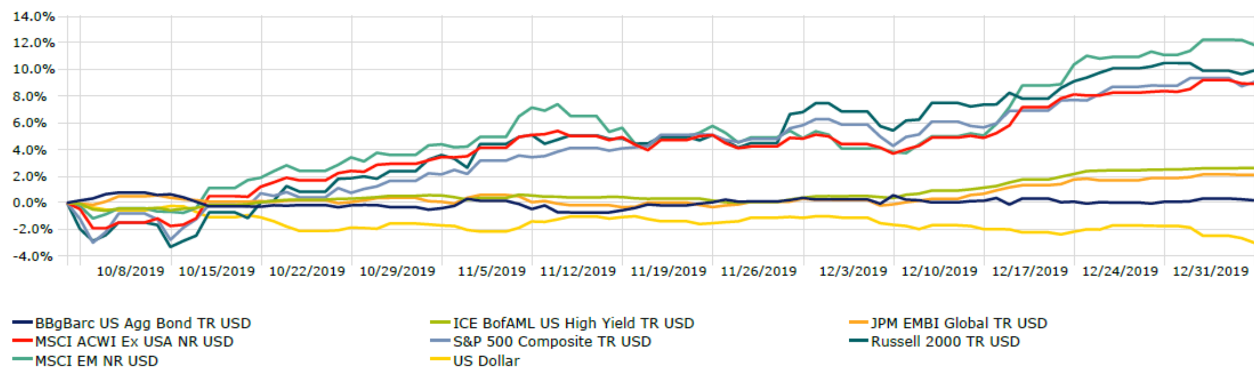
Q4 2019 Market Commentary

Despite turbulent headlines throughout the quarter, the US economy and markets posted their best year since 2013[14]. While politics and geopolitical conflicts will continue to dominate the investment landscape in 2020, the longest economic expansion in US history continues to run.

Global Markets Performance

The US stock market, as represented by the S&P 500, finished up 9.07% on the quarter, adding to a slightly positive return in the third quarter and closing the year up 31.49%. Smaller US stocks[1] trailed behind but still rose significantly, up nearly 10% for the quarter and over 25.5% for the year. International stock markets[2] and emerging markets[3] trailed domestic equity markets further on the year but performed well in the quarter with returns of 8.92% and 11.84%. On the credit side, core bonds[4] rose 0.18% and high yield bonds[5] rose as well, up 2.61% for the quarter, impacted by lower rates and tightened spreads[a]. Emerging market (EM) bonds[6] rose moderately as well, up 2.09% on the quarter.

Historical Performance



Calendar Year Returns

	YTD	2019	2018	2017	2016	2015
BBgBarc US Agg Bond TR USD	8.72	8.72	0.01	3.54	2.65	0.55
ICE BofAML US High Yield TR USD	14.41	14.41	-2.26	7.48	17.49	-4.64
JPM EMBI Global TR USD	14.42	14.42	-4.61	9.32	10.19	1.23
MSCI ACWI Ex USA NR USD	21.51	21.51	-14.20	27.19	4.50	-5.66
S&P 500 Composite TR USD	31.49	31.49	-4.38	21.83	11.96	1.38
Russell 2000 TR USD	25.52	25.52	-11.01	14.65	21.31	-4.41
MSCI EM NR USD	18.42	18.42	-14.57	37.28	11.19	-14.92
US Dollar	0.22	0.22	4.40	-9.87	3.63	9.26

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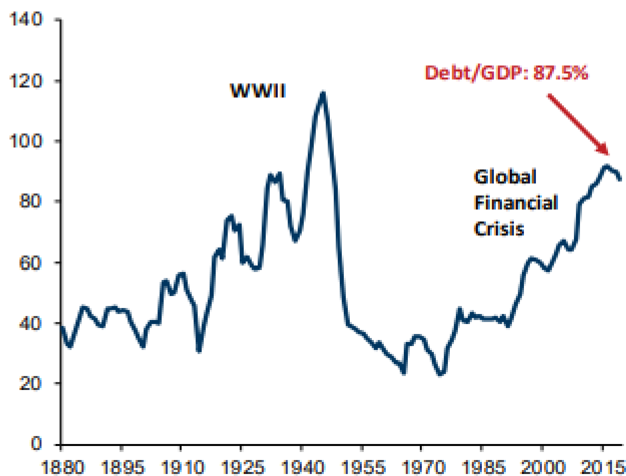
Modern Monetary Theory (MMT)

Governments around the globe borrowed an estimated $8 trillion in 2019, adding up to total outstanding sovereign debt of over $50 trillion[7]. That number is nearly double the level of similar debt outstanding at the end of 2007, and many countries have incurred more debt than the value of their annual GDP. Modern monetary theory became a prevalent topic in 2019 as a means of dealing with that large debt load, and it is likely to grab headlines again in 2020.

So, what exactly is modern monetary theory? In essence, it involves the financing of large fiscal spending and budget deficits[b] through both substantially increased taxes and the central banks printing money to cover government debts[8]. In the former, those taxes can apply to both companies and wealthy individuals. The central banks, on the other hand, print money in order to buy local government bonds and subsequently forgive the debts at or before maturity.

Proponents of MMT argue that deficit spending is healthy and that a large government debt is unlikely to harm future economic growth. Further, governments that print their own money cannot technically go bankrupt as they can always create more currency. The total level of national debt is simply an investment the government makes into the economy, under this view.

Advanced economy govt debt is near all-time highs



*Note: includes Australia, Canada, France, Germany, Germany, Italy, Japan, Korea, the UK, and the US.
Source: IMF, Goldman Sachs Global Investment Research.
Source: Goldman Sachs.[9]

The counterargument contends that such deficit spending is irresponsible and will ultimately lead to liquidity problems, solvency problems, or both[c]. There are a fair number of empirical cases to support the argument against MMT as well, but as the global attitude continues to turn toward populism there will be ever louder voices supporting this theory.

But it's important to understand the potential implications of MMT as there are hints in the global economic system already and sovereign debt is at peak level. As governments try to grapple with that debt, they will be incentivized to increase taxes on the wealthy. Historically, increased taxes on the wealthy have generally been avoided either by loopholes or by those individuals moving that capital abroad.

And that loss of revenue from the wealthy can cause further budget issues that can continue to spiral out of control. MMT is a bold idea, and one that looks good on paper, but the risks loom large. For every example that supports MMT, like Japan, there are warnings like Venezuela. It's possible we will see this occur in some degree in the US if the status quo persists, but we must be cognizant of both the positives and negatives.

The Fiscal Silk Road

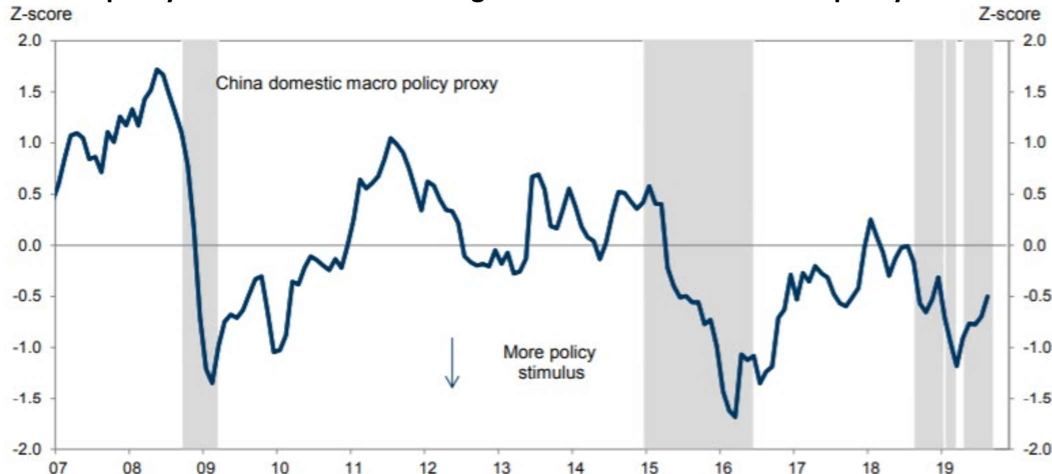
China has become a global behemoth in a relatively short amount of time and is now the second largest country in the world by GDP. Since it joined the World Trade Organization in December 2001, annual GDP has increased by over an estimated 900%[10]. As a socialist republic, China possesses some democratic institutions but is overwhelmingly controlled by its main party, the Communist Party of China.

The Global Financial Crisis of 2008-2009, driven primarily by excess in the US economy, left China largely unscathed and even contributed to its growth. But China's meteoric rise and its global prominence in supply chains, technology and finance mean that the global economy is now largely connected to the performance of the Chinese economy, and a Chinese financial crisis may have similar effects worldwide.

Chinese economic policy is first and foremost driven by fiscal policy, as the large central government can manage the economy in a manner not possible in the US. In the US, on the other hand, fiscal policy generally follows the financial conditions that are created through monetary policy, which is controlled by the Federal Reserve[11].

What's unique about Chinese policy pools is the degree to which they work together. In the United States, the Federal Reserve is an independent agency free to manage monetary policy under their mandate in whatever manner they believe is best. In China, however, monetary policy is required to support fiscal policy and since the government controls both this can be fairly easily achieved.

Chinese policymakers have reacted to growth weakness with easier policy



Note: Shaded areas refer to periods when China CAI growth was below 6%.

Source: Goldman Sachs[12].

The bottom line is this – since the state sector controls both monetary and fiscal policy, China is likely to better manage the economic cycles that impact capitalist economies like the United States. However, as China's economy continues to open to global trade that balance may be threatened. In the US, we typically dissociate political change and economic performance, but in China the two may very well be inseparable. As China continues to grow, it becomes more and more likely to experience growing pains.

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In The Grand Scale Of Things

One of the most common topics in portfolio management today, especially between financial advisors and their clients, is the importance of diversification. And one of the key tenets of that diversification is correlation. We've covered correlation in previous missives but thought it imperative to circle back given the outstanding performance of both stocks and bonds in 2019.

To recap and to start, what is correlation? It's the degree to which two series deviate in similar fashion from their respective trends. In other words, if one goes up and the other goes down, there is negative correlation between those two items. Stocks and bonds have, in fact, generally followed this pattern over the last 30 years.[13]

But correlation is a partial measure and fails to capture the relative performance of the two items. For example, if one trend is positive and the other is negative, they can still be positively correlated if they move in similar fashion within their respective trends. Thus, in the grand scheme of things correlation doesn't tell us anything about the actual returns and only very little of how the two series perform relatively.

So why is this important? Because correlations are often used as the crux of investment decision making, but there in fact only one piece of a larger pie. Bonds have generally been a good hedge for stocks because their returns have typically been positive, but not necessarily because correlations have been negative[13]. Remember to consider this within the larger scope of your investment plans.

Looking Forward

This new year will be dominated on all fronts by politics. From the democratic primaries in the first quarter, the democratic convention in the third quarter, and the election in the fourth quarter, there will be no lack of political headlines. But as touched on earlier, politics and the economy in the United States are largely independent, and investment strategies shouldn't necessarily change simply due to elections.

In the short-term, economic policy, monetary policy, and the psychology of the markets will determine investment performance. But as long-term investors, we believe in focusing on your financial plans to meet your goals, not timing or speculating on markets. The capital markets will wax and wane, but your financial plan will help you get through the turbulence. Remember to consult your financial advisor if your situation changes.

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As Of December 31st, 2019.

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References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index

Core intermediate bonds[4] – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds[5] – as represented by the ICE BofAML US High Yield Index

Emerging market bonds[6] – as represented by JPM Emerging Market Bond (EMB) Global Index.

Global government debt[7] – sourced from Reuters, "Global sovereign debt to jump to $50 trillion – S&P Global."

Modern Monetary Theory Breakdown[8] – sourced from "The Threat to Limit Capital Flows to China and Pending Impeachment Conflict: Next Logical Steps in a Classic Dangerous Journey?", Ray Dalio, 1 October 2019.

Advanced Government Debt Chart[9] – sourced from Goldman Sachs, "Top of Mind: Fiscal Focus", November 2019.

China's Annual GDP[10] – data from Wikipedia, "Historical GDP of China."

Chinese/US economic & monetary policy[11] – sourced from "China's Fiscal Policy: How Is It Different?", Goldman Sachs, November 2019.

Chinese policy chart[12] – sourced from Goldman Sachs, "Three uses of our 'China domestic policy proxy'," October 2019.

Stock/Bond Correlation[13] – sourced from "Does the Stock-Bond Correlation Really Matter?", PIMCO, November 2018.

US Stocks and Markets[14] – sourced from "Stocks on Track for Best Year Since 2013", The Wall Street Journal, December 2019.

Glossary:

Spreads[a] – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Fiscal spending & budget deficits[b] – fiscal spending relates to all government expenses, and a budget deficit implies a government is spending more than it is receiving from taxes, interest, etc.

Liquidity vs Solvency[c] – liquidity relates to having enough cash on hand to continue operating in the short term, while solvency relates to the long-term and whether or not equity is sufficient to continue operating.

Repos (repurchase agreements) – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that's neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.

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