Ever Changing ... Never Changing

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We titled our third-quarter 2018 market commentary "Goldilocks and the Three Fears" because our thesis was that the U.S. economy was in a well-balanced environment marked by low inflation and relatively strong economic growth. Still, investors were worried about three things: the Federal Reserve tightening the U.S. economy into submission; ill effects from the U.S.-China trade war; and fears of being the last person in before a big market plunge. We felt that all three of these fears would dissipate and the economy and markets would continue hitting new highs. The trio of fears caused an ugly fourth-quarter 2018 market plunge that drove U.S. large cap stocks down by nearly 20 percent, but throughout 2019 these fears all faded — as expected — and stocks posted a banner year as a result.

In January 2019, the Federal Reserve reversed course and broadcast to investors that the central bank was prepared to bolster markets through economic troubles. This promise kept markets afloat while the trade war twisted and turned and fueled uncertainty throughout the first three quarters of 2019. Trade uncertainty peaked in the third quarter as political tensions reached unprecedented heights and threatened to topple both the economy and markets. However, we held fast in our belief that some sort of a trade deal would be reached in the fourth quarter. As 2019 ended, the U.S. and China finally agreed to a phase-one trade deal that has cooled the political temperature.

Although investors are now less fearful, sentiment remains relatively subdued and far short of euphoric levels that typically precede market contractions. We note that investors continue to park elevated levels of investible dollars in money market funds, which we view as a positive because we believe these "dry powder" reserves could provide fuel for continued equity market gains in 2020, given our forecast for a U.S. and global economy that continues pushing higher.

Despite our relatively positive outlook, geopolitical and recessionary fears are still noisy. However, if you filter out the chatter, you'll hear a normal, healthy business cycle ticking in the background. We think 2020 will be much quieter than 2019, and that should allow economic fundamentals to steal the show. And if the market party gets too rowdy, no worries, the Federal Reserve will not follow its historical script of removing the punch bowl by raising interest rates to moderate growth. As the 2010s close and the 2020s are ushered in, investors need to understand the secular shift in the Federal Reserve's playbook. Let us explain.

This ain't Volcker's Fed anymore

Regular readers and listeners know that we've often discussed the seismic shift underway at the Fed. For starters, in 2019 we witnessed the Fed shift from hiking rates to ultimately cutting rates three times (and in consecutive policy meetings). Still, we believe this is evidence of a larger, fundamental philosophy at the Fed, which was solidified in late 2018 and throughout 2019.

But this course correction doesn't begin in third quarter 2018. Instead, we need to go way back to 1979. Four decades ago, the U.S. was besieged by runaway inflation that was causing all sorts of trouble for the economy. The Fed had tried but failed to quell this incipient beast as inflation heated up to 11.3 percent year-over-year on July 31, 1979. To slay the beast, President Jimmy Carter nominated Paul Volcker to head the Fed in early August, and he swiftly began aggressively raising interest rates. After watching inflation top out at 14.8 percent in early 1980, Volcker's actions eventually drove inflation much lower, even if the higher costs associated with mortgages and other loans were a bitter pill to swallow. When Volcker left the Fed eight years later, inflation checked in at a moderated 3.9 percent. And for much of the past 40 years, the Fed has been following Volcker's script and built a reputation as an inflation-fighting entity. Unfortunately, in December 2019, Mr. Volcker passed away at the age of 92. While we mourn his passing, we believe it has come to symbolize a major shift in the Fed's playbook. Now, the central bank has moved from inflation fighter to inflation ally.

During a December 2019 press conference, current Fed Chairman Jerome Powell said the bar is very high for the Fed to even consider raising rates in 2020 and beyond. Chairman Powell at one point was asked a question related to the death of former Fed Chair Volcker. In his answer, Chairman Powell talked about the hard-earned inflation-fighting credibility that took the Fed years to earn once Volcker showed them the blueprint. But now, he said the Fed is effectively trying to unwind its inflation-fighting reputation and convince the markets that Fed officials are squarely focused on pushing inflation expectations higher. Chairman Powell concluded by saying that, just as it took time to gain inflation-fighting credibility, it will take time to earn its inflation-enhancing stripes after a prolonged period of relatively low inflation.

We believe there is no chance the Fed hikes rates in 2020. Given President Donald Trump's public flogging of the Fed, coupled with former Federal Reserve Bank of New York President Bill Dudley's op-ed in the *Bloomberg Opinion,* where he essentially urged the Fed to contemplate how rate cuts may impact the 2020 election, we think rate hikes are a non-starter so close to the election.

Importantly, in the intermediate to longer term, we believe the Fed has completely changed its philosophy. Today, the Fed is focused on increasing the longevity of economic cycles. The Fed now believes its actions can cure the divides between the haves and the have nots, something that the "old" Fed left to the purview of fiscal (government) policymakers. Importantly for investors, the Fed now "listens" to the markets. If the market falls as it did in Q4 2018, the Fed will shift course and intervene to help push it back up. Case in point: The Fed's 2019 economic forecast is largely going to play out, but rather than hiking rates two more times as it initially expected, the Fed ended up easing three times. That's because the markets spoke, and the Fed listened.

Today, the "new" Fed is an important factor in our investment process and outlook, given our belief that the central bank plays a critical role in determining the direction of both economic and market cycles. We believe that recessions cause bear markets and that recessions in the past have been triggered after the Fed raised real interest rates above the real opportunity of borrowing money (economic growth). We don't believe this condition has yet been met, and we don't believe the Fed has any desire to get there anytime soon. The 2010s were the only decade without a recession (going back to 1854), but that doesn't mean one is knocking on the door – economic expansions don't die of old age. As we enter the 2020s, we continue to see a rising economy and rising markets.

Our general outlook for 2020

While we believe markets will continue to move higher in 2020, we think the leaders that pull it higher will be different. Last year, investors were focused on the three fears mentioned at the open of this commentary, and their remedy has been to invest with a defensive tilt. Large cap U.S. stocks and defensive U.S. sectors, such as consumer staples, utilities, and REITs, have been relative winners as a result. We believe that as investors shake off their fears and economic growth re-strengthens, cyclicals and other sectors will take pole position from more defensive plays. We particularly like the prospects for U.S. small cap stocks and even international securities in the 2020 performance derby.

While this is our current forecast, there will inevitably be many twists and turns in the future and we promise to continue looking forward in an attempt to navigate the ever-changing landscape. And that brings us to our closing comments. Given that this is the beginning of a new decade, we thought it was an opportune time to look back and reinforce why investing based on past performance and abandoning diversification is a bad formula for financial success – in any decade.

The 2010s saw U.S. equities greatly outperform their international counterparts, which has once again led many investors to believe they should pile into U.S. stocks at the expense of international securities in their portfolios. This reminds us of a similar set up 20 years ago, back in 1999, when U.S. assets were likewise investors' darling simply because they had outperformed their international counterparts. At the time, U.S. assets made up nearly 57 percent of the world's global investible universe (international 43 percent). What happened next? U.S. large cap securities disappointed rear-view mirror investors with a -.95 percent return during the 2000s. That was in stark contrast with the more than 10 percent return provided by International Emerging Markets in the 2000s. We'd also be remiss not to remind that one of the best-performing asset classes was Commodities in the 2000s, and many couldn't get enough exposure at the time.

Of course, by December 31, 2009, investors once again were focused on what had recently worked to inform their outlook. International Markets were now the darlings as they represented 57 percent of the global market after their decade-long outperformance. Unfortunately, many of those investors likely missed much of the recent U.S. rally. We continue to worry that many investors are setting themselves up for similar trouble by shifting their portfolios to reflect the recent outperformance of U.S. securities. Times change, and so do leading asset classes. Today, much like in 1999, not many investors have commodities and emerging markets at the top of their 2020 wish list, but their mood will almost certainly change — someday. With strategic diversification, you'll already be in position to capture some upside when sentiment shifts, regardless of the asset class that leads over the next year, or decade.

The world is uncertain and diversification remains the best antidote to uncertainty. After all, how many in 2009 would've predicted that bonds in some parts of the globe would have negative yields during the decade? How many in 2009 would've believed that U.S. oil production would have gone from 5.9 million barrels per day in late 2009 (down from 10 million barrels per day in 1970) to today residing at nearly 13 million barrels per day? Remember the Tea Party and government fiscal responsibility? Today, most policymakers are pushing for more debt and heavy spending (for more information, just dig into what's known as modern monetary theory). Today, inflation is a friend after so many years as the enemy. And, finally, how many would've predicted that Amazon would go from employing 24,000 people in 2009 to over 750,000 today and provide investors with a nearly 30 percent annualized return while General Electric would shrink and provide a measly 0.26 percent return? It's impossible to perfectly predict the future, but it is possible to put yourself in a good position to weather a wide variety of outcomes.

There are other notable headlines, but the takeaway here is that the world is a fluid place with countless moving parts. For every expected outcome, the world throws us surprises — so-called, unknown unknowns. Asset classes go in and out favor, but rarely ever die. Remaining rational is of essence and the best path forward remains a carefully considered financial plan, implemented with the help of a skilled financial advisor, using an integrated portfolio of world-class insurance and diversified investments.

Happy New Year.

There are a number of risks with investing in the market; if you want to learn more about them and other investment related terminology and disclosures click here.