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Santa Fe Advisors

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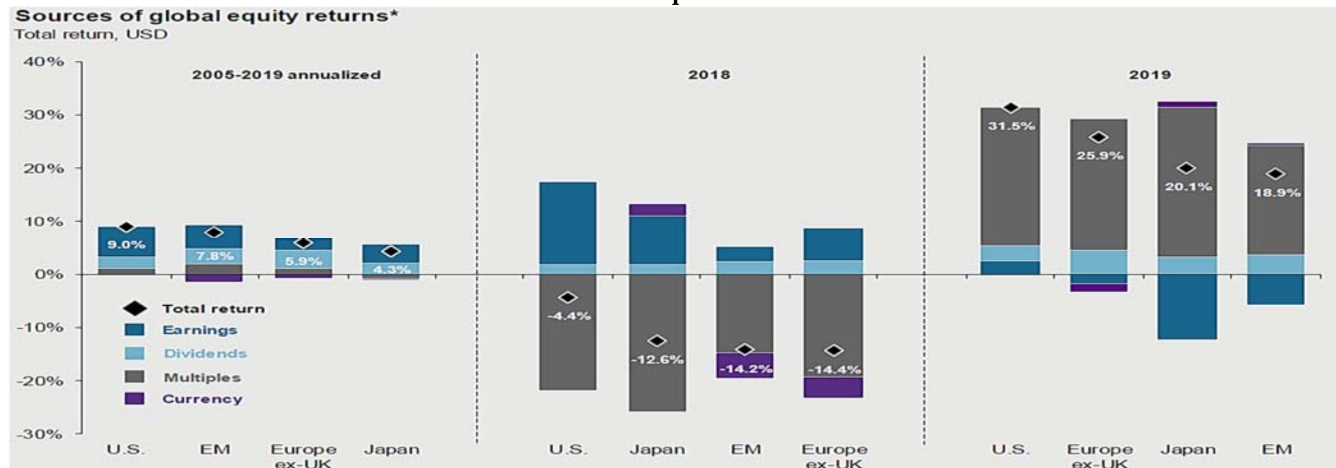
The Long Expansion Continues

Financial markets surged in the fourth quarter of 2019, capping a banner year and richly rewarding those who stayed fully invested. The S&P 500 returned 10.9% for the quarter and 31.5% for the full year. Foreign markets also performed quite well, with developed and emerging market stocks returning 22.8%[i] and 18.6%[ii] for the full year. After lagging significantly (largely due to trade related issues) emerging market stocks actually outperformed US and other developed markets in the fourth quarter, as the US and China appeared to be moving toward a reduction in trade tensions. Bond investors also fared quite well in 2019, with fixed rate high yield returning 14.3%[iii], and high grade debt (benefitting from easier monetary policy) returning 8.7%[iv]. Also boosted by lower interest rates, REITs returned 28.7%[v] for the year. So the longest bull market and economic expansion in US history continue, yet again defying doomsayers, many pundits, and those who obsess over negative news headlines.

Nevertheless, just like there are generally silver linings and opportunities during market and economic downturns, there are always looming risks during boom times…which often build while obscured by investor complacency amid strong returns. One such risk is that the significant price gains that stocks posted in all major regions occurred against a backdrop of weak company earnings – in fact earnings in the US, developed international markets, and emerging markets ***all*** declined in 2019 when compared to 2018. In other words, the great equity returns of 2019 were entirely due to stocks ***becoming more expensive***, rather than resulting from rising company profits. While this (or the converse) are not unusual occurrences, a continued rally in the face of poor earnings growth is ultimately unsustainable.

Graph 1 illustrates that the majority of 2019's global equity returns were due to price/earnings (P/E) multiple expansion (a reversal of 2018, when markets became cheaper as P/E contracted), as opposed to the healthier mix of dividends and earnings growth reflected in the average returns of the last 15 years.

Graph 1



Source: JPM, Factset, S&P, MSCI

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Central Banks Reverse Course

After holding short-term interest rates near 0% for 7 years, in late 2015 the Federal Reserve Bank embarked on a series of gradual rate increases as the US and global economies recovered from the Great Recession of 2008/2009. Although markets had expected continued rate increases, in 2019 the Fed abruptly reversed course and implemented multiple interest rate cuts in response to softening economic conditions. Several other global central banks followed suit. This reversal of interest rate "normalization" bouyed stock and bond markets, as investors took confidence that future monetary policy would be accommodative, with low financing costs and ample liquidity. Graph 2 illustrates recent Fed Funds policy rate history, as well as the shift in expectations of future rates.

Graph 2

Source: JPM, BBG

Valuations and Supply

As a result of the strong rally and weak earnings, the S&P 500 now trades at a 22x P/E ratio – in other words at a price of 22x the aggregate earnings of the previous 12 months. By this common valuation measure, US large company stocks are now roughly 1/3 more expensive than the 50 year average. While valuations in this range are not unprecedented, they are quite high on a historical basis and therefore merit caution. International stocks are currently not as pricey, for a number of reasons including weaker economic conditions. While US stocks are quite expensive on an absolute basis, they appear relatively quite attractive when compared to high grade bonds, which are even more expensive as a result of the current low interest rates. Graph 3 compares stock market yields (defined as earnings divided by price, the inverse of the P/E ratio) to government bond yields by region, and illustrates that global equity markets yield far more than high quality bond alternatives. The current stock yield advantage, which is well above the historical average differential, is an important relative value dimension to bear in mind: cash must be deployed somewhere, and stocks (even when expensive) can rally significantly when they are perceived as the "least unattractive" option by investors.

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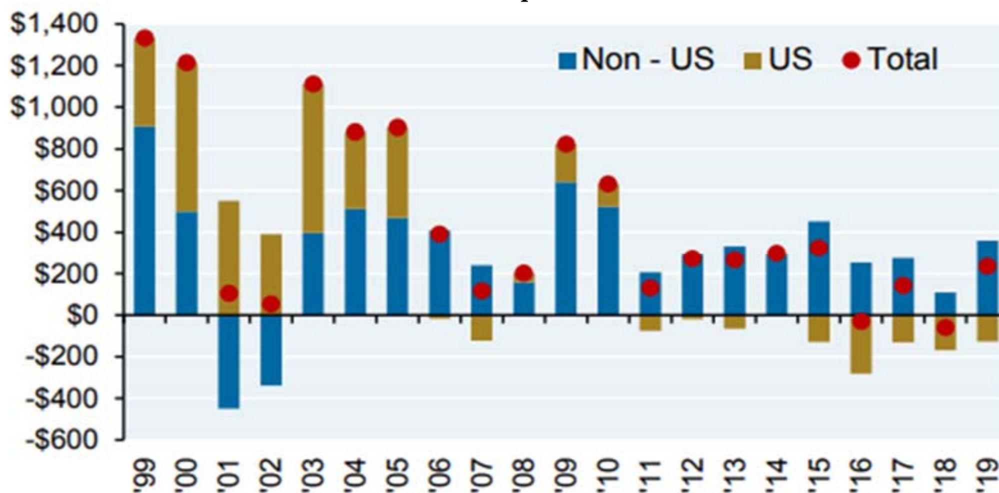
Graph 3

Source: Blackrock, Refinitiv Datastream

In addition to being relatively cheap when compared to debt, stocks have benefitted from a dramatic contraction in supply since the financial crisis, at least in part because many companies have opted to stay (or go) private, in order to avoid the increased public company regulatory burden imposed after the crisis. Graph 4 illustrates that this phenomenon has been particularly acute in the US, which has seen a net contraction in equity supply in recent years even as the economy has consistently grown. As economic law suggests, this net contraction in supply has been supportive of higher prices.

Graph 4



Source: JPM

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There Are Always Risks and Opportunities

As always, there are currently several pros and cons to consider when navigating today's markets. On the positive side, the US and global economies are recovering from the mid-2019 downturn, consumer confidence and spending are high, employment is near historical highs and wages are rising, manufacturing seems to be bottoming out, monetary policy is quite accommodative, and the US/China trade conflict appears to be moderating. On the negative side, business investment and confidence have dropped significantly, markets are expensive, earnings growth has been poor, trade issues have by no means been resolved, and global debt levels continue to ratchet up with no sign of abating.

Many of these issues, both positive and negative, can turn on a dime.....and generally tend to once a consensus arises that extrapolates past trends into the future. It's for this reason that we regularly reinforce the imperative of ignoring today's news headlines (particularly negative ones) when constructing an investment plan, and rather aligning strategy to fit one's unique personal financial situation and objectives.

Thanks for your trust, which the Santa Fe Advisors team strives to earn every day.

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[i] MSCI EAFE Index
[ii] MSCI Emerging Markets Index
[iii] Bloomberg Barclays US High Yield Total Return Index
[iv] Bloomberg Barclays US Aggregate Total Return Index
[v] FTSE NAREIT All Equity REITS Total Return Index

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