The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets January 2020

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***U.S. Gross Domestic Product Growth Will Slow to an Average 1.9% in 2020.*** *While this compares to an estimate of 2.3% for 2019, the upward mobility that we mentioned in our last market commentary continues on to foster sustained growth, a strong labor market and low inflation.*
- ***Monetary Policy is Always a Major Player Influencing the Direction of the Economy.*** *The Federal Reserve's three consecutive meetings throughout 2019 served to ensure that there was sufficient liquidity in the banking system to keep interest rates in support of continued economic growth.*
- ***Fiscal Policy is the Other Hand to Deal in Orchestrating the Direction of the Economy.*** *We all know of the immense spending that continues to go on in our military. While we do have some concern with the amount of debt we have incurred, spending and the many infrastructure initiatives in place have certainly produced a lot of jobs and improvements. The rationale here is that spending today brings increases in wealth tomorrow.*
- ***The Global Economy Has Steadied in Recent Months, Coming Off a Very Stagnant Period.*** *The International Monetary Fund (IMF) is expecting improvements in 2020, estimating global growth at 3.4%. Our view is that there are significant risks to these numbers, but we do agree that growth will be positive. This growth can only help the U.S. economy, which heretofore has been pretty much going it alone.*

THE ECONOMY

U.S. manufacturing is showing signs of improvement, which will only further be enhanced by a European business turnaround. China's official measure of activity likewise points to an expansion in manufacturing output. They recently announced a major increase in liquidity within their banking system and the never-before action by a Communist government seems systematic of the times in which we live. So important is all of this throughout other countries in Asia and around the entire world. On the subject of the UK, Brexit won't disappear from the agenda with the trumping conservative majority. The formal exit from the European Union will be followed by painful discussions regarding the UK's long-term trade relations with all the countries in the EU. Business, however, should begin to slowly benefit from the victory.

The consumer continues to be the driving force of the U.S. economy. Unemployment is at 3.5% with wage gains accelerating in the back half of 2019, surpassing inflation. With consumer confidence remaining at its high in the present cycle, no wonder workers spend close to 70% of any wage increases earned.

Central banks around the world have been even more accommodative than our Federal Reserve. While U.S. yields on Treasuries, corporates and other debt instruments are at historic lows, or close to it, these yields are relatively giant in comparison to the rest of the world.

With Federal budget deficits projected to average $1.2 trillion a year for the next decade, what effect does this have on the opinion around the world of the dollar and its backing? There was a time when gold backed the dollar and the U.S. had to maintain some sensible fixed relationship to gold with their amount of outstanding debt. Now, the world holding dollars looks to the U.S. economy for the safety of their investment. The simple answer, and it is rather simple, the U.S. must continue to be the safe haven in the world with the strongest military, most stable government and a growing economy, making the world a better place for everyone. As long as the U.S. can meet these objectives, our international reserve currency status will remain intact. We are seeing signs of countries, such as China, attempting to go around the dollar with their trade deals, but it will be a long time, in our view, before the U.S. dollar loses its worldwide prestigious position.

FINANCIAL MARKETS

EQUITIES

The past year was a very robust year for the stock markets. As shown in the chart below, large capitalization companies, represented by the S&P 500, and the technology-laden NASDAQ outperformed both the Dow index and the Russell 2000 index of smaller companies, although, at 25%+, both also had compelling returns for the period.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	9.07%	1.70%	4.30%	13.65%	31.49%
Dow	6.67%	1.83%	3.21%	11.81%	25.34%
NASDAQ	12.17%	-0.09%	3.58%	16.49%	35.23%
Russell 2000	9.94%	-2.40%	2.10%	14.58%	25.52%

*Total: price change + reinvested dividends

Technology, technology, technology was the ticket during 2019. With the Information Technology weight in the S&P 500 at 23.2%, as shown in the table below, anyone invested at this level or above, and in the right technology stocks, did extremely well. Other areas, such as Health Care, performed well, but here again, these sectors have many sub-industries and correct positioning in those industries was all important for performance. Our mandate, or charge, for portfolio investment is to maintain a well-diversified portfolio representing participation in the majority of the S&P 500 sectors. With the S&P 500 ahead 9.07% for the fourth quarter, and areas such as Energy, Materials, Industrials and Consumer Discretionary ahead barely half that amount, one can see how influential Technology was on the total return. Looking forward, 5G cell service, companies providing cloud-based platforms and semiconductor companies involved in new applications, these areas and more should continue to provide shareholders with strong returns.

S&P 500

Sector	Weight	Returns* 4th Qtr	Returns* 2019
• Energy	4.3%	5.49%	11.81%
• Materials	2.7%	6.38%	24.58%
• Industrials	9.1%	5.53%	29.37%
• Cons. Discretionary	9.8%	4.47%	27.94%
• Consumer Staples	7.2%	3.51%	27.61%
• Health Care	14.2%	14.37%	20.82%
• Financials	13.0%	10.47%	32.13%
• Info Technology	23.2%	14.40%	50.29%
• Communication Svcs	10.4%	9.00%	32.69%
• Utilities	3.3%	0.75%	26.35%
• Real Estate	2.9%	-0.54%	29.01%

12/31/19
*Price + income
Source: S&P Dow Jones

Our view, and it is shared by many, is for stocks overall to remain at their current valuation level. The consensus has the S&P 500 at $174.00 in earnings, up 6% from the consensus 2019 level. The path could be bumpy, however. Headlines on trades, the economy and the election front threaten to drive a reactive market higher or lower for extended periods.

Financials, Health Care and Industrials are good bets for better performance in 2020. While they were relatively flat investments last year, they are now at more attractive valuations than the rest of the market. So, while we will have Technology our primary lead interest, for at least part of the year, with confidence now for a positive economy and market in 2020, last year's under-achievers may well be frontrunners themselves this year.

FIXED INCOME

The big news on the fixed income calendar of events was the Fed's flooding of the money markets with hundreds of billions of dollars in cash to avoid a repeat of volatility that roiled cash markets in September. Obscure, but vitally important, lending rates in the markets are called "repos." These are borrowings by banks and other firms for short periods of time, pledging government securities as collateral. When there is not sufficient liquidity to allow overnight borrowing, then imbalances with supply and demand occur.

The U.S. Broad Market Index for bonds continued its slide into the fourth quarter and right up through the end of the year. The good news, however, is that for all of 2019, the Index had its best return in 17 years. The Corporate Index spreads tightened four straight months and six out of the last seven months.

Fixed Income Returns

Index	4th Qtr	YTD
Corp/Govt	-0.06%	9.77%
Int. Corp/Govt	0.42%	6.91%
Long Corp/Govt	-1.34%	18.81%
U.S. Government	-0.89%	6.99%
- Intermediate	0.03%	5.15%
- Long	-4.00%	14.31%
Corporate	1.15%	14.23%
- Intermediate	1.11%	10.20%
- Long	1.22%	23.58%
- **Quality**		
- AAA	-0.17%	14.34%
- AA	0.16%	10.78%
- A	0.75%	12.93%
- BBB	1.67%	15.91%
Municipal	0.63%	7.74%
- Intermediate	0.77%	5.28%
- Long	0.55%	9.29%

Source: BofA Merrill Lynch

Rating services treated corporates harshly in the fourth quarter. Reports of poor business in the manufacturing sector, weak global demand and unsettling trade news all contributed to a number of bond downgrades. On the other hand, Treasuries became even more popular. The very facts that hurt corporates helped Treasuries. Foreigners couldn't get enough Treasuries as their news sent investors our way. We witnessed the largest new inflow the U.S. Treasury Index has seen in 9½ years.

How do we see it in 2020? For one, the Federal Reserve and other central banks will take a "wait and see" attitude before any further action is taken with interest rates. Data flow and policies will likely dominate the direction and magnitude of bond returns in the coming year. Easing monetary conditions by central banks around the world will continue to take place, while the risk of recession is slowly declining.

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In conclusion, as usual, a lot of balls remain in the air for 2020, and they all will have their own effect on the economic outcome in the U.S. and other areas of the world. Policy uncertainties, unabated trade tensions, impeachment proceedings and the 2020 Presidential election all stand in the wind to no one's knowledge. One thing we all know is that there will be surprises and these surprises will have a price, good or bad. Our best way to prepare for what we don't know is to stay diversified with our equity weight and no more than intermediate length with our bonds, even shorter when clients can afford less interest income. For all the negatives that could arise with our trade talks, the impeachment proceedings and the election, one must keep in mind the dollar is an asset unlike any other. Its position as the world's reserve currency makes it the pre-eminent mechanism for world trade and foreign exchange. While it is natural to focus on and react to domestic events, the status of the United States in the world, sitting at the center of everything, softens the domestic blow of events and should allow refrain from overreaction.

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