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2019 was a great year for U.S. equity and bond markets. In the attached commentaries, we take a look back at the fourth quarter and 2019 as a whole. We also discuss the 2020 outlook for equities and municipal and high yield bonds.

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Fourth Quarter 2019 Market Commentary

Equities

Party Like It's 1999

James P. O'Mealia – Head of Equity Portfolio Management

January 7, 2020

I was dreamin' when I wrote this,
Blame Powell if it goes astray
But when I woke up this morning,
He promised lower rates were here to stay
The tech stocks were all rising
New IPOs were everywhere
Trying to be part of the disruption,
And you know they don't even care
Cuz they say 2020 party oops out of time
So today we're gonna party like it's 1999

-Apologies to Prince - 1999

The stock market ended the decade with a bang, not a whimper! Equity indices rose to record levels in the fourth quarter and had their best annual gain since 2013. The Federal Reserve lowered rates in October for the third time in four months, causing investors to focus on the promise of an improving economy rather than the signs of weakness in industrial manufacturing at home and abroad. The lingering issues of trade wars with China and other nations headed closer to resolution and Boris Johnson's election as England's Prime Minister added certainty that the nation will split from the European Union in the new year. Investors ignored the impeachment process as a partisan undertaking, unlikely to succeed through the Senate. In addition, the Federal Reserve's promise to be patient and keep rates unchanged in coming months proved a tailwind for stocks and they finished the quarter with a sharp 9.06% gain. I am pleased to report that our equity and balanced accounts achieved extremely competitive results, outperforming the relevant value market benchmarks for the quarter and year.

Technology stocks led the equity market higher for the year, but market breadth improved as the year progressed and equities of all sizes and styles participated in the advance. In fact, while the S&P 500 led the broad market indices with a 31.48% rise, the Russell 2000 Small-Cap Index rose 25.52%, the Russell Mid-Cap Index advanced 30.54% and the Russell 1000 Value Index rose 26.54%. The once-mighty Dow Industrials were only able to eke out a 22.0% gain for the year, dragged down by a variety of stocks: Walgreens Boots Alliance caught the retail flu, 3M Co. couldn't tape over its weak global demand and Pfizer's merger with Mylan left investors unsatisfied. For the quarter, tech issues led the market higher as the Nasdaq Composite rose 12.17%, dusting the 9.06% return for the S&P 500 and the 7.41% return for the Russell 1000 Value Index.

During the last quarter, there were certainly plenty of reasons for investors to feel confident about the domestic economy, as job growth continued at a solid pace and the unemployment rate settled in at the lowest level in over 50 years. Even though home price gains have slowed dramatically, low absolute interest rates and still-low levels of available inventory have kept the housing market robust. Indeed, the market for starter homes is expanding and November's report of housing starts was the second strongest in twelve years, while the number of housing permits were the most since 2007. With the Federal Reserve promising to keep rates low, we believe the fundamentals for home builders will remain positive for the year ahead.

The services side of the economy has continued to lead the domestic economic recovery as it continues its shift away from manufacturing. The demand for increased services reflects strong employment levels, solid job creation and the growing needs of businesses and their customers. Individuals continue to party like it's 1999 and the Commerce Department noted that consumer spending rose in November by 0.4%, while incomes rose by 0.5%. Hiring activity was strong as well, accelerating to its strongest level since January. Surprisingly, while the economy continues to improve and consumers remain confident in the health of the economy, credit card delinquencies have been creeping up. Federal Reserve data show that credit card delinquencies have steadily increased from 2.12% in the second quarter of 2015 to 2.58% in the third quarter of 2019, not what you'd expect to see in the tenth year of an economic recovery! Whether it's from too-easy credit or over-confident consumers getting stretched on credit, it bears watching.

The manufacturing side of the economy tells a different tale, as new car sales have stalled at about 17 million per year and Boeing first reduced, then suspended production of its 737 Max as it undergoes extensive testing to improve the safety of the plane. According to a recent report in the Wall Street Journal, business executives are exhibiting more concern and list the risk of recession as their greatest concern for 2020. When CEOs get nervous, they are reluctant to spend on new plants or increase capacity. In November, the Atlanta Federal Reserve reported that 12% of surveyed companies and one in five manufacturing companies had cut or delayed capital spending in the first half of the year due to trade and tariff worries. Since we haven't completely resolved our trade issues and seem to continue waging tariff wars on multiple continents, my guess is that uncertainty has continued to negatively affect capital spending plans. Indeed, the Institute of Supply Management's November manufacturing report was its fourth in a row exhibiting lower activity levels and its average reading of 51.2 for all of 2019 was its lowest of the decade.

Trade issues and concerns have negatively impacted manufacturing activity overseas as well, with China's economy exhibiting slower growth and European economies experiencing weaker industrial demand. The Conference Board estimates that global growth will accelerate slightly in 2020 to 2.5%, but we are less confident that growth will improve as political tension and turmoil escalate in places like Hong Kong, Latin America and the Middle East. The U.S. conflicts with Iran are a major near-term concern and could lead to increased downside volatility over the very near term.

Oil prices started the year at $45.41 per barrel and rose 34% to over $61.00 at year-end 2019, yet the worst performing sector of the S&P 500 was Energy which eked out only a 6.9% gain. As a result of OPEC demonstrating strong compliance with its recently reduced supply quotas, exports from the cartel are at their lowest level since 2016. While the stocks of energy companies have regularly underperformed as investors worry about the health of the global economy and its impact on demand, fundamentals have proven to be stronger than many expected. Those improved fundamentals, combined with renewed tensions with Iran and political uncertainties around the globe, could cause energy issues to gain renewed representation in investors' portfolios. Furthermore, in the past, the Federal Reserve had set a 2% inflation rate as a target for when it would begin raising rates again. Now, however, Federal Reserve Chairman Powell has indicated that its previous inflation ceiling no longer applies, stating that "risks of an accommodative monetary policy…(to boost the economy are) relatively low." In other words, the Federal Reserve is going to continue goosing the money supply and trying to stimulate the economy without regard to longer-term inflation ramifications. We believe that mindset suggests that inflation plays like energy, materials and gold could outperform in the years ahead.

Fed Chair Powell stated in December that "As you can see, inflation is barely moving, notwithstanding that unemployment is at 50-year lows – and expected to remain there… And so the need for rate increases is less." The Federal Reserve might be convinced that inflation is dead, but we are not. Indeed, there are too many signs that inflation not only exists, but might be accelerating to ignore the risks. The Wall Street Journal reported this week that pharmaceutical companies have increased hundreds of drug prices by an average of 5.8% to start the new year, many health care coverage plans continue to rise by double digit percentages and, according to the Federal Reserve Bank of Atlanta, the tight job market has caused annualized wage gains to accelerate to 3.7%! Let's not forget that 24 states and 48 cities and counties will be increasing their minimum wage levels in 2020, a record number of jurisdictions. (source – Treasure Coast Newspapers) We expect that an increase in inflation will lead to a steeper

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yield curve, benefiting financial firms like banks and mortgage REIT companies. As such, clients can expect to see some new financial issues in their portfolios in coming months.

International global tensions are clearly on the rise and political uncertainty could impact the markets with increased frequency in the year ahead. The U.S. is slated to ink the first phase of a new trade deal with China on January 15th, but there is already skepticism that the Chinese will follow through on promised levels of agricultural purchases. While Boris Johnson's election means Brexit is coming, there are no guarantees it will be without some bumps along the way. There are riots in Hong Kong, political upheaval in Venezuela, a new Administration in Argentina and we are having a new trade war with France. I would buckle up the seat belt tight and low and keep a bottle of Pepto Bismol or Dramamine handy, because something tells me we are going to be entering more turbulent times in the equity markets.

Stocks are expensive on a historical basis and according to FactSet, sell at the highest price to earnings multiples since the dot-com era. However, even at current elevated valuations, stock valuations are not excessive due to the historically low levels of interest rates. Nevertheless, many of the bull market's leading sectors and winners are extended and could be subject to profit taking and are likely to suffer from a healthy rotation into other undervalued sectors. Bank of America Merrill Lynch's quantitative strategy group pointed out in November that the last time value stocks were this attractive was in 2003 and 2008, periods which preceded massive outperformance of value over growth. Just because stocks have strong returns in one year, doesn't mean the next year's return will be a clunker. Barrons noted on December 30 that in years after the S&P 500 gained by more than 25%, two-thirds of the time stocks rose in the subsequent year. Furthermore, as pointed out by the Leuthold Group, stocks generally perform well when interest rates are less than 3%, with 12-month returns being positive 88% of the time. That favorable risk/reward falls dramatically when 10-year Treasury rates exceed 3%. Based upon everything we know about the history of equity markets and how valuation influences returns, we anticipate the market will have less robust returns in the year ahead, with the most likely winners the laggard value issues of the past few years.

We are honored to manage a portion of your investment portfolio and, as always, welcome your comments and questions.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five pooled investment funds.

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High Yield Bonds

2019 Will be Hard To Top

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

January 10, 2020

The high yield market finished a great 2019 with a strong closing kick in December. The ICE Bank of America High Yield II Master index (BAML HY II index) rose 2.1% in December, topping off a year in which it gained a robust 14.4%. In 2019, all the stars aligned for high yield: interest rates fell significantly (yields on the five-year Treasury dropped from 2.51% to 1.69% over the course of 2019), the economy stayed on solid footing, geopolitical risk was contained despite lots of headlines, and the Fed reversed course, cutting rates three times and indicating that future rate hikes were not in the cards unless there was an extended pick-up in inflation. Of course, the high yield market was not the only market in 2019 that benefited from this favorable backdrop: the S&P 500 returned over 31% including dividends, and the Barclays U.S. Aggregate Index generated an 8.7% return. Even gold got in the act, jumping 18.3% over the course of the year.

That's the good news. The bad news, at least for high yield, is that the run-up in bond prices in 2019 left the high yield market starting 2020 with very anemic yields. The yield to worst call for the BAML HY II index sat at just 5.41% at 2019 year-end, a five-year low. The spread, or risk premium, to comparable Treasuries was 3.72%, compared to a five-year average of 4.68%. As I mentioned in my last commentary, the high yield market has been transformed into the "mediocre yield" market.

Given high yield's stellar performance in 2019 and current low yields, it is hard to be overly bullish about the high yield market's prospects in 2020. Indeed, over the last twenty years, high yield has performed in a saw-toothed fashion: a good year is followed by a not-as-good year. On the plus side, the economy continues to chug along at a growth rate of around 2% and personally I am not of the belief that just because we have not had a recession in a long time there has to be one lurking around the corner. The Fed has clearly indicated that any rate hike will be predicated on much higher for longer inflation numbers. With the Fed's preferred inflation metric, the Personal Consumption Expenditure Core Price Index, sitting at its five-year average of 1.6%, we are far away from the 2% prolonged period that the Fed has indicated will get its attention. On the minus side, geopolitical risk remains elevated with 2020 elections, tensions with Iran, Brexit, and a trade war with China that has resulted in a truce rather than a cessation of hostilities. The energy sector remains a particular concern for high yield, and though high yield energy prices are depressed I remain cautious. Shale-oriented companies are likely to remain under pressure given current energy prices, production curves that have failed to meet expectations, and tightened bank lending. Problems in the exploration and production sector have spilled over to oil field services companies and even some pipelines exposed to declining throughput volumes.

Putting it all together, it seems that high yield will offer muted returns in the 3%-5% area for 2020. This does not look so bad given the 30-year Treasury is currently yielding 2.3%. However, some short corporate bond funds are offering yields of 2.5%, and the S&P 500 is yielding 1.8% with growing dividends. Although we found some gems in 2019, it is currently very difficult to find higher yielding securities with attractive risk/reward parameters. At Seelaus Asset Management, our cautious, lower volatility approach to high yield hurt us as the market zoomed in 2019, and it helped us when the market dropped in 2018. Given the elevated prices and corresponding depressed yields in the "mediocre yield" market, we are at most giving away modest upside in 2020 by maintaining a conservative posture.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Seelaus Asset Management in January 2014 He is also a Senior Portfolio Manager on the firm's long-only private credit fund.

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Intermediate Municipal Bonds

Grinding Out Value in a Modest Muni Yield Environment

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

January 11, 2020

There's no other way to put it: 2019 was a pleasant year for fixed income investors. Interest rates generally fell throughout most of the year, boosting total returns to meaningfully above-average results for a number of fixed income sectors. Setting the way in terms of direction was the ten year Treasury bond which finished last year at a 1.92% yield, 70 basis points lower than where it started 2019. Municipal bonds in 2019 had a good year as well and investors who allocated to the municipal bond market were likely pleased with the results. Even in the modest intermediate maturity muni bond space, municipal bonds had a total return of +5.36% in 2019 according to the Bank of America/Merrill 3-7 year Muni Index. The Bloomberg/Barclays 5-year Muni Index was up 5.45%. Considering the tax-exempt nature of municipal bonds, these returns for upper tax bracket investors were quite pleasant indeed.

The strong, steady demand for municipal bonds continued throughout 2019. Its persistence is now something of a marvel as demonstrated by 48 straight weeks of positive net flows into municipal bond ETFs and bond funds. New issue municipal bond supply last year grew by 22% although approximately one fifth of that increase came from greater taxable muni bond issuance. Regardless, the consistent appetite for municipal bonds, both tax-exempt and taxable, resulted in investors absorbing the additional supply with little drama.

An environment where rates are falling, bond values are increasing, and interim total returns are above average undeniably produces feel-good effects on investors with existing bond portfolios. The flip side, of course, is the lower rate environment available with which to capture yields and generate income….and also the nagging worry rates surely must be poised to rise from present low levels.

In these kinds of environments, I suggest a few things to keep in mind.

While we would love to order up a more attractive investing environment, we can only work with the markets that are given to us. There is a price to pay for waiting on sidelines or for misguided attempts at timing. For individual investors, I say look at where inflation is, where money market fund yields are, and where Treasury and Corporate bond yields are. Keep in mind the likely volatility of these alternatives and the impact of taxes on available yields. With these things in mind, municipal bonds for upper tax bracket investors have consistently offered after-tax yields and expected volatility worth considering.

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As I go through the process of examining the probable forces that might push interest rates and muni bond yields higher, I conclude that the present low rate environment could persist for some time. Will economic growth and inflation in the near term increase to levels that would prompt the Federal Reserve to resume monetary tightening? Will a large, encompassing China trade deal be agreed to in the near term? Will tax or fiscal policy be altered this year to induce a new burst of economic growth? Will the demand for municipal bonds decline meaningfully now that the deductibility of state taxes has been limited and tax increase proposals have proliferated in the political arena? Will the supply in the municipal bond market increase to such an extent that it will outpace consistently strong muni bond demand? The answers to these questions I suggest is a likely no. Instead, we have a modestly growing economy and inflation rates below Fed targets, an accommodative Fed on hold, negative interest rates in many places across the globe, and persistently strong muni bond demand. Investors waiting for an environment materially different from the present could be disappointed.

In short, for 2020, I suggest acknowledging and getting used to a rate environment generally similar to what we've been experiencing and continuing the daily search for value (complete with after-tax bond math comparisons) with the market we have.

Recently, we have selectively found value in the muni bond market in single A and BBB rated paper with nine to thirteen year maturities. Including all muni bond purchases executed last year, we garnered an average yield to call of 110 basis points above a standard triple A muni bond scale and an average yield to maturity of +134 basis points. For all of 2019, our average maturity for bonds purchased was ten years, average call six years, and average rating single A. We use this comparison to a triple A scale because the pristine high grade space is a real world safety spot for many retail muni bond buyers and their advisors.

I continue to believe the modest maturity, value-oriented focus of our approach to munis including the use of spread product and defensive bond structures should work together to garner attractive yields and generate modest volatility. These are the standard pillars of our approach that I believe provide a safeguard of sorts when bond markets inevitably confound us.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

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