OUR FAMILY OFFICE

2020 Market Outlook & Review

February 14, 2020

OFO Perspective on 2020

"Approach each new problem not with a view of finding what you hope will be there, but to get the truth, the realities that must be grappled with."
- Bernard M. Baruch

Market commentators love waxing eloquent each time we turn a calendar page; however, the reality is that starting a new year amounts to crossing a completely arbitrary threshold. Global economic momentum and the trajectory of corporate earnings will most assuredly turn out to be the same on the first day of a new year as they were on the last day of the preceding year! Nonetheless, it presents an opportunity for market forecasters to capture the imagination of investors (and perhaps their wallet) with all manner of wild prediction.

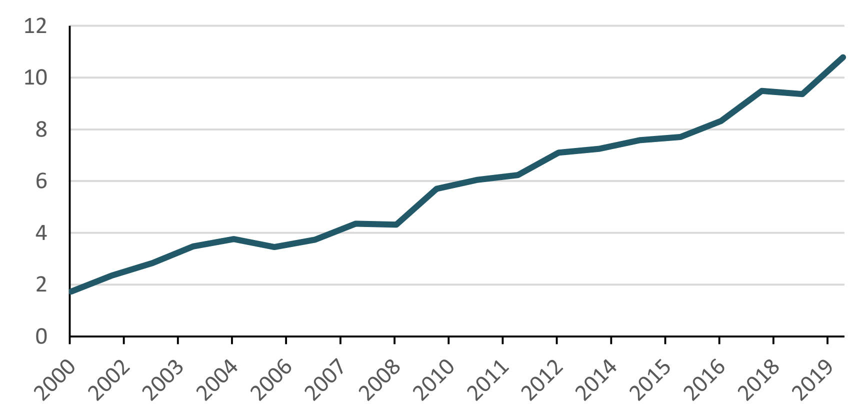
Recognizing this, we are immediately reminded of why we step back from media outlets of the world so as to identify and focus on the larger forces at play, those predominantly responsible for long-term investment outcomes – and thus success. In so doing, we detach from any fear of missing out on another 30% year in equity markets, an emotional response that appears to be driving irrational allocations into equity markets early in 2020.

We recognize that valuations have become stretched (Chart 1), that a debt bubble is most likely forming in some developed nations (Chart 2) and that monetary authorities around the world have a problem with low interest rates. Positively, it brings into focus that Coronavirus does not, at this point, represent a permanent impairment to asset values, and thus shouldn't drive more than a temporary and modest pullback in investment portfolios.

The investment team at Our Family Office endeavours constantly to find reasonable risk-adjusted return opportunities for our clients' capital, but always minding the risks and aiming to preserve capital above all else.

Chart 1: S&P 500 Valuation Peaking (EV/EBITDA Ratio)

Chart 2: Aggregate Global Corporate Debt (US$T)



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Candidly, our incessant focus on risk and capital preservation most likely causes us to be overly conservative when markets begin exhibiting typical late-stage symptoms. In this category, we presently observe, 1) cycle high equity valuations, 2) a record high proportion of investment grade debt only one notch above junk (Chart 3), 3) notably weak global manufacturing indicators (Chart 4), and 4) moribund earnings growth, with Q4 U.S. earnings per share tracking only +2% over 2019 and Europe showing no growth at all.

That said, let's keep things in perspective by noting some important economic indicators, namely employment and consumer spending, remain strong and keep us from recommending clients stock up their bunkers with water, canned goods and gold bars. Indeed, the market backdrop appears more likely to cause a shallow correction/mild recession scenario than anything involving parallels to the Global Financial Crisis.

Mercifully, we're not in the business of calling market tops and bottoms. Our role is to provide prudent portfolio allocations that stand the test of time, i.e. OFO All-Weather Portfolios. Accordingly, we continue to reduce allocations to traditional equities in favour of non-traditional capital appreciation opportunities. Reducing market risk and portfolio volatility during later stages of the longest bull market in history observes our predilection for avoiding unnecessary risk and capital impairment. Re-allocating to Multi-Strategy Absolute Return mandates aims to continue delivering reasonable portfolio returns throughout what may prove to be a more challenging next few years.

Chart 3: Record BBB Issuance as % of Global Inv. Grade Debt

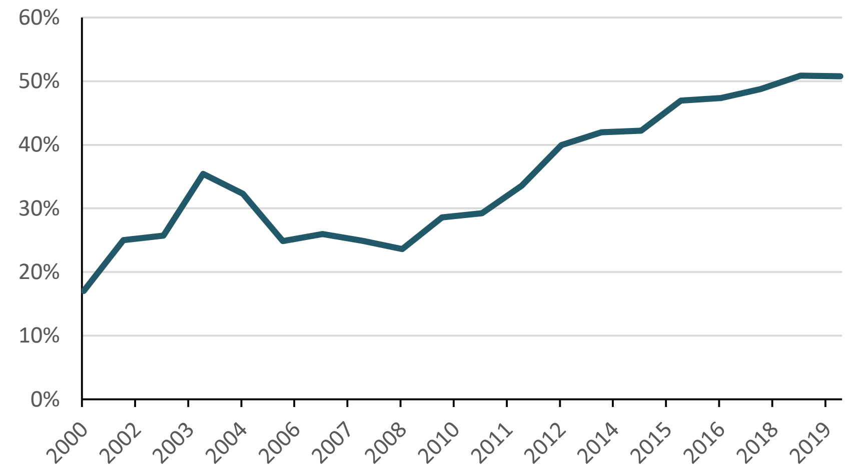
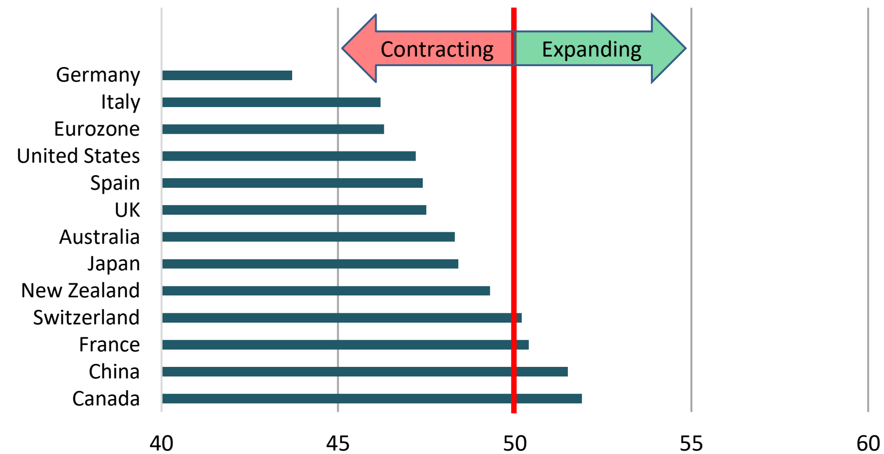


Chart 4: Global Manufacturing Contracting (Dec. PMIs)



2019 At a Glance

Against all odds, 2019 proved to be a stellar year for almost every asset class and especially for traditional equities (Chart 5). Indeed, rare is the year when investors make double-digit returns on just about everything (Table 1).

Headlining the year's challenges, China – U.S. trade tensions created significant headwinds at every level of the global economy. Governments wrangled tariffs and their domestic implications while the corporate sector struggled to make reliable capital expenditure plans, well known to be the underpinnings of future economic growth. Bottom line, the effects of this economic and political stand-off over trade are most visible in contracting global manufacturing indices and particularly in the auto production recession. It's worth noting, unfortunately, that none of this was good for Canada, which now rests perilously on the edge of recession.

Incredibly, however, global trade tensions, slowing growth in China, moribund corporate investment and earnings growth, and even the threat of President Trump's impeachment were not enough to shake investors' appetite for risk assets. The fourth quarter in particular, which saw partial resolution of trade disputes, drove many global equity markets to fresh all-time highs, led by technology stocks but notably including bond proxies too.

By the end of 2019, volatility remained under control due to broad-based buying on trade relief. Correlations among stocks and also between stocks and other traditional asset classes, reached elevated and dangerous levels. With so much complacency built into the valuation of risk assets, especially at a time of slow global growth, we are left to wonder what justification those adding to stock positions are using to predicted next leg of growth.

Indeed, rare is the year when all asset prices rise. Rarer still is it to see two of those years back-to-back. Look for divergencies to emerge in 2020.

Chart 5: S&P 500 Index

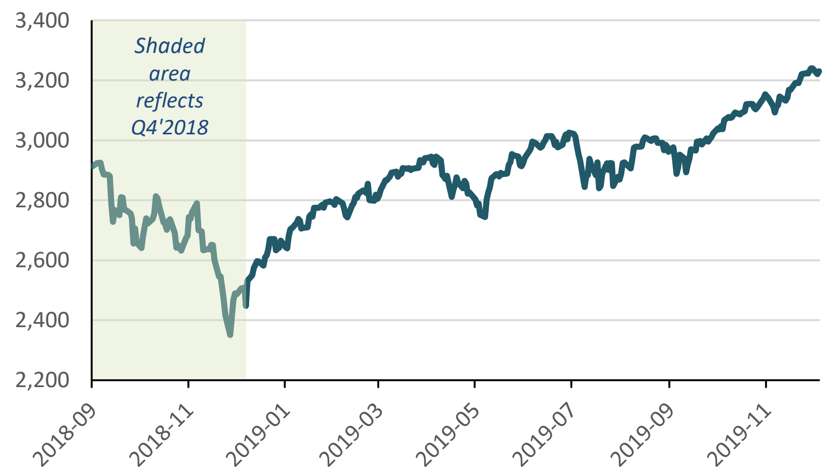


Table 1: Summary of 2019 Investment Returns

	2018	Q4 2019	2019
Canadian Large Cap: TSX Comp	-8.9%	3.2%	22.9%
US Large Cap: S&P 500	-4.4%	9.1%	31.5%
US Small Cap: Russell 2000	-11.0%	9.9%	25.5%
US REITs	-3.6%	0.0%	28.5%
International: MSCI EAFE	-10.5%	5.2%	22.3%
Japan: TOPIX	-16.0%	8.6%	18.1%
UK: FTSE 100	-8.7%	2.7%	17.3%
Eurozone: Euro Stoxx 50	-11.3%	5.2%	29.3%
Emerging Markets: MSCI EM	-9.7%	9.6%	18.5%

Global Equities

Recall the situation in December 2018: stocks were suffering through a nearly 20% decline in the quarter, and sentiment was pessimistic. The Fed had raised interest rates four times during the year, hoping to return to more "normal" levels after years of near-zero policy rates. U.S. economic growth was slowing after the burst from the tax reform package passed in late 2017. Growth in Europe and China was also slowing, and a possible acceleration in the trade dispute between the U.S. and China threatened to make things worse. On top of all that, the federal government was shut down over spending disagreements between Democrats and the White House.

If we had known at that time that S&P 500 earnings growth in 2019 would be virtually zero, what would a rational forecast for stock market returns have been for 2019? Probably not so great.

Well, the results are in, and they exceeded even the most bullish market forecasts. The S&P 500 surged 31.5% in 2019 (including dividends), posting the best performance since 2013. The MSCI ACWI, the broadest measure of global stock market performance, vaulted 26.6%. Overseas, the MSCI EAFE Index of developed market economies jumped 22.3%, while the MSCI Emerging Markets Index was the relative laggard at 18.5% (Chart 6).

In stark contrast to 2018 when the best performing asset class was cash, it was hard to avoid making money in 2019. So what caused the big reversal? Most obviously, it was a notable change in monetary policy by the Fed. The old market adage "don't fight the Fed" was never more true than in 2019. After the Fed cut rates once in December 2018, it proceeded with three more cuts in 2019. The Fed's efforts to keep rates low, along with the unconventional capital injections made in the fourth quarter to stabilize the short-term repo market, provided the necessary boost to liquidity and investor confidence to drive most markets to all-time highs by year-end.

Chart 6: Global Equity Markets (Indexed to 100)

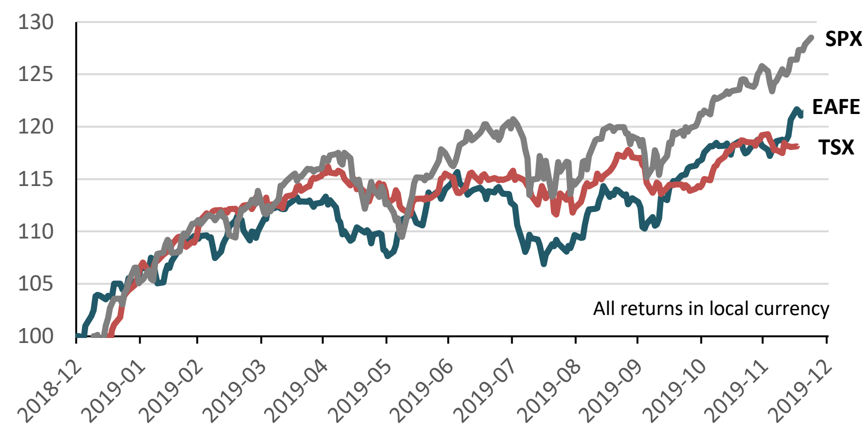
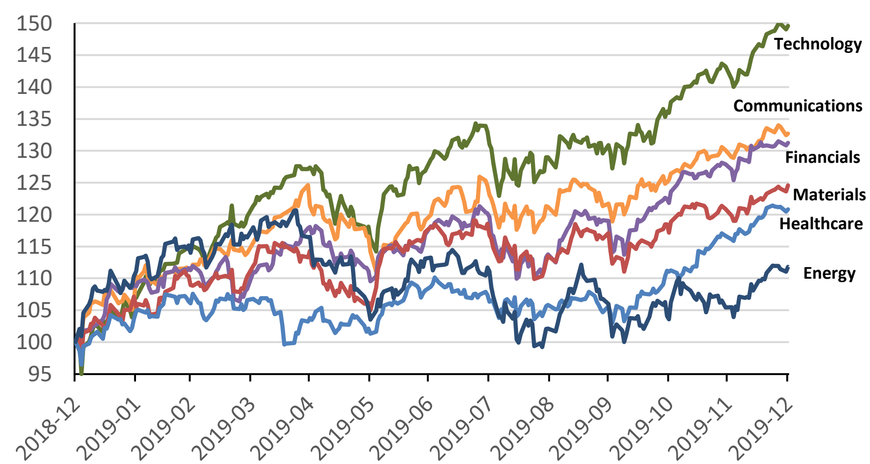


Chart 7: Top & Bottom S&P 500 Sectors (Indexed to 100)



Global Fixed Income

The great performance party of 2019 was not limited to just equities. Where 2018 saw a painful confluence of falling risk assets *and* declining bond prices, principally owing to rising rates, the opposite played out in 2019. Falling interest rates (Chart 8) propelled bonds and other interest-sensitive assets to a year of above-average returns.

The broadest measure of U.S. investment grade bonds, Bloomberg Barclays U.S. Aggregate Index, gained 8.7% in the year, and lower-rated high yield bond indices surged nearly 15%. Moreover, the broader Bloomberg Barclays Global Aggregate Index rose a decisive 6.9%, so strong results were not isolated incidents.

Traditionally referred to as "bond proxies", interest-sensitive equities all the way to real asset categories, such as real estate investment trusts (REITs) and infrastructure, rallied more than 20% in 2019. Even the volatile energy pipeline sector, as measured by the Alerian MLP Index, rose 6.6%, helped by both falling rates and strong oil prices.

More on the cautionary side, we note U.S. corporate credit spreads are at cycle lows (Chart 9), which in the best of cases indicates limited remaining upside. Further, in late summer and early fall, the U.S. yield curve inverted, which refers to a situation when long-term yields fall below short-term yields. This matters because every U.S. recession since 1955 has been preceded by an inverted yield curve, although not every inversion has produced a recession. With an average duration between inversion and recession of about 1.5 years, we'll be watching carefully for additional signals in 2020.

Chart 8: Ten Year U.S. Treasury Yield (%)

Chart 9: U.S. IG Corporate Credit Spread (bps)

Currencies & Commodities

Crude oil had a strong fourth quarter and ended the year up significantly (Table 2), owing to several notable factors. China – U.S. trade deal optimism provided a much-needed boost on the demand side, while Middle East tensions and production cuts by OPEC+ factored into lower supply expectations. Thankfully, calmer heads prevailed in the Iran – U.S. stand-off, sparked by the killing of a top Iranian general. Oil has since returned to the lower end of its 2019 range where, in the absence of a new catalyst, it appears likely to remain for the foreseeable future.

Natural gas, on the other hand, is one of the few assets that really struggled in 2019, falling almost continuously and ending the year only pennies off it's low. Everything conspired against the commodity, from milder weather sinking demand to structural forces lifting supply, e.g. record high U.S. production. With the latter unlikely to change any time soon, the outlook for Nat Gas is not particularly bright.

Gold was a particularly curious high-flyer in 2019, soaring 18.9% (USD). While positive on the surface, we note this also represents a warning sign coinciding with typical late-stage, risk-off portfolio positioning. In this instance, falling real rates definitely boosted gold's appeal as a store of value; however, we've learned over cycles past not to ignore soaring gold prices.

Lastly on currencies, the Loonie rose modestly against most major global currencies, largely on the back of higher absolute interest rates. Although the economic backdrop suggests weak underpinnings for CAD, discussed next, currencies adhere to different drivers at different times. Globally, the growing stock of negative yielding debt supports the value of CAD on the interest rate differential alone. Also of note was the modest USD underperformance against Swiss Franc (CHF) and Japanese Yen (JPY), classic safety currencies and typically good warning indicators (Table 3).

Table 2: Commodities (USD)

	2018	Q4 2019	2019
Commodities	-11.2%	4.4%	7.7%
Agriculture	-8.0%	5.8%	-0.3%
Copper	-17.5%	7.9%	3.4%
Natural Gas	4.8%	-16.3%	-32.3%
Crude Oil	-25.3%	13.0%	35.4%
Gold	-2.1%	3.4%	18.9%

Table 3: Global Currencies vs. USD

	2018	2019	2019 USD Direction
EUR	-4.25%	-2.40%	USD Stronger
JPY	2.69%	0.91%	USD Weaker
GBP	-5.76%	4.11%	USD Weaker
AUD	-9.73%	-0.61%	USD Stronger
CAD	-7.57%	4.61%	USD Weaker
CHF	-0.96%	1.71%	USD Weaker

Distilled to its most basic description, momentum investing parallels the Newtonian principle that an object in motion tends to stay in motion. In practice, markets need to demonstrate growth to maintain a rising trend, i.e. stay in motion. To sustain growth, there needs to be an ever-increasing source of liquidity. This is a critical link in understanding the relationship between markets and their economic underpinnings.

It’s accepted convention that monetary authorities around the globe inflated their way out of the Great Financial Crisis with massive outright liquidity injections and by lowering interest rates, which fosters increased liquidity through greater borrowing. Essentially, supplying cheap money to individuals and corporations was intended to spur investment and spending.

Gauging the success of this approach by examining unemployment, housing prices and non-manufacturing economic indicators (Table 4), it would be fair to call it a raging success. If, however, you look at the proportion of debt on business and consumer balance sheets compared to pre-crisis levels, it becomes clear the price of this success was the future vulnerability of developed economies to higher interest rates.

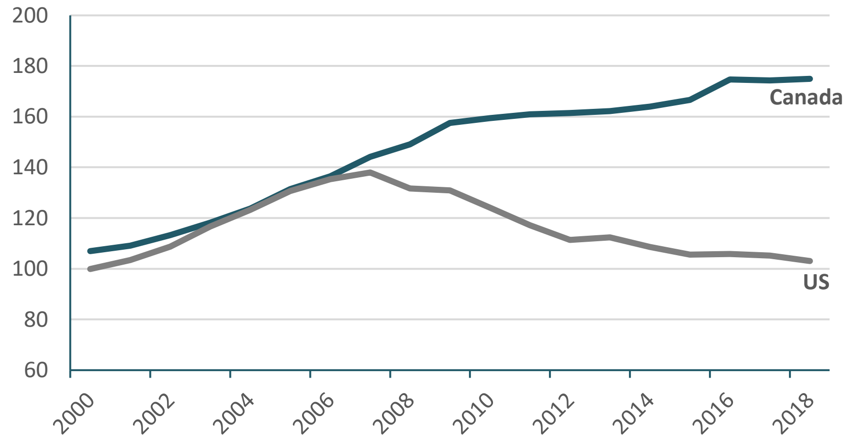
In Canada, for example, families have taken on a greater amount of debt relative to their income than at any point in history, leading the world in this unenviable measure (Chart 10). While interest rates remain low, this incremental debt load appears manageable, though barely. If rates begin to rise appreciably, however, research and polling both show the average Canadian household will likely struggle to meet their financial obligations.

Unfortunately, over-indebtedness of this nature is prevalent across developed nations and makes the global economy highly sensitive to interest rates. Accordingly, it seems likely “lower for longer” will last quite a while.

Table 4: Key Economic Stats (U.S.)

		Current		Previous	
GDP	Year over Year (%)	2.1%	Q4-19	2.1%	Q3-19
Industrial Production	Year over Year (%)	-0.83%	Jan-20	-0.91%	Dec-19
Prices	CPI Year over Year (%)	2.5%	Jan-20	2.5%	Dec-19
	Core CPI Year over Year (%)	2.3%	Jan-20	2.3%	Dec-19
Labour	Unemployment Rate (%)	3.5%	Dec-19	3.5%	Nov-19
	Non-Farm Payrolls ('000s)	145	Dec-19	256	Nov-19
ISM Econ Indicators	Manufacturing	50.9	Jan-20	47.8	Dec-19
	Services	55.5	Jan-20	53.9	Dec-19
House Prices	Case-Schiller Index (%)	2.2%	Dec-19	2.1%	Nov-19

Chart 10: Household Debt to Disposable Income (%)



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Data sources for charts and tables: Morningstar, Bloomberg, Bureau for Economic Analysis, and StatsCan.