69	-0.94	-3.92	-4.73
Total US Market (all cap stocks)	Russell 3000 Index	2.89	9.10	31.02	14.57	11.24	13.42
Real Estate Investment Trusts	Wilshire US REIT Index	-0.68	-1.14	25.76	7.63	6.87	11.94
Oil	West Texas Crude Intermediate Oil	5.20	13.03	35.42	4.39	2.72	-2.58
Cash	US T-Bill 90 Day	0.13	0.39	2.06	1.64	1.06	0.56

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2019.*
All returns include the reinvestment of dividends.

Narrowing spreads are often associated with weakening economic conditions in the near future (we do not see the economy as weakening, however). Spreads have narrowed primarily because investors are chasing the higher yields earned from junk bonds in this low interest rate environment.

REITs were the laggard for the quarter as they are interest rate sensitive. The Wilshire U.S. REIT Index declined by 1.14% in the quarter. Commodities performed well, especially oil.

As we transition from 2019 into a new year and a new decade, will we see continued momentum upward in the equity markets? Will we continue to “melt up” in 2020? We face many challenges and opportunities as the calendar turns over. A potential “cease fire” in the trade war with China has been reached, but possibly a new trade war with the European Union and global macro issues could weigh on the markets. We are in an election year, the Federal Reserve is accommodative, the economy is strong and earnings are good which should all be positive catalysts going forward. We elaborate on these topics a little more as follows.

Trade War Averted For Now

President Trump first introduced tariffs on Chinese goods on March 22, 2018. Hence the beginning of a trade war with China as China followed suit by imposing its own tariffs on U.S. imported goods. Since March 2018 a lot of back and forth between China and the U.S. has taken place and it appears that the agreed upon “Phase 1” deal may alleviate tensions just a bit. Phase 1 is intended to stop China’s strongarm tactics regarding technology transfer, require China to buy a lot of U.S. farm and energy products and open China’s financial services market to foreign companies.

Given that it is an election year and Trump would like to savor victory with what has been accomplished thus far, Phase 2 will likely not occur until after the November election. Phase 2 would go after China’s subsidies of its businesses.

Now that it seems as if China is smoothed over for the upcoming year, the Administration is likely going to begin a new trade war, this time with the European Union (EU). Many goods being exported from the EU will see tariffs imposed on them. In retaliation, the EU will impose tariffs on goods coming from the United States starting another trade war. If the trade war with China is any indication, the equity markets may see a pick-up in volatility as a result of any trade war with the EU. The President complains about the perceived unfairness with trade between the U.S. and the EU. He cites the $169 billion trade deficit with the EU as evidence of the unfairness. It is our opinion that trade deficits really don’t matter and may simply be indicative of the Americans’ higher standard of living than that experienced by the Europeans. Nonetheless, another trade war hopefully will not derail the optimism for continued equity returns in 2020.

Global Macro Issues

A war with Iran is very unlikely but tensions have been elevated as we enter the new year with the United States’ killing of Iranian General Soleimani. His killing was in response to the Iranian’s alleged killing of a U.S. Citizen contractor at the Iraqi embassy. Adding to the tensions is our withdrawal from the Iran deal the Obama Administration had implemented. Also, in June 2019, Iran shot down one of our surveillance drones over the Strait of Hormuz.

Tensions with Iran have the potential to impact the price of oil. Iran has the ability to block the Strait of Hormuz which is a major pathway for Middle Eastern produced oil. A rise in oil prices can have an adverse impact on the global economy including the economy in the U.S. The recent conflict did cause oil to rise modestly but it fell back quickly.

Needless to say, the United States is now a net exporter of oil so any blocking of the Strait of Hormuz may possibly not have the same impact it once would have.

We also cannot ignore North Korea as a possible area of concern in 2020. Things have been quiet for a while but nothing has really been resolved nor agreements made between the U.S. and North Korea despite Trump's meeting with the North Korean dictator.

Elevated tensions around the world can have an adverse impact on equity prices.

The Federal Reserve

In October 2019 the Federal Reserve announced that it would begin to again expand its balance sheet. But it also said that this would not be a new Quantitative Easing program like those programs we saw between the years 2010 and 2014 which were implemented in response to the financial crisis. The current balance sheet expansion was started as a result of trouble in the overnight lending market seen in early September. Effectively the expansion of the balance sheet injects additional liquidity into the system which, as a byproduct, is ultimately a positive for the prices of equities. Prior to October 2019, the Fed had been reducing its balance sheet since late 2015.

Furthermore, the Federal Reserve left interest rates unchanged at its December 2019 meeting after cutting interest rates three times in 2019. It has signaled that it intends to leave interest rates alone in 2020. However, the Fed has left the door open to making changes to policy in 2020 if warranted. It forecasts GDP growth in 2020 at 2%, a slight reduction from previous forecasts of 2.2% growth. It also expects low inflation in 2020. It targets an inflation rate of 2%. The Federal Reserve does not want to be seen as political and given that 2020 is an election year it is likely to be more restrained with its policy changes than in non-election years.

Despite its intent to leave interest rate policy alone in 2020, the Federal Reserve is being very accommodative today with the expansion of its balance sheet and such accommodation is very positive for the stock market. The famous investor, the late Marty Zweig, once said years ago "don't fight the Fed". This expression rings clearly today. Investors taking a "short" position in equities today do so at great peril.

2020, An Election Year

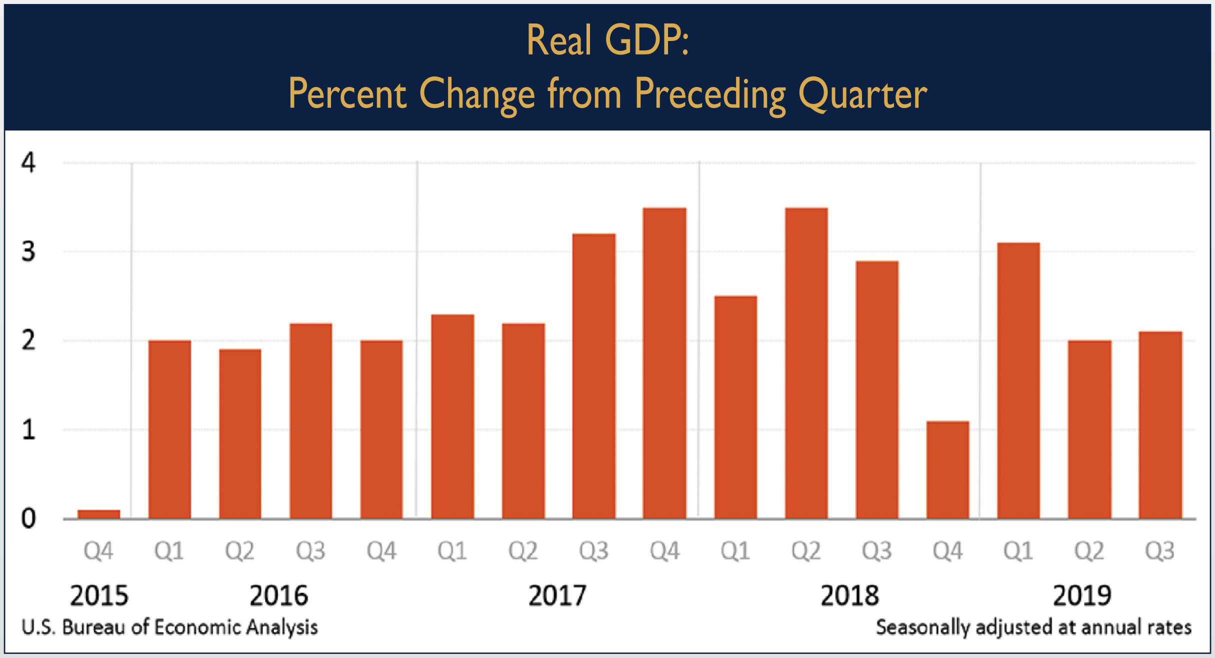
Since World War II, the S&P 500 Index has risen in 78% of election years and by an average of 6% regardless of which party is in power. Particular attention should be given to the three months prior to the election as if they are positive, history says the party in power wins the election. In 20 out of 23 occurrences since 1928, if the S&P 500 was positive three months prior to the election, the party in power won the election (*Miami Herald*, January 11, 2020).

What is less clear this election year is the question, will anything positive get done for the country? Recently, the House of Representatives passed President Trump's United States Mexico Canada Agreement or USMCA bill, giving a clear victory for the President. The USMCA bill claims to greatly improve upon NAFTA (the North American Free Trade Agreement). But the question remains, will anything else get done this year? It seems as if neither political party wants to allow the other side to appear to have accomplished anything so that such perceived "inaction" can be used politically against the other party. Especially, the Democrats do not want President Trump to be able to claim any victories as he runs for re-election. It also looks like the Senate will spend time with an impeachment trial, which will ultimately result in complete exoneration of the President.

Perhaps after the election, Congress will get down to some serious business with regard to infrastructure, health care and immigration. But it would be very surprising to see anything meaningful happen prior to November 2020.

The Economy

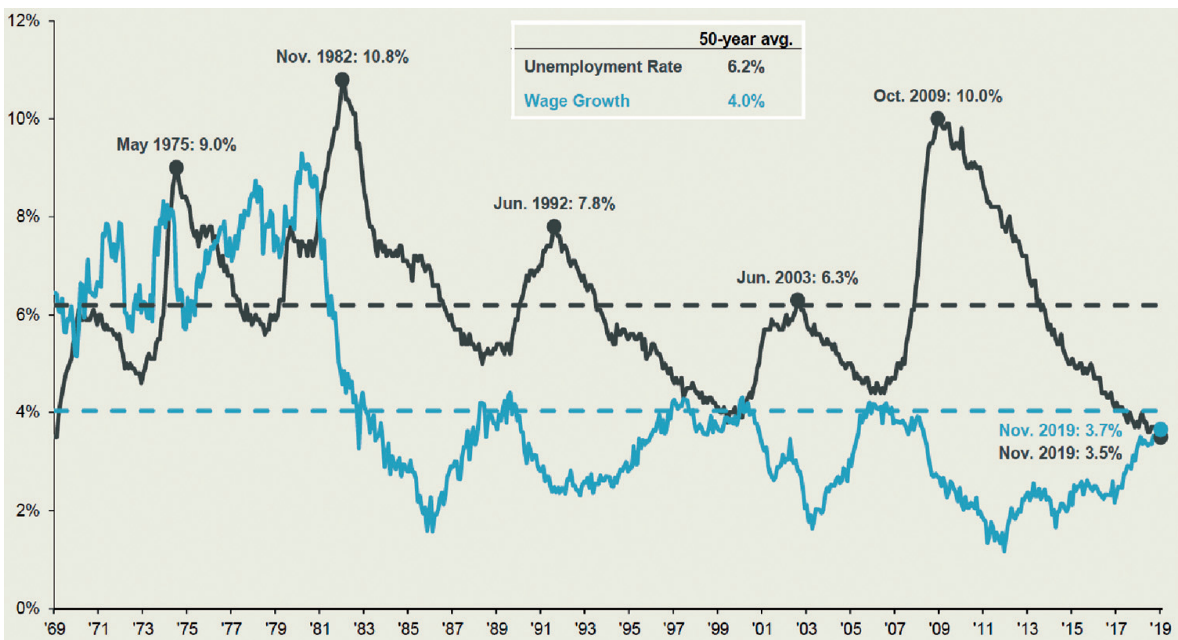
Last year the media speculated that the U.S. economy was heading into a recession. Whether the speculation was politically motivated hysteria or based on real factual data is debatable. Nonetheless, the U.S. economy continues to grow. The third quarter of 2019 (third estimate) showed that the real Gross Domestic Product grew by 2.1%. In the second quarter 2019 the growth rate was 2.0%. A recession is defined as two consecutive quarters of negative real GDP growth. The economy is still benefiting from the lingering effects of the 2017 tax reform law as well as benefiting from an accommodative Federal Reserve, low energy prices and the roll back of regulations.



As a result of the steady growth of the economy over the past several years, we are experiencing the lowest unemployment rate in 50 years. The current unemployment rate is 3.5%. Job growth is prevalent and jobs openings are abundant. With the supply of available jobs increasing with a shrinking pool of available workers, wages are also growing, currently growing at an annual rate of 3.7%. For those holding a college degree or greater, the unemployment rate is 2%. Even those who do not even have a high school diploma, see that their unemployment rate is just 5.3%.

Civilian Unemployment Rate and Year-over-year Wage Growth for Private Production and Non-supervisory Workers

(Seasonally Adjusted, Percent)



Source: BLS. Fact Set, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2019.

Inflation is also very low. The current headline inflation rate (November 2019) is 2%, a slight increase over the 1.8% inflation rate reported in October. The 50-year average inflation rate is 3.9%. The low inflation rate enables the Federal Reserve to be more accommodative.

Not everything is positive however. The ISM Manufacturing Purchasing Managers Index fell to 47.2 in December. This was the lowest level since June 2009 during the depths of the "great recession." This continued a trend of five straight months of decline in this index. A reading of this index below 50 is considered recessionary. The December jobs report further showed that the country shed 12,000 manufacturing jobs for the month, another sign of manufacturing's woes. For the year manufacturing has added 46,000 jobs. Manufacturing is an important component of the U.S. economy.

Corporate Earnings

The Standard & Poor's Corporation estimates full year 2019 earnings on the S&P 500 Index component companies at $158.13 per shares. This represents a 4.3% growth rate of earnings for 2019. Likewise, the projected earnings for full year 2020 are $175.52 per share reflecting an estimated earnings growth of 11% for full year 2020. It should be pointed out that forward earnings estimates made one year ago were taken down several times for full year 2019. So, nothing is set in stone.

Corporations are returning a good bit of earnings back to shareholders. 47% of each dollar earned is expected to be returned to shareholders in the form of a dividend or share buyback for 2019. 39% of every dollar is plowed back into the companies by being spent on research and development or capital expenditures. Acquisitions make up about 11% of every dollar earned.

Tax cuts from the 2017 tax reform law are still benefiting companies. The current average tax rate for the S&P 500 Index component companies is 18.59% (as of the June 2019 quarter). The average tax rate in June 2017 was 25.89%. These tax savings go right to the bottom line of companies and leave more dollars available to be returned to shareholders or reinvested back into companies to help enhance further growth.

Market Valuation

Based on corporate earnings and the current price of stocks, is the market expensive right now? Looking at the current price of the market at 3,230.78 (market price as of the end of 2019) and the current estimate for earnings for the full year ending 2019, we have a trailing price-to-earnings (P/E) ratio of 20.43. The 20-year average trailing P/E ratio for the S&P 500 Index is 18.92. We are currently above average for the P/E ratio but we would not consider the market to be over-valued at this time given the low level of interest rates.

Going forward, the Standard & Poor's Corporation estimates earnings on the S&P 500 Index at $175.52 for the full year 2020. We believe that given where interest rates are right now, the market can justify a P/E ratio of at least 20 times. If we apply a multiple of 20 to earnings of $175.52, we get a price for the S&P 500 Index at 3,510.40. This would suggest that the S&P 500 Index could achieve a total return (with dividends reinvested) of around 10.5% in 2020.

Although the market does not appear too over-valued, and our outlook for the market is positive, we do believe the market is susceptible to a short-lived "correction" in the very near future. Again, we are constructive on the markets but a pullback would not be out of the question.

Further, according to the Fed Model, stocks are cheap relative to bonds. The current earnings yield on the S&P 500 is 5.43% (earnings estimated over the next twelve months divided by the year-end price on the S&P 500 Index). The year-end yield on the 10-year U.S. Treasury Note was 1.919% giving a spread of the stock yield over bond yield of 3.511%. The competing assets of stocks and bonds suggest that stocks have more room to rise (or bonds need to fall).

The Fed Model is a valuation model, which compares the earnings yield on stocks (S&P 500 Index) to the current level of interest rates (yield to maturity on the 10-year U.S. Treasury Note).

Summary

The fourth quarter 2019 was fantastic for equity prices. These gains added to what had been an already spectacular year. As we move forward into 2020, will the “melt up” of equities continue? We face challenges as well as opportunities in the new year. Trade with China and the EU will be closely watched by investors. Tensions with Iran and North Korea will gain focus undoubtedly. It is an election year and although usually positive for stocks, probably means nothing gets done in Washington this year.

The economy is doing well for the most part. We are expected to grow by 2% this year. The growth so far has quieted those prognosticators calling for a recession last year. Earnings from U.S. corporations are pretty good. They are growing, albeit slowly, but still growing. Market valuations are reasonable and we expect to see a total return of 10.5% from the S&P 500 index this year. However, we do expect to see a market correction at some point this year. Never forget the cliché “Stocks Take the Stairs Up and Elevator Down.”

As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer