



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2019

Leigh Bivings, Ph.D., CFP®

Sean Beznicki, CFA, MBA



Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420



Executive Summary

- Global equity market returns in Q4 of 2019 were sharply positive across most all segments. The U.S. market led the way, increasing by +9.0%. Ample liquidity provided by the Federal Reserve, the announcement of phase one of a trade agreement with China, and some clarity (finally) regarding Brexit, all helped to reduce recession fears, and paved the way for the market to move higher.
- The optimism was shared across markets. International developed market equities notched a strong advance (+7.9%), supported by better economic data out of Germany, as well as the U.S.-China trade deal. Emerging market equities also posted a strong gain (+11.4%) in Q4, benefiting from the same easing of geopolitical concerns.
- In contrast, returns in many segments of the bond market were flat to negative in Q4 as yields moved upward. In the U.S., those segments of the bond market more correlated to the equity market (i.e. corporate bonds, high yield) fared well.
- Q4 capped a positive year overall due largely to the dovish U-turn from many central banks. The year was also one of extraordinary technology sector outperformance. These results helped the U.S. market overall to widen its outperformance versus the rest of the world, a divergence that got underway after the Trump tax cuts started showing their impact in 2018. Finally, due to ramped up central bank activity in 2019, bond markets had a stellar year overall, despite the weak finish.
- **2020 Outlook.** Our outlook for 2020 is predicated on the view that markets are fully priced, having front-run better expected profit growth in 2020, and that apart from China, little is expected in the way of fiscal stimulus during the year. We do think the Fed will remain supportive, given that we are in an election year. As such, we do not expect a recession in 2020, nor do we expect another breakout year.
- **Artemis Strategy.** We are largely comfortable with our current positioning. We will be looking to add a bit to emerging market equities and trimming bond duration if growth surprises to the upside. Other than these moves, we will remain focused on selected technology themes and sustainable investing.

Q4 and Year in Review

In sharp contrast to the bloodbath in late 2018, global equity market returns in Q4 of 2019 were sharply positive across most all segments. See Figure 1.

The U.S. market led the way, increasing by +9.0%. Ample liquidity provided by the Federal Reserve, the announcement of phase one of the trade agreement with China, and some clarity (finally) regarding Brexit, all helped to reduce recession fears paving the way for the market to move higher. The technology sector was among the principal beneficiaries of the easing trade tensions. Smaller company stocks also outperformed on the back of renewed growth optimism. In contrast, real estate lagged in Q4 as bond yields increased, and the hoped-for rebound in value stocks did not materialize.

Figure 1. Asset Class Returns in USD for 2019 (%)*

Asset Class	2019				Total Year	Index
	Q1	Q2	Q3	Q4		
Equities						
All Markets - Global*	12.3	3.4	(0.2)	9.1	26.4	MSCI ACWI IMI (net)
U.S. Large Companies	13.7	4.3	1.7	9.1	31.5	S&P 500
U.S. Small Companies	14.6	2.1	(2.4)	9.9	25.5	Russell 2000
Int'l Developed Markets	10.5	3.8	(0.9)	7.9	22.5	MSCI EAFE & Canada (net)
Emerging Markets	11.3	0.8	(3.6)	11.4	20.4	FTSE EM All Cap China A Inclusion (net)
Fixed Income						
All Segments - U.S.*	2.9	3.1	2.3	0.2	8.7	Barclay's U.S. Aggregate
U.S. Treasuries	2.9	3.9	2.7	(1.2)	8.4	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds	2.5	1.8	1.1	0.8	6.4	Barclay's Municipal Bonds, 1-15 Years
U.S. Corporate	4.9	3.9	2.1	1.3	12.7	Merrill Lynch U.S. Corporate Bond, 5-7 Years
U.S. High Yield	7.4	2.6	1.2	2.6	14.4	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	1.3	3.7	0.0	(0.4)	4.6	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds	7.4	4.2	1.6	2.1	16.1	J.P. Morgan USD Emerging Market Bonds
Floating Rate Bonds	5.1	1.6	1.3	2.3	10.7	S&P.LSTA U.S. Leveraged Loan 100 Index
Real Assets						
U.S. Tips	3.2	2.9	1.4	0.8	8.4	Barclays Capital U.S. TIPS
Commodities	6.3	(1.2)	(1.8)	4.4	7.7	iPath Bloomberg Commodity
U.S. Real Estate Income	9.9	2.7	4.0	0.9	18.4	Fidelity Series Real Estate Income Composite
Int'l Real Estate	11.5	0.4	2.8	5.2	21.1	Dow Jones Global Ex-US Select RESI

Note: The two benchmarks marked with an asterisk (*) are utilized to create blended client benchmarks.



The optimism was shared across markets. International developed market equities notched a strong advance (+7.9%), supported by better economic data out of Germany, as well as the U.S.-China trade deal. Emerging market equities also posted a strong gain (+11.4%) in Q4, benefiting from the same easing in geopolitical concerns.

In contrast, returns in many segments of the bond market were flat to negative in Q4 as yields moved upward. In the U.S., the 10-year Treasury bond yield increased from 1.7% to 1.9%, while the two-year yield dropped a bit, steepening the yield curve as investors took a more optimistic view on the economy. Those segments of the bond market more correlated to the equity market (i.e. corporate bonds, high yield) fared well, capping off an excellent year overall.

Figure 1 on the previous page also shows how markets fared over the course of the entire year. Q4 capped a positive year overall due largely to the dovish U-turn from many central banks. The year was not without volatility, however. During the summer, the yield curve inverted, manufacturing confidence plunged, and the U.S.-China trade war intensified. As such, investors became worried that a recession was around the corner, prompting the Fed to announce a third rate cut in the fall. This, in addition to continued positive news on unemployment and job growth, was enough to reset investor sentiment leading to the aforementioned outstanding fourth quarter results.

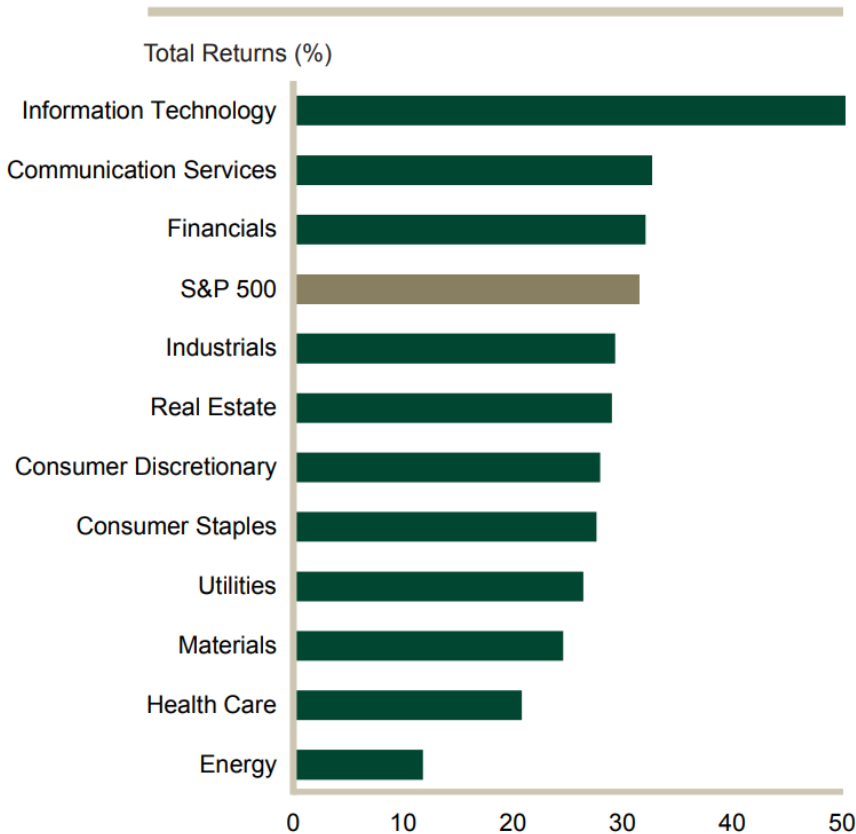
The year was also one of extraordinary technology sector outperformance, as shown in Figure 2 (on the next page), driven in large part by the FAANG stocks (Facebook, Amazon, Apple, Netflix, Google). Apple led the pack by generating a total return of 89%. Microsoft investors also had a good year, with the stock increasing by 55%. These results helped the U.S. market overall to widen its outperformance versus the rest of the world, a divergence that got underway after the Trump tax cuts started showing their impact in 2018 (see Figure 3 on page 5).

Finally, due to ramped up central bank activity in 2019, bond markets had a stellar year overall (see Figure 1 again). Both long-duration bonds and more credit-sensitive bonds had good reason to increase in value.

In short, a very good year for stock and bond market investors. Absent deep contrarian bets, it was virtually impossible to lose money in 2019.



Figure 2. 2019 U.S. Sector Performance



Source: Standard & Poor's

2020 Outlook

On the surface, the most curious aspect of 2019 was that the U.S. market increased handsomely in a year in which year-over-year corporate profit growth was negative in the first three quarters of the year and is expected to show negative growth again in the fourth quarter. This is the longest streak of negative profit growth since a period in 2015-16.

However, investors are banking on a turnaround in profits in 2020, with expected YoY earnings growth of S&P 500 companies of +4.6% in Q1, 6.4% in Q2 and +9.4% for the year as a whole. As such, they have bought in anticipation of this profit recovery. At these estimates, the forward P/E (stock price / next 12 months earnings) now stands at 18.2, approaching one standard deviation above its long-term mean. (See Figure 3.) At this level, it becomes harder to argue that equity is going to have another breakout year.



Figure 3. U.S. Equity Market vs. Rest of the World – 2018-19

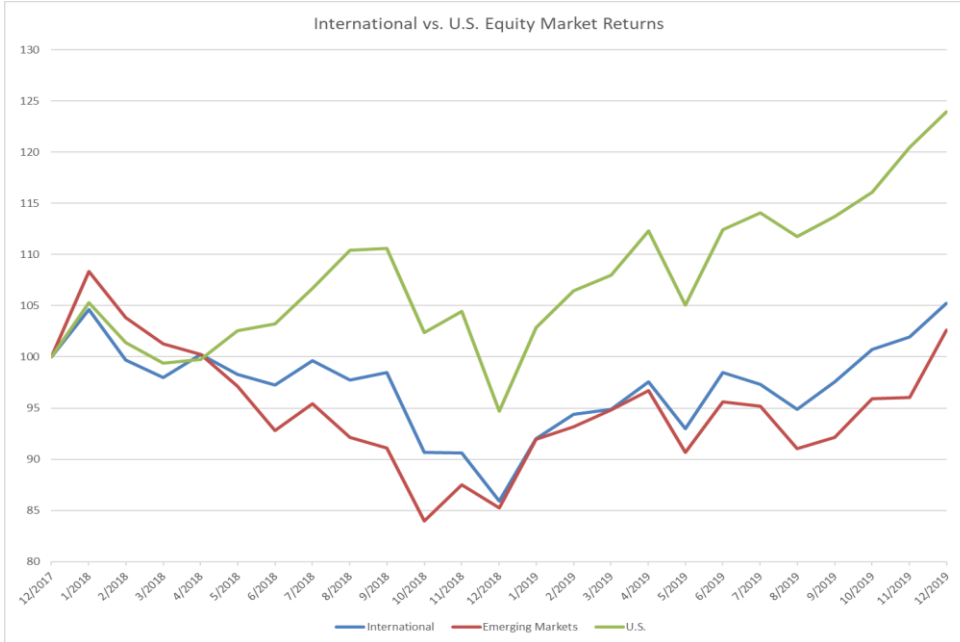
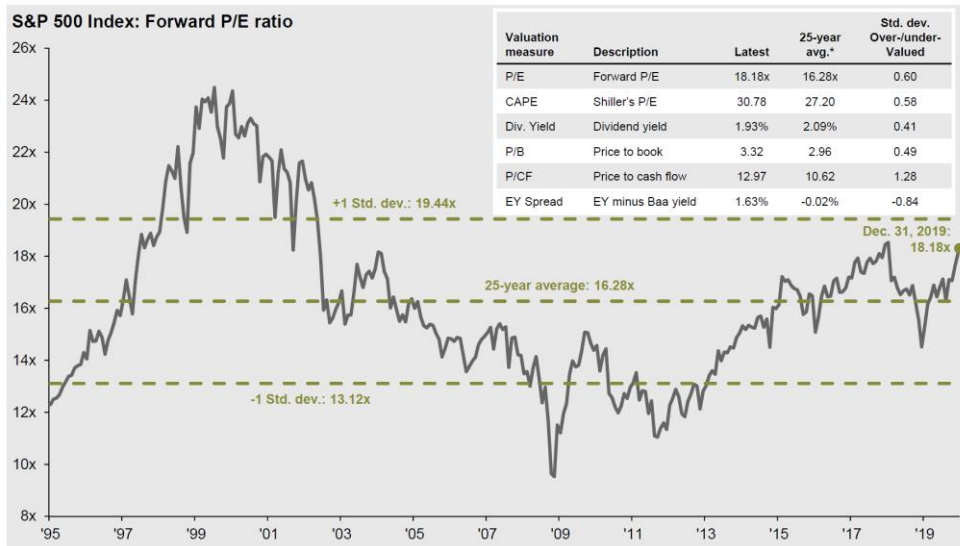


Figure 4. S&P 500 Valuation Measures



Source: JP Morgan



What are the main macroeconomic forces that will influence the investment landscape for 2020? As usual, central bank activity will be key, and the good news is that the U.S. Federal Reserve, in particular, may be reluctant to remove its interest rate cuts during an election cycle. But it's hard to see what other growth catalysts might be able to drive the market higher. For example, I doubt businesses are going to rush to build factories before the next election, given Trump's erratic policymaking. And with a Democratic majority in the House, we are unlikely to see much stimulative fiscal policy.

The situation doesn't look that much different in Europe. Europe is perennially averse to using fiscal policy to stoke growth, and the political stasis affecting the bloc has not gone away. In contrast, there is increasing hope that China may provide a growth impulse via monetary easing and increased infrastructure spending, both of which it is currently doing. But the recovery in Chinese economic growth is at a very early stage and may disappoint. If China exceeds expectations, then emerging markets might have a very good year.

Even still, the economic backdrop remains supportive for U.S. equities, given the limited upside of holding bonds that provide meager fixed rates of interest. And frankly, I think the political backdrop is also supportive in the U.S., as the last thing President Trump wants is a hit to business and consumer confidence right before an election. This may help explain why he has backed away thus far from a military confrontation with Iran.

I am less sanguine when it comes to Europe and Japan. It appears that economic performance in these regions has troughed, but it has not yet improved. While this weakness is likely to gradually recede (assuming protectionism does not escalate), I am of the view that a significant and sustained shift in investment flows away from the U.S. awaits a decisive uptick in non-U.S. manufacturing activity (currently in recession mode) and global trade. I think this will happen slowly if, at all, and I am therefore highly reluctant to start shifting assets away from the U.S.

To summarize, there are very few recession warning signals flashing yellow currently, and the consensus now is that there will not be a recession in 2020. By the same token, we need to see some solid growth in earnings in 2020 to move the market measurably higher in the U.S., which may be hard unless the dollar depreciates, wage inflation stays muted, and/or economic growth accelerates from its sluggish 2.0% pace.



Artemis Portfolio Strategy

The key macroeconomic call of 2019 boiled down to whether recessionary fears, both at the beginning of 2019 and during the summer, were justified. Artemis portfolios fared well because we decided that such fears were not justified for a variety of reasons and so did not reduce our equity exposure.

We feel much the same this year, so we are not changing our current strategy much *at the moment*. Nevertheless, volatility tends to be higher in election years than in non-election years, so we are approaching the year with some caution.

Our thoughts for 2020 portfolio positioning are as follows:

Favor high-quality fixed income. Despite 2019 turning out to be a good year overall for fixed income, I slept a lot more easily during the year knowing that almost all Artemis clients had enhanced downside protection built into their portfolios just in case our no-recession call was wrong. This was made possible by becoming more defensive in our fixed income allocations early in 2019. As it turned out, fixed income returns were stellar across the spectrum due to central bank activity during the year, something very unlikely to happen again in 2020.

This year I am going to check in on our longer-duration fixed income (i.e., the type of bonds that are more interest rate sensitive) and may even jump into cash on a tactical basis if growth and/or inflation surprise to the upside. But we have no intention of loading up on high-yielding debt at this stage of the market cycle, and so will remain defensive.

Favor the U.S. over other developed international markets. Many market pundits are trying to make the argument that this might be the year to shift assets away from the U.S. into more reasonably-priced markets, namely in Europe and Japan. Apart from relative cheapness of these markets, these analysts point to data indicating that the decline in global trade and manufacturing may be troughing and that the dollar is poised to depreciate. While returns in both regions may improve in 2020, I still doubt they will surpass the growth we are seeing at home, due in large part to technological innovation (which seems to be bypassing European companies) and the strength of the U.S. consumer. Hence, I continue to favor the U.S.

Increase emerging market exposure. Emerging market equities did not have a stellar year in 2019 due to the global manufacturing and trade recession and the lack of progress until recently in the trade war. In addition, while China purportedly was stimulating its economy,



it hasn't been enough to move the needle much as the government announced on January 22 that the Chinese economy grew at its slowest pace in 29 years. Perhaps due to this relatively poor showing, more recent data indicates that China is ramping up its use of both monetary and fiscal stimulus. This, in addition, to the signing of phase one of the trade deal, might be enough to lift emerging market asset prices. I think the bet is worth taking, and we will be modestly increasing our allocation to the emerging markets over the next couple of months.

Rebalance to portfolio targets. For those of you who follow our investing style closely, you might have noticed that we are not strict rebalancers and this has benefited all of you, given that we have been in a decade-long bull market. As a result, most of you have more equity in your portfolios than you did five years ago. But I believe we are at a stage in the market cycle now when the upside is going to be more muted and the downside more extreme.

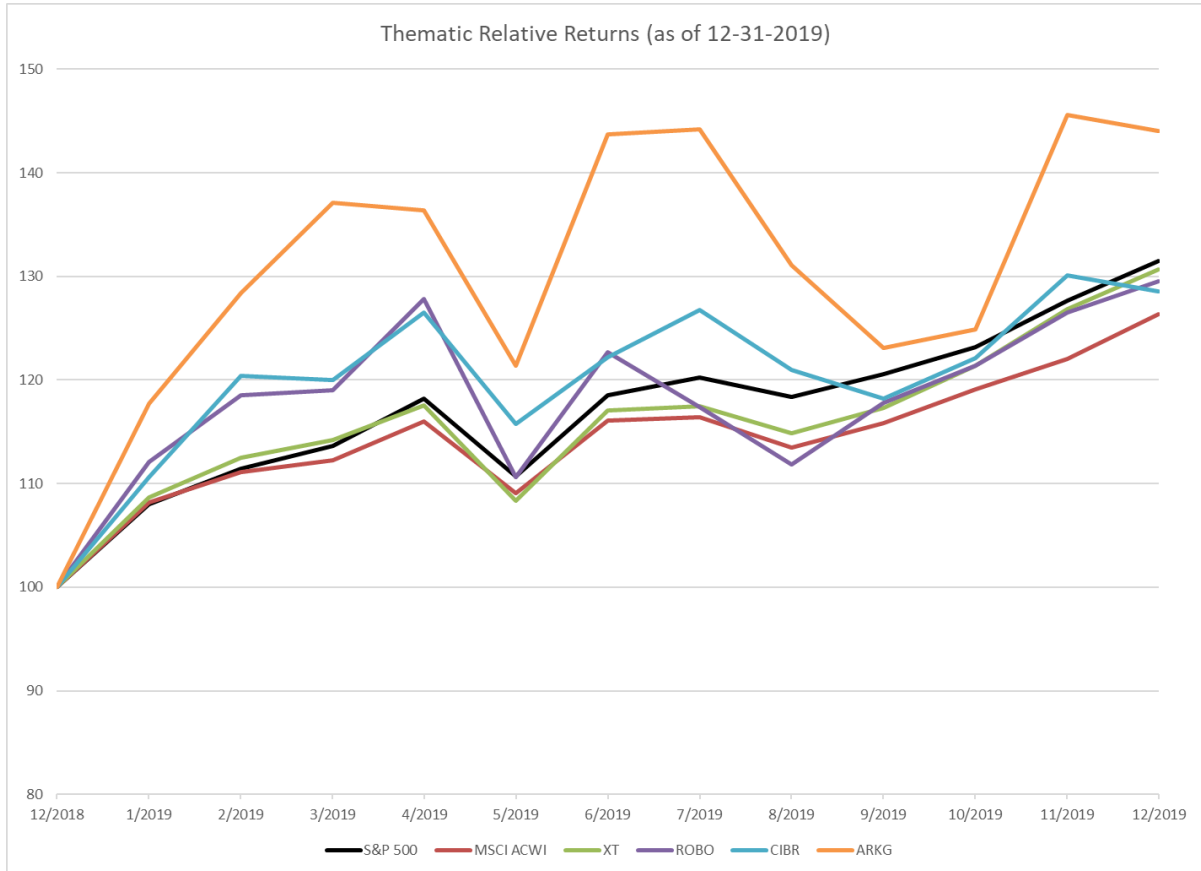
Stay focused on long-term technology themes. As I have written about before, we established an allocation to technology innovation themes in 2018 and largely completed our desired exposures in early 2019. Most all clients, except the most risk adverse, are now invested in four technology ETFs investing in a range of new technologies such as robotics, genomics, artificial intelligence, and cybersecurity, to name a few.

Figure 5 on the next page shows how these investments fared against each other in 2019 and relative to both the S&P 500 and the overall global equity market (most of the funds invest globally). As the chart indicates, while it didn't hurt one's overall return to have these exposures in 2019, only ARKG (genomics revolution technology) broke out of the pack. It's early days, but I commit to you to report annually on how we are doing.

The astute reader among you might notice that none of these funds did as well as the technology sector as a whole did in 2019 (see Figure 2 again), and so might be wondering whether we are wasting our time and should instead be buying passive market exposure to all technology. The problem here is that the outperformance of the technology sector in 2019 is in large part due to the extreme outperformance of a handful of stocks. Just five of those stocks, Apple, Microsoft, Alphabet, Amazon, and Facebook currently comprise over 18% of the S&P 500, so clients already have a sizeable exposure to this basket. The goal of the global thematic play is to gain exposure to a much broader set of companies, not to simply buy more FAANG (Facebook, Amazon, Apple, Netflix, Google) stocks. Is this strategy the right one? Only time will tell whether new technology has become a "winners take all" play. In the shorter term, the euphoric rise in the FAANG stocks are defying earnings fundamentals and so are unsustainable over the long run. We'll see what happens.



Figure 5. Relative Performance of Our Technology Innovation Themes.



Source: Morningstar

Focus on sustainable investing. My original (and flawed) idea was that we would have a quick chat about sustainable investing during every client annual review and, at that point, clients would be sufficiently informed by this conversation to make a critical and important choice regarding their investment portfolio. What typically happened is that we all would agree during the meeting that the topic warranted a much more in-depth conversation and so would skip over the topic entirely. As such, we are in the process of completing a more in-depth educational piece and will be holding dedicated meetings with those clients who have expressed interest in 2020. We will be in touch shortly, if you were one of them.