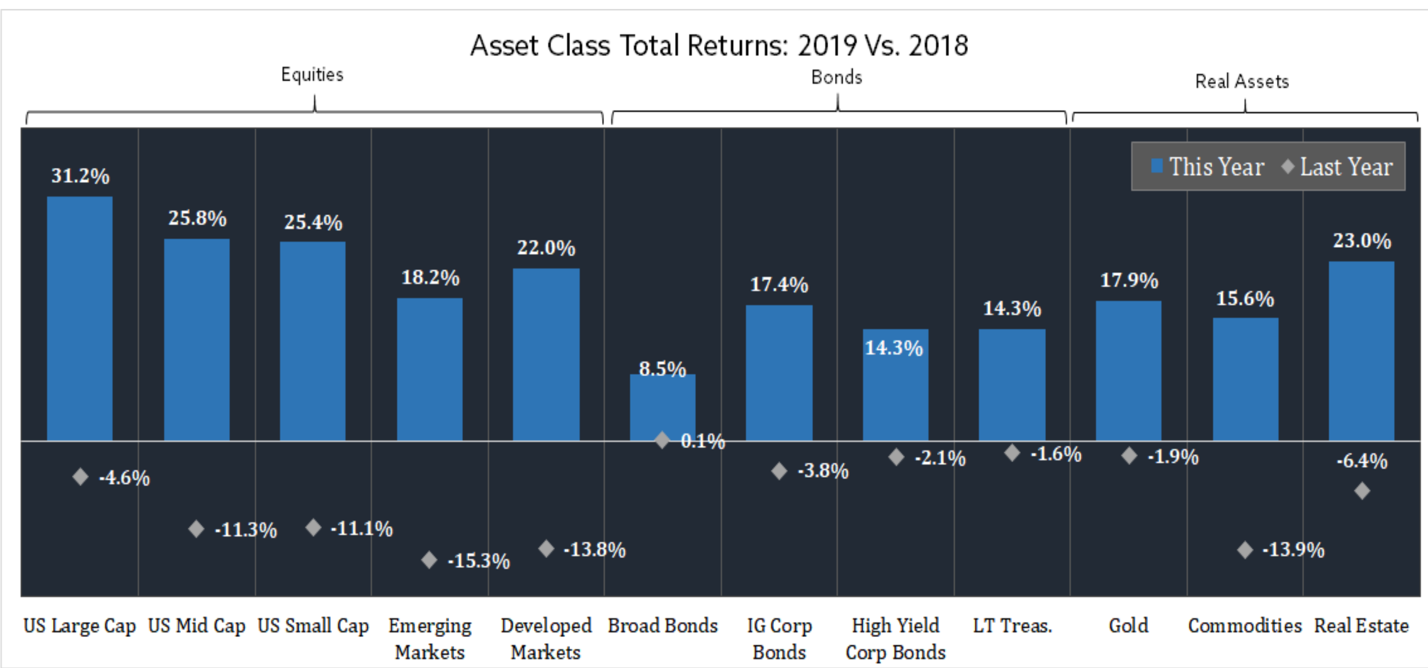
Pendleton Street Advisors
4th Quarter 2019 Investment Commentary
January 10, 2020

Index Returns	4th Quarter	Full Year
S&P 500 US Large Cap Stock Index	10.9%	31.5%
MSCI All Country World Ex-USA Stock Index	7.0%	21.5%
Barclays Capital US Aggregate Bond Index	2.5%	8.7%
US Core Consumer Price Index - (Inflation)	1.4%	2.3%

**All figures as of 12/31/2019 unless otherwise noted.*

After narrowly escaping a bear market heading out of Q4 2018, the S&P 500 index of large cap US stocks ended 2019 with the fifth best annual return on record since 1962 - up over 30%.[1] Smaller US stocks and international stocks followed suit. Remarkably, this strong rise in equity prices occurred against a backdrop of 4% earnings growth compared to growth of 22% in 2018 when the S&P ended the year down -4.6%.

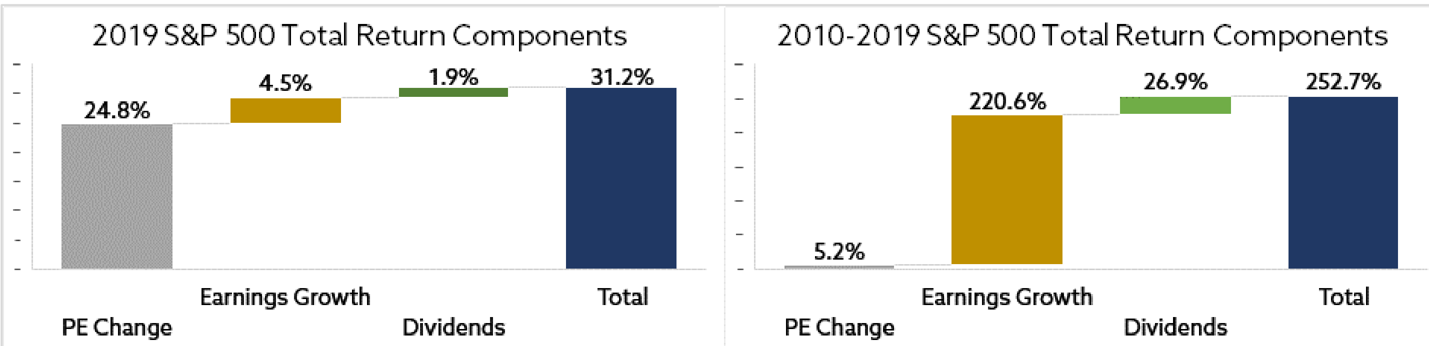
Looking ahead, we believe four issues stand out as most important for markets in 2020: consumers, global trade, central banks, and the presidential election. Another year of market strength like 2019 would be great for client portfolios but is by no means expected. We enter 2020 with portfolio positioning that reflects confidence in our long-term expectations and a healthy acknowledgement of the only rule that consistently holds true for markets over short-term periods: **<u>respect the unexpected</u>**.



[1] Presented on a Total Return basis. Total Return includes price increases and dividends, as opposed to price return which includes only price-change.

Equities showed strength in general for the year, but the magnitude of returns varied between 18.2% on the low-end for Emerging Market stocks, and 31.2% on the high end for US large cap stocks. Bonds also had a strong year, with the Barclays US Aggregate Bond Index increasing by 8.5%, significantly above the index's 3.5% annualized return over the previous ten years heading into 2019. Even commodities, which have had negative returns in three of the last five years, increased by 15.6% as measured by the S&P GS Commodities Index.

One way to look at what drove such strong performance for stocks is to break index return down into components: profitability (earnings growth); the price investors pay for earnings (price-to-earnings ratio); and additional return from Dividends.



<u>In 2019, 75% of the index's 31.2% return was due to an increase in price paid per dollar of earnings</u>, with the price to earnings multiple increasing from 16.5 to 20.4 while earnings grew by only 4%. By comparison, **<u>over the last ten years, 70% of the S&P 500's return has come from earnings growth</u>** in underlying companies, while only 14% has come from an increase in the amount investors are willing to pay for those earnings.

Looking at price as the major determinant of return for the year, the conclusion could be that investors just felt like paying more for the same companies than they did last year. But, why would they have felt that way?: **<u>Interest Rates & Outlooks</u>**.

- **Interest Rates**: During 2019, the Fed announced three interest rate cuts of 0.25%, and the effective Federal Funds Rate declined from 2.40% to 1.55%. As short-term interest rates decline, yields on cash savings, government and other bonds typically decline meaning investors earn less income by investing in those securities. This makes investments with higher expected rates of return, like stocks, more attractive. **<u>We estimate that 74% of the increase in the PE ratio is attributable to declining interest rates</u>**[2], meaning that declining interest rates were the driver of **<u>55% of the S&P 500's return in 2019</u>**.

- **Outlooks**: Markets are influenced by investors' collective expectations about the speed and trajectory of growth. Expectations can change quickly and significantly over shorter time spans depending on trends in economic and corporate fundamentals, and events that could potentially impact those trends such as global trade policy, social/political unrest, and election cycles.

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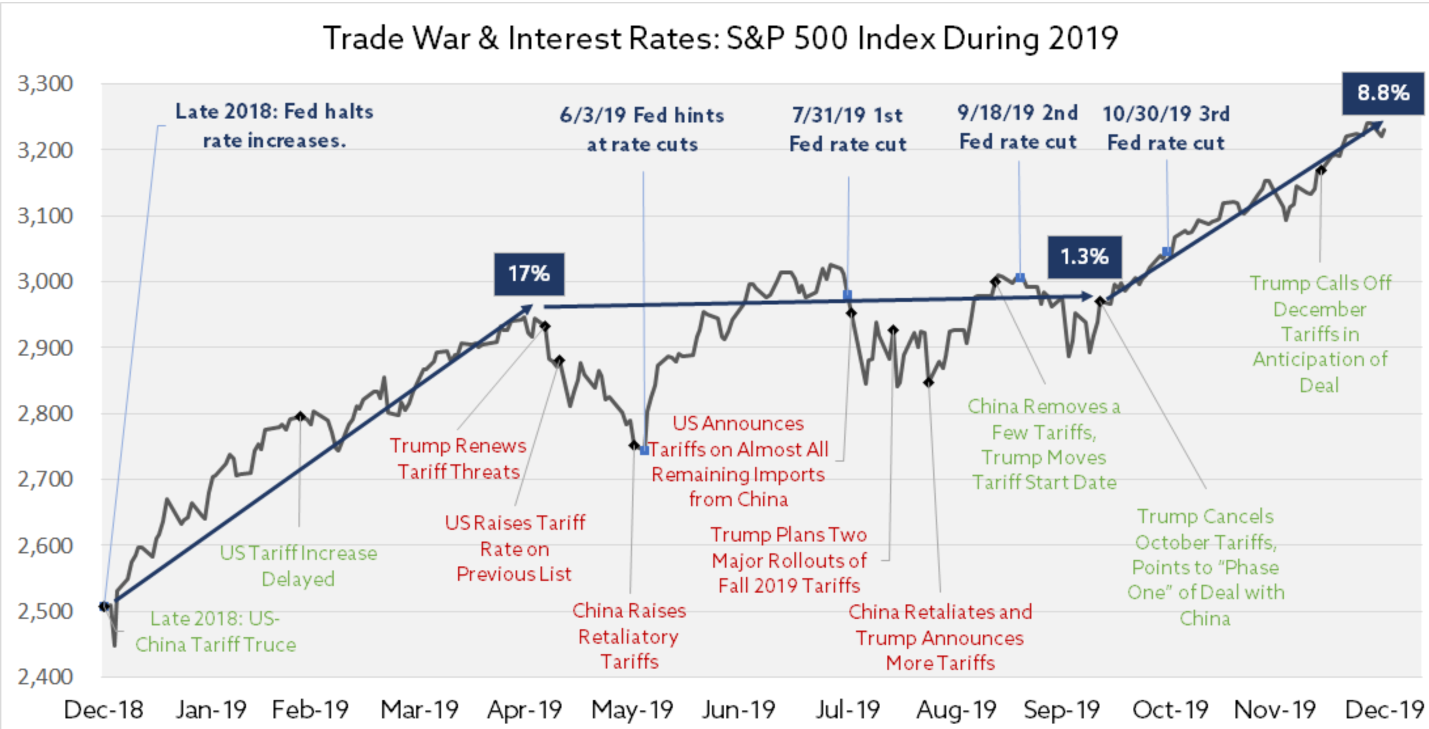
[2] The reciprocal of the PE ratio is the Earnings Yield (Earnings / Price). The Earnings Yield declined by 1.15%, from 6.05% to 4.89% in 2019. The effective Federal Funds rate declined by 0.85%, which represents 73.7% of the decline in the Earnings Yield.

Looking back at the S&P 500 over 2019, the impacts of interest rate policy and developments in the trade war with China jump off the page:

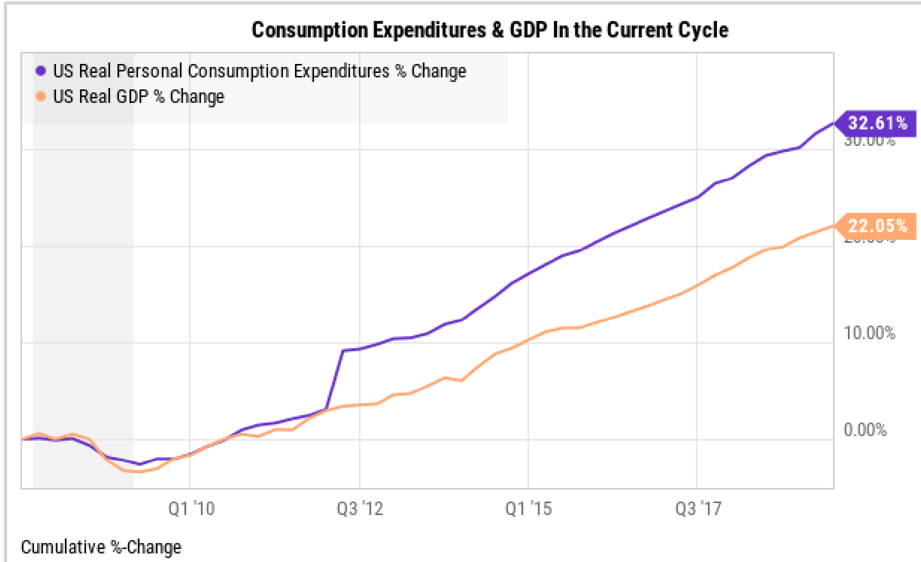


- **January – May 5 (17% Increase)**: The year began strongly with the Fed's announcement of a halt to any further interest rate hikes and was followed by further strength when the US announced it would delay tariff rate increases in late-January.
- **May 5 – October 10 (1.3% Increase)**: A short downturn and heightened volatility began in early May when President Trump began threatening more tariffs and higher tariff rates. The downturn ended when the Fed hinted that it was considering rate cuts in early June, but volatility continued as the US and China went tit-for-tat through August without any substantial positive developments in the trade war.
- **October 10 – December 31 (8.8% Increase)**: The year ended strongly with the Fed cutting interest rates two more times, and both the US and China relaxed tariff threats as they began openly discussing an imminent deal to de-escalate.

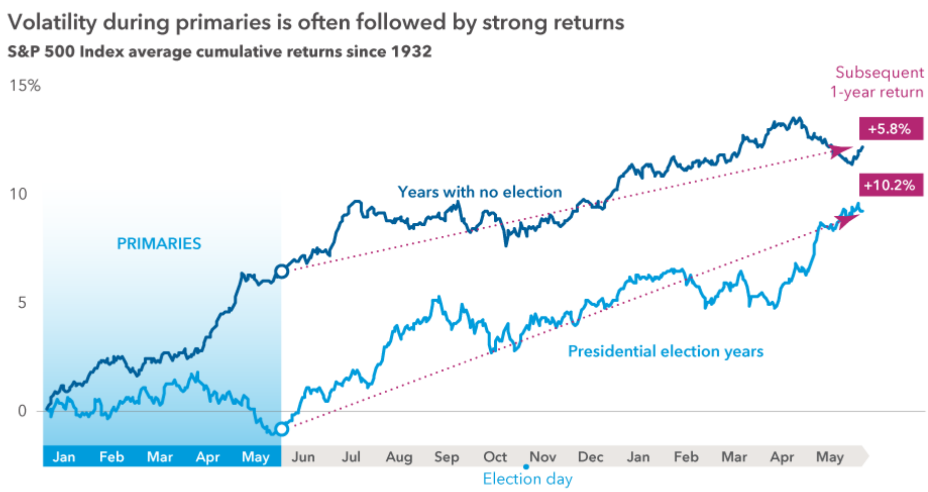
As for 2020, we have started the year with no indication that the Fed intends to cut or raise rates in the near future. By all appearances, the US and China are days away from signing a definitive trade agreement. Although we consider both issues to be of importance this year, we also expect other economic and political issues to impact markets going forward.

- **Economic:** As manufacturing recovers from a slowdown both globally and domestically, we expect attention to turn towards the health of Consumption Expenditures, which make up over two-thirds of US Gross Domestic Product. While other GDP components such as non-residential fixed investment and federal and local government spending are important, consumers have been the driving force of the current economic expansion.

Deterioration in consumer spending would be cause for concern that the economy is at-risk of falling into recession. Most recently in November, Consumption Expenditures had grown by 2.4% year-over-year, which is in-line with their average growth during the expansion of slightly over 2.5% annually and coincides with average real growth in GDP of approximately 2.3% over the last ten years.



- **Outlooks & Uncertainty**: As the impeachment of President Trump proceeds and the presidential election gains steam when the Democratic party settles on a nominee, uncertainty regarding the outcome will likely result in periods of heightened volatility. Volatility in election years is not unusual (see adjacent chart), but we will still be watching closely and adjusting positions in client portfolios as and if necessary.



Sources: Capital Group, RIMES, Standard & Poor's. Includes all daily price returns from 1/1/32-10/31/19. Years without an election exclude all years with either a presidential or midterm elections. Subsequent one-year return calculation begins on May 31 each year, a proxy for the end of primaries. Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We welcome hearing from you. We appreciate and do not take lightly your patience and the trust you place in us as advisors, and we look forward to speaking with you soon.

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