MAINSTREET ADVISORS
2019 YEAR-END REVIEW

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DON'T FIGHT THE FED

If a future market historian sought to understand the path investment markets took in 2019, he or she would be best served to begin with an examination of the U.S. Federal Reserve's interest rate policy as the largest determinant. More specifically, they would want to focus on Fed Chair Jerome Powell and his fellow Federal Open Market Committee (FOMC) voters' evolution from tightening policy throughout 2018 to loosening it by the summer of 2019. In our opinion, the effects this shift had on stock prices, bond yields and investor sentiment cannot be emphasized enough. The second broad development of markets in 2019 which deserves to be featured by future chroniclers was the glaring disagreement throughout the year between an optimistic view taken by stock and corporate credit markets versus a significantly less hopeful one priced by government bond markets. Finally, a third storyline worthy of attention was the disconnect between a weakening manufacturing picture in the U.S. and a steadfast level of consumer sentiment and activity.

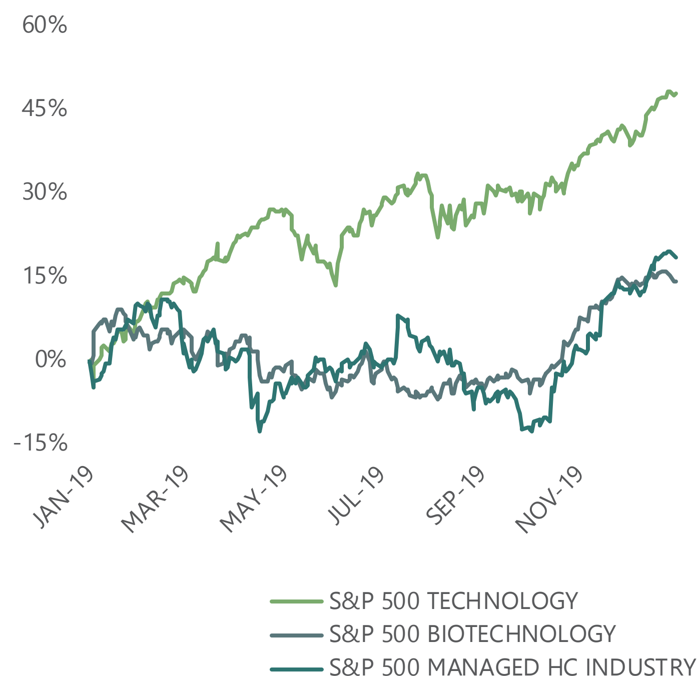
CHANGE OF PLANS

After five consecutive quarterly interest rate increases concluding in December 2018, Federal Reserve policymakers began to adopt a less aggressive stance toward rate hikes in the first weeks of 2019. In large part due to concerns that further interest rate hikes in 2019 would derail the economic expansion, equity markets plunged deeply enough in the fourth quarter of 2018 to erase all of their gains from the first three quarters of the year. In the first several weeks of 2019, however, notable Fed officials started to communicate a more patient, data-dependent approach toward interest rate policy. Up to that point many market participants viewed the Fed to be on "autopilot," ready to deliver a 0.25% rate hike every quarter until further notice. Throughout the first quarter, FOMC members conveyed in speeches and interviews a preference toward pausing interest rate hikes in the first half of 2019, citing a need to evaluate any growth-sapping effects from global manufacturing weakness and mounting trade policy risks. Following its March meeting this preference was made more official, as the FOMC's summary of economic projections showed the median voter expected no further rate hikes in 2019. This was a marked change from policymakers' December 2018 projections, in which the median voter expected two additional 0.25% rate hikes in 2019. Additionally, in comments following the March FOMC meeting, Chairman Powell indicated that the Fed intended to end the reduction of its balance sheet by September. This was another signal to markets from policymakers that the steady withdrawal of liquidity from the monetary system which began in earnest during the fourth quarter of 2016 was coming to an end.

The Fed's move to a neutral policy stance in the first quarter of 2019 combined with hopes for a de-escalation in tit-for-tat tariffs between the U.S. and China helped drive the S&P 500 higher by 17.5% in the first four months of the year. This enabled the benchmark to nearly recover from its steep decline in the final quarter of 2018. Notably, the much-maligned bull market in U.S. stocks reached its tenth birthday in March, becoming the longest in history by surpassing the bull market of the 1990s. U.S. large cap technology stocks were the biggest winners both in the first half of 2019 and for the full year across the entire global equity landscape.

Many consumer-oriented and software-driven technology sector companies seemed to benefit in 2019 from the anticipation, then delivery of, lower interest rates. This is due, in large part, to the support many of their stock market valuations receive from their long-dated future cash flows and earnings streams discounted back to present value with lower risk-free rate assumptions. Moreover, many of the largest and most well known of this cohort including Apple, Mastercard, Microsoft and Adobe benefitted from the widely held view that their growth trajectories are aligned with durable, secular themes and not closely tied to the ebbs and flows of the global economic cycle. Some of these themes include the ongoing transition from on-premises server power to cloud-computing, the shift from paper to electronic payments and the forthcoming rollout of 5G networks. Unlike the high-flying technology sector, healthcare stocks were stuck in neutral for most of 2019 amid a whirlwind of concerns. Blowback from mounting opioid crisis-related litigation, prescription drug pricing and several leading Democratic presidential nominees' plans to abolish the private healthcare industry held the S&P 500 healthcare sector to a pedestrian 4.2% gain in the first three quarters of 2019 compared to 18.8% for the broad index. Healthcare stocks staged a recovery in the fourth quarter following a reduction in several of the headwinds previously mentioned, but still recorded the second-lowest returns across all eleven S&P 500 sectors in 2019.

TECHNOLOGY AND HEALTHCARE DIVERGE
JANUARY 2019 THROUGH DECEMBER 2019

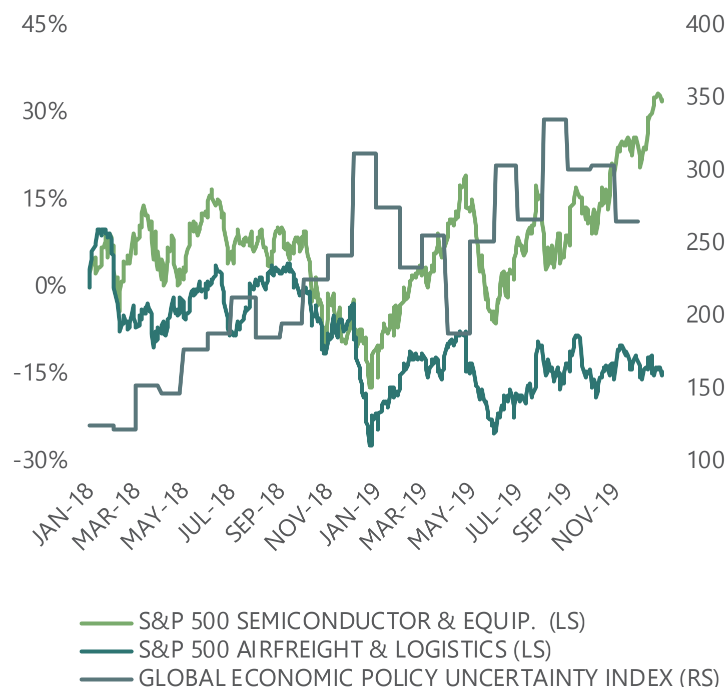


Source: Bloomberg. Past performance does not guarantee future results.

A RESTLESS SUMMER

As the calendar turned to May, a swift escalation of the U.S. – China trade war and subsequent breakdown in negotiations brought increased volatility and weakened investor sentiment despite a strong start to the year for stocks and the Fed's new wait-and-see approach. The S&P 500 recorded its seventh worst May since 1940 with a 6.6% monthly drop. Yields on the benchmark U.S. 10-year Treasury bond fell sharply from 2.53% at the end of April to 2.12% on May 31, at the time marking their lowest level since September 2017. The trade dispute between the U.S. and China intensified in late May when President Trump issued an export ban against Chinese telecommunications giant Huawei Technologies in an effort to prevent U.S. companies from supplying Huawei with crucial technology and components. The U.S. semiconductor industry's high exposure to Huawei caused this group to suffer significant share price declines during this period, underscored by the S&P 500 semiconductor industry index's 21% drop from April 24 to June 3. Despite this rough spell, of all the trade war-related industry groups, semiconductor and component stocks recorded some of the strongest full-year 2019 returns in the entire U.S. stock market. Shares of Advanced Micro Devices, LAM Research, Skyworks Solutions, Nvidia and Micron Technology all advanced by at least 70% for the year. While there were endless headlines about the pain caused by the trade dispute for semiconductor and heavy machinery makers, it was the automobile, air freight and logistics and communications equipment industries that were the trade war-related industries which underperformed the broad indexes by the most in 2019. In any event, a thawing of trade tensions between the world's two largest economies materialized at the G20 Summit in Osaka, Japan in the last weekend of June. There, the U.S. and China reached a temporary ceasefire by agreeing to hold off imposing new tariffs and to open up negotiations. The American side agreed to continue selling components to Huawei, while China indicated it would continue to buy U.S. agricultural products.

TRADE WAR-RELATED UNCERTAINTY
JANUARY 2018 THROUGH DECEMBER 2019

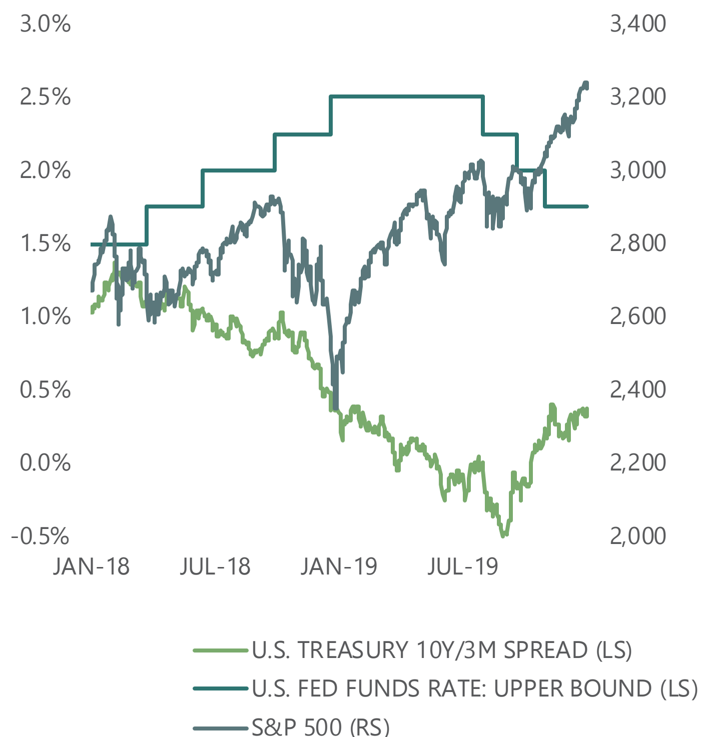


Source: Bloomberg. Past performance does not guarantee future results.

BOND MARKET SKEPTICS TAKE CENTER STAGE

While the trade policy diplomacy in Osaka helped stabilize equity markets for several months beginning in June, government bond markets began to reflect a much more pessimistic set of expectations for near-term economic growth. As noted above, U.S. 10-year Treasury bond yields plummeted in May to what were 20-month lows at the time. The downward shift in intermediate-term yields helped create an inversion in a key part of the U.S. Treasury yield curve which lasted from May 23 to October 11 except for one day in July. A yield curve inversion occurs when yields of shorter maturity bonds are greater than yields of their longer maturity counterparts. This interest rate structure has developed before every recession in the post-World War II era, although there have been several occasions where a yield curve inversion did not immediately precede a recession. While bond markets were in many ways signaling an economic downturn, major U.S. indexes traded in a range from the beginning of May to the end of September despite mounting trade policy risks and low expectations for earnings growth in coming quarters.

Over a roughly five-month period in the middle of 2019, equity markets were signaling that the current bout of economic and policy risks were likely to be transitory. Meanwhile the bond market seemed to be pricing in a much gloomier outcome. Over many decades, previous examples of this type of disagreement between bond and equity market expectations often led to pain for stock investors and self-congratulations across the government bond world. Many market commentators suggested that since the bond market has a much better track record of predicting economic downturns than the often-intemperate stock market, there must be a period of weakness around the corner. U.S. GDP is indeed expected to decelerate in 2020 to 1.8% from annual average growth of 2.5% from 2017 through 2019 according to Bloomberg consensus economists' expectations. Yet, this level of growth is a far cry from recession and can reasonably be described as a return to the trend of average annual GDP growth of roughly 2.0% from 2009 through 2016. We would argue that parts of this deceleration of domestic growth can be attributed to the fading effects of the December 2017 Tax Cuts and Jobs Act. Another important indicator of a healthy domestic economy that the bond market seemed to overlook was the labor market. The U.S. economy generated a monthly average of 176,000 non-farm jobs in 2019, which helped to push the unemployment rate to a 50-year low of 3.5% in the fourth quarter. Thus far, we would argue that the bond market pessimists have been more nearsighted than prophetic.

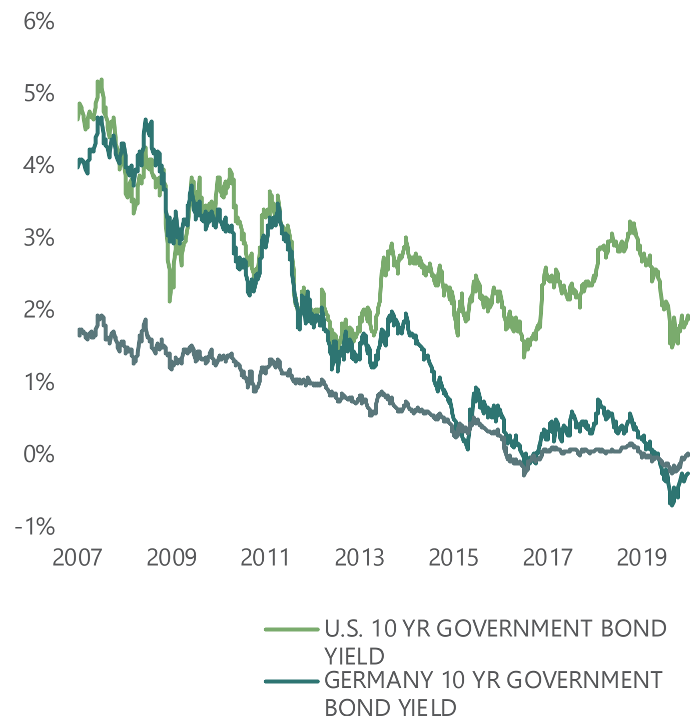


Source: Bloomberg. Past performance does not guarantee future results.

NEGATIVE YIELDS AND INVERSIONS

Given this ostensibly solid economic backdrop, could there have been other factors besides negative sentiment across large parts of fixed income markets on the prospects for U.S. economic growth that helped pressure U.S. government bond yields downward for most of 2019? We would answer "yes" and point to parts of the developed world outside American borders. Here, yields on intermediate German government bonds went into negative territory in early May and stayed negative for the remainder of the year. Amazingly, yields on the German 30-year government bond dipped into negative territory for about six weeks in the late summer. Even more amazingly, Austria, with an economy the size of Mississippi, issued a 100-year maturity government bond in September 2017 with a 2.10% coupon that saw its yield dip below 0.70% in the second half of August. A similar environment had already existed in the immense Japanese bond market, where the Bank of Japan explicitly targets a nominal yield of 0% for its 10-year government bonds. As recently as August, there were $17 trillion of global bonds worldwide with negative yields. Given this backdrop, the demand for even a modest nominal yield from large institutional buyers in major economies like Germany and Japan, including insurance companies and pension funds with long-dated liabilities, very likely helped put a ceiling on U.S. Treasury yields in 2019.

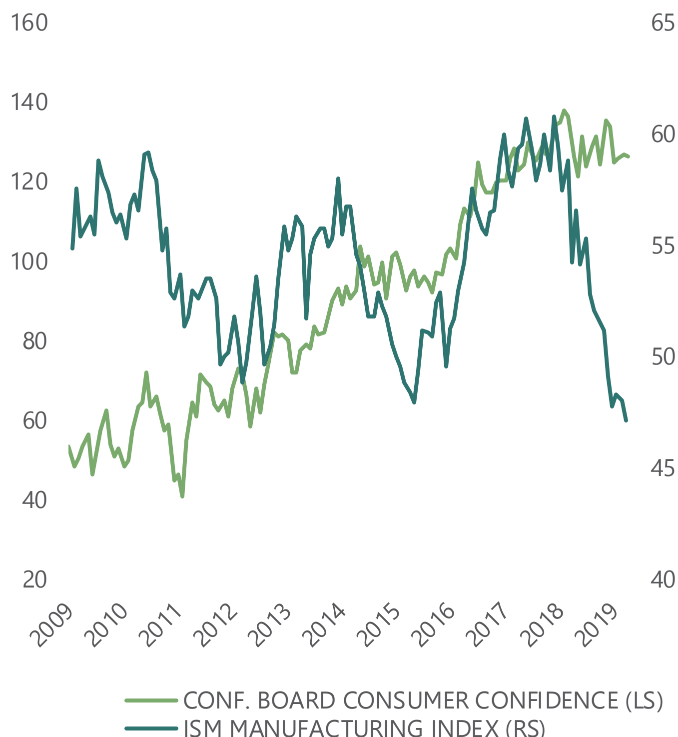
As the summer months rolled along, domestic bond markets still seemed to be anticipating an economic downturn even after the FOMC delivered, in late July, its first 0.25% cut to its policy rate of the eleven-year economic cycle. Recession fears in the U.S. government bond market seemed to peak in the final week of August, as yields on the benchmark U.S. 10-year Treasury bond fell below 1.50% and within striking distance of the 1.36% all-time low reached in June 2016 following the surprise Brexit referendum result. Meanwhile, the yield differential between the 10-year U.S. Treasury bond and the 3-month note (the 3-month – 10-year yield curve) plunged deeper into negative territory to move below -0.50% in the last days of August. A discouraging escalation in the Sino-American trade war driven by another round of reciprocal rounds of tariffs and the Trump Administration's threat to label China a currency manipulator spooked all global markets in August.



Source: Bloomberg. Past performance does not guarantee future results.

CONSUMERS AVOID A MANUFACTURING GLITCH

In addition to recession fears and pressure from ultra-low government bond yields abroad, U.S. fixed income markets may have been pricing in another potential risk in the form of a contraction in the domestic manufacturing sector seeping into the consumer side of the economy. As seen in the chart (right) the Institute for Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) fell into contractionary territory below a reading of 50 in August and September for the first time since early 2016. The ISM PMI is a sentiment-based data series or so-called "soft data" based on responses to a set of questions from a sample of managers making purchasing decisions at U.S. manufacturing companies. In late summer, a majority of these respondents cited expectations for weakness in new orders and export activity for the first time in over three years. It seems likely to us that the festering trade dispute caused increased uncertainty related to supply chain management and business expansion for at least a portion of the respondents to the ISM Manufacturing PMI survey. Outside of the trade clash, the 40-day General Motors labor strike and disruption to aerospace supply chains from the production delays for Boeing's 737 Max commercial airliner probably contributed to the erosion of manufacturing sentiment given the size and scale of the two firms' operations. Despite the reduced size of the U.S. manufacturing sector relative to the overall economy in 2019 compared to one or two generations ago, many economists and market commentators still view it as a leading indicator for the overall economy. So, in the late summer and early fall, there was no shortage of alarm bells raised across the financial news media that the slowdown in factory activity would weigh down consumer spending once American workers with manufacturing jobs began to see reduced demand for their labor. Up until this point, the consensus view was that U.S. consumers had been the stalwart component of the economic expansion. The final four months of 2019 brought no convincing evidence that manufacturing sector weakness caused consumer confidence to falter or the labor market to stall out in any meaningful way. Widely followed sentiment indicators and national retail sales numbers have been solid in recent months. Meanwhile, better-than-expected second quarter and third quarter sales growth numbers from large national consumer-oriented companies including PepsiCo, Walmart, Target and Costco suggested that U.S. consumer activity remained strong heading into the holiday season.



Source: Bloomberg. Past performance does not guarantee future results.

TRADE TRUCE AND FED LIQUIDITY TO THE RESCUE

By the time September drew to a close, the FOMC had delivered a second widely anticipated 0.25% rate cut with Chairman Powell citing uncertainties surrounding global growth and trade policy risks and indicating that the Fed would "act as appropriate to sustain the expansion." Meanwhile, an easing of tensions between the trade delegations from the White House and Beijing led to the first whispers of a so-called "phase one" trade deal to be struck between the two belligerents in the fourth quarter.

While the Fed's September rate cut was largely priced in by markets, its injection of a large dose of liquidity into short-term funding markets in October amounted to an unexpected additional layer of easing. To soothe building stress in overnight lending markets, on October 11, the FOMC announced its plans to purchase $60 billion of short-term U.S. Treasury bills each month through June 2020. Policymakers strained to differentiate between this temporary measure and large scale bond purchases under various rounds of quantitative easing (QE) from 2008 through 2014. Yet, we would argue that up to $500 billion of planned short-term bond purchases is a significant expansion of the Fed's balance sheet just like the installments of QE in years past. Several weeks after the announcement of short-term bond purchases the FOMC made a third consecutive 0.25% rate cut on the day before Halloween, moving the federal funds rate to a target range of 1.50% to 1.75%. From July through October, the Fed's three 0.25% interest rate cuts unwound 40% of its interest rate hikes from December 2015 through December 2018.

Combined with its infusion of cash through U.S. Treasury bill purchases, we believe policymakers significantly increased liquidity across the U.S. financial system and helped create an environment where stocks, real estate, high yield bonds and other risk assets can continue to grind higher. This backdrop propelled the S&P 500's 8.5% fourth quarter advance. All told, approximately 75% of the S&P 500's 29% gain in 2019 came in the first and fourth quarters, while the middle of the year produced more pedestrian returns.

Higher valuations applied to U.S. stocks drove the lion's share of gains in 2019, as the S&P 500 saw its ratio of price to trailing twelve-month earnings (P/E ratio) expand from 17.0 on December 31, 2018 to 21.6 on December 31, 2019. Meanwhile, the S&P 500 aggregate earnings per share (EPS) is not expected to increase in 2019 from approximately $151 in 2018. So, we can attribute nearly 100% of the index's 724-point ascent in 2019 to an expansion of its P/E ratio and essentially 0% to EPS growth. Earnings may need to take the baton in 2020, however, considering the benchmark's current P/E ratio is approximately 29% greater than its 50-year average according to Bloomberg data. S&P 500 earnings and revenues are expected to grow 8.5% and 4.6%, respectively, in 2020 according to the median analysts' estimates compiled by Bloomberg.

Across the global equity landscape, domestic stocks outpaced their international peers in 2019 for the eighth time in the ten years following the global financial crisis. Over this decade of U.S. equity dominance, the Russell 3000 Index registered an average annualized return of 13.4% versus 5.5% for the MSCI ACWI ex-U.S. Index. Within the American stock market, large capitalization stocks outperformed their mid and small cap counterparts for the third consecutive year and fifth time in the last six years. U.S. value stocks trailed their growth style peers by nearly 10% in 2019, marking the third consecutive year of at least 6.0% of outperformance in favor of growth.

While domestic growth portfolios were the biggest winners of 2019, an investor focused on investment grade U.S. bonds also booked a solid year. The Bloomberg Barclays Intermediate U.S. Government Credit Index recorded a total return of 6.8% in 2019, surpassing its cumulative total return for the entire four-year period spanning 2015 through 2018. In fixed income markets outside the world of government bonds, both investment grade and high yield corporate debt prices benefitted in 2019 from many of the same factors discussed here that boosted equity returns. The yield differential between the Bloomberg Barclays High Yield Index and a similar maturity U.S. Treasury bond index narrowed from 5.37% in the first week of January to 3.36% on December 31. High yield credit spreads are often considered a reliable harbinger of forthcoming equity market stress and economic weakness. To the extent that these spreads were well contained in 2019 suggests that at least some parts of the bond market had a less pessimistic view than government bond investors.

When the final curtain closed on 2019, the S&P 500 registered its best year since 2013 and second-best year since 1997 despite a mounting trade war between the U.S. and Chinese governments, a contraction in global manufacturing activity, a prolonged inversion of the U.S. Treasury yield curve and the pending impeachment trial of President Trump. None of these events, however, could interrupt the ascent of stocks in 2019 for more than six weeks at the most. We believe a majority of the credit for strong equity returns last year should go to the Fed's pivot to a more accommodative policy stance and a resilient U.S. consumer. Looking forward to 2020 and beyond, one of the biggest questions will be whether Fed policymakers have enough ammunition left to adjust their monetary game plan quickly enough to prevent or dull the impact of a future economic downturn.

S&P 500 INDEX: EARNINGS AND VALUATION

Source: Bloomberg. Past performance does not guarantee future results.

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120 N LASALLE ST, 33RD FLR
CHICAGO IL 60602
31.223.0270
MAINSTREETADV.COM