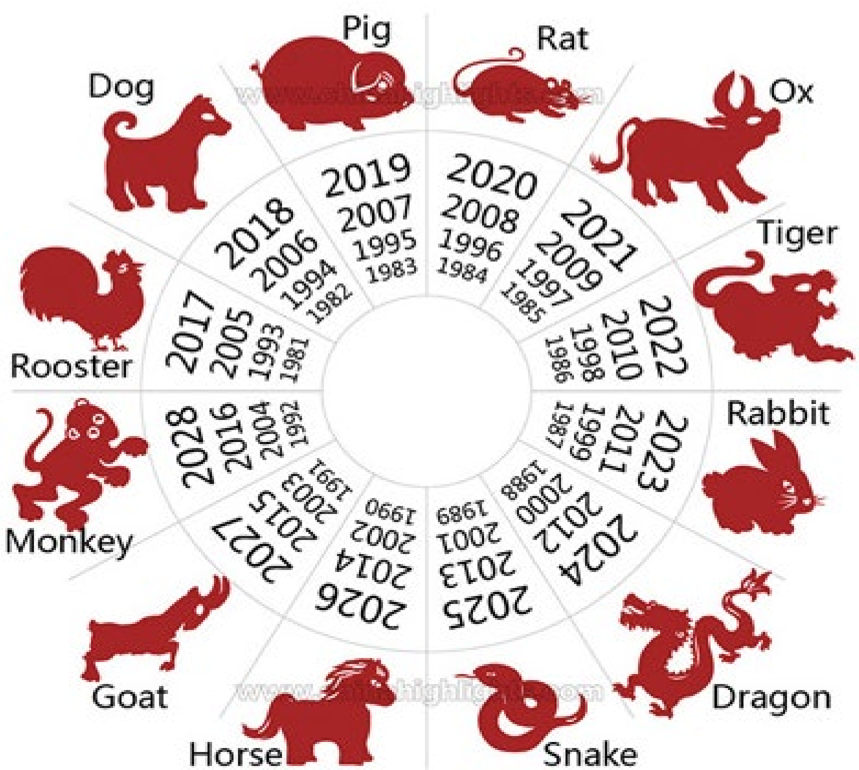
CCR
WEALTH MANAGEMENT

# January 2020 Outlook

On January 25th, the Chinese celebrated their New Year. The Chinese zodiac calendar is a 12-year cycle which follows the phases of the moon. Each year the zodiac sign is represented by a particular animal. This year, which runs from the 25th through February 11th, 2021 (yes, 12 ½ months) is the year of the Rat. Chinese tradition holds that those who are born in a Rat year tend to share the traits of being quick-witted, resourceful, versatile, and kind.

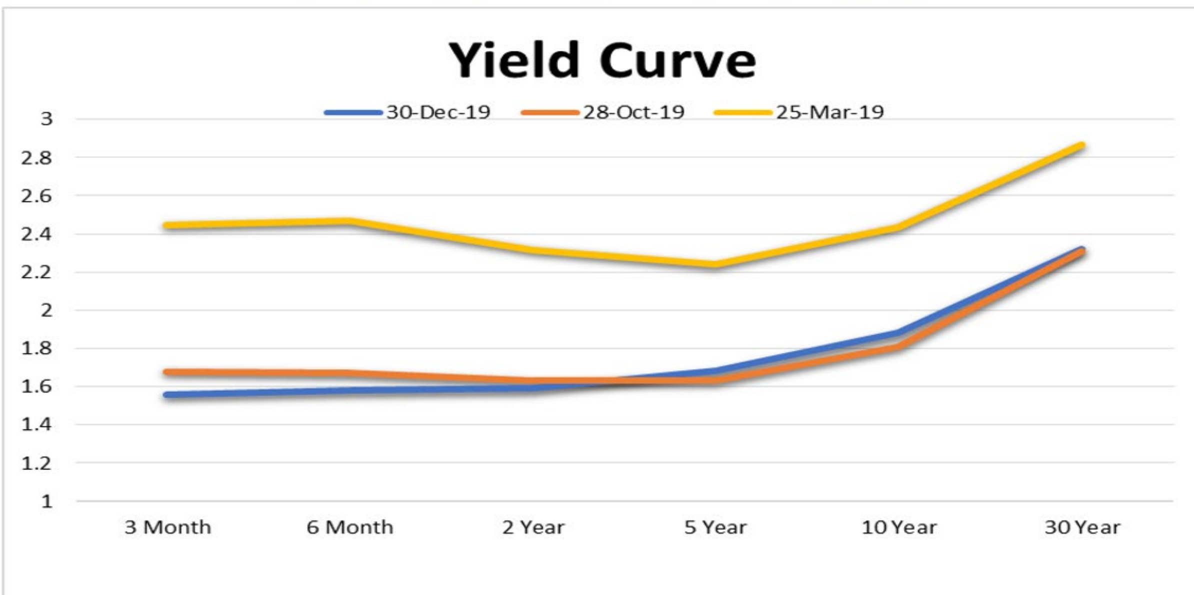



On January 15th, President Trump signed a trade deal with China which has been termed "Phase 1". We note that neither President Trump nor Chinese President Xi Jinping are Rats. Trump was born in 1946 (a Dog year; lovely, honest and prudent), and President Xi was born in 1953 (a Snake year; enigmatic, intelligent and wise). No doubt, many readers will savor these valuable nuggets of information and draw their own conclusions.

The market has been celebrating two things since the end of September. The first was Federal Reserve Bank (Fed) Chairman Jerome Powell's acknowledgment that the Fed is on a long-term hold from the point of the last interest rate cut, effective September 2019. The second cause of celebration has been the thawing of relations between the US and China, which soured considerably after the breakdown of trade-talks in May—a thawing perhaps lubricated in part by the additional 15% tariffs applied on Sept 1 to $120 billion of Chinese imports. Both developments are welcome, of course, and remove sources of concern that have, at-times, vexed the markets for the last 18 months or so.

Regarding the Fed and interest rates, the market showed its appreciation of the three rate cuts (in July, August and September, 2019) by un-inverting the yield curve, which had been inverted (and thus predicting imminent recession) since last March. Keep in mind, it is generally thought to take between six and twelve months for a single Fed action to be reflected in the economy. So, the first cut in July? We

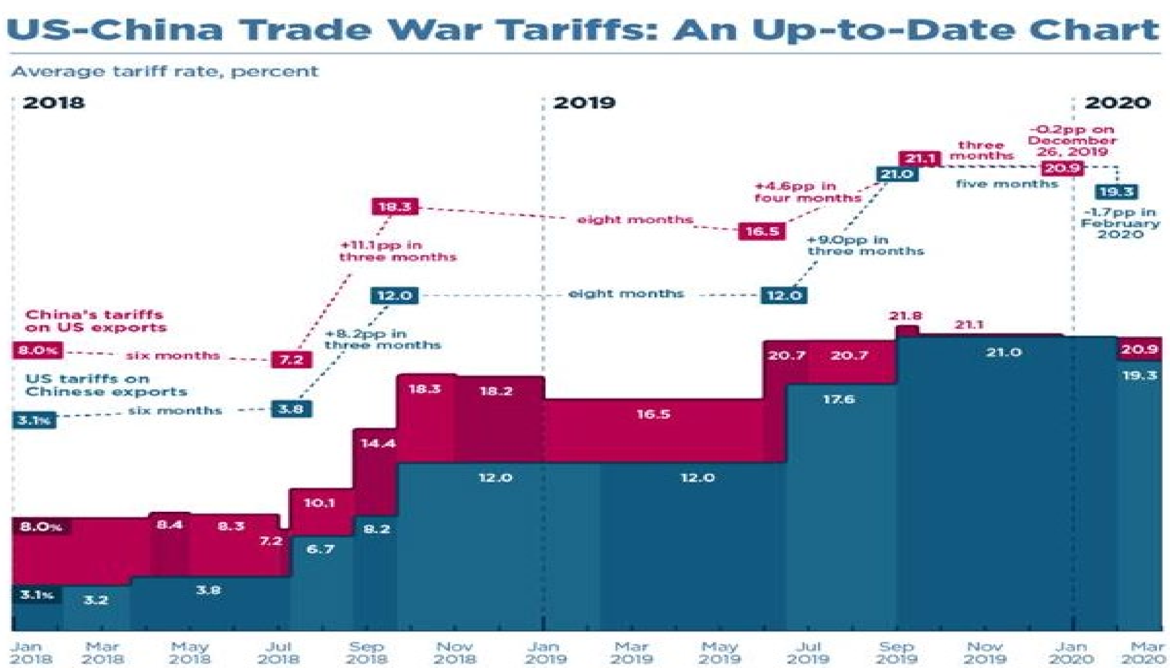
# Yield Curve Reversion




are probably just beginning to feel whatever minor benefit that move was intended to bring about. Never-the-less, employment and consumer data held strong throughout the fourth quarter and the less-than-robust manufacturing sector at least showed signs of stabilization—*all before the rate cuts could be influential*. Additional consideration must be given to the fact that 2020 is, of course, a presidential election year. While President Trump's public excoriations of the Federal Reserve, and Jerome Powell are, by now, legendary, we have pointed out before that tension between the Fed and the White House is nothing new from a historical perspective. Election-year interest rate manipulation, however, is usually avoided at all costs. It will invariably be seen as a political move by a supposedly a-political body. In our view, the Fed likely took actions beyond what the data called for last summer to buffer them through the political season.

The thawing of relations between the US and China are symbolized by the "Phase 1" deal. Phase 1 is more difficult to parse because it strongly suggests a "Phase 2" is right around the corner. At this point we would like to direct you to our November Outlook and our discussion of the large divide separating Western sensibilities from the Chinese modus operandi. While talk in the political and media circles has already pivoted to Phase 2, we caution our clients that any additional agreements with the Chinese in 2020 is highly unlikely. In fact, drawing from our history with past "agreements" with China, we would not be surprised to see a reemergence of tensions regarding the implementation, follow-through, and enforcement of Phase 1. We see plenty of potential for more market-rattling rhetoric surrounding tariffs.

Let us also consider the gist of Phase 1. While we would agree that in some respects, some progress was made—it primarily (and partially) addressed the trade deficit between China and the US. China agreed to purchase an additional $200 billion of US goods and services over the next two years. At this point the data for 2019 is not in—but we know China purchased approximately $186 billion in goods and services in 2017, the year before the "trade war" began. If implemented as written, this represents an increase in annualized purchases, though spread out over two years. There is also more nuanced language in the pact outlining China's agreement to relax restrictions on US firms trying to gain admittance to their financial markets, and efforts to combat forced technology transfers. In response, the US agreed to in-definitely suspend tariffs on $160 billion of Chinese goods scheduled to go into effect of December 15 (of last year), and to halve the 15% tariffs on $120 billion of Chinese goods that were implemented on September 1. What does this mean from a tariff perspective? A picture tells a thousand words: https://www.piie.com/research/piie-charts/us-china-trade-war-tariffs-date-chart



The drop in September's tariff rates represents a mere 1.7% drop in overall tariffs imposed on Chinese goods. While China has, in turn, suspended their planned retaliatory tariffs scheduled to go into effect in December, all other tariffs imposed since July 2018 remain in effect.

Phase 1, therefore, is more *détente* than progress. Wall Street is clearly happy with *détente*. While the bulk of the tariffs remain in place as bargaining leverage for Phase 2, the Chinese also know this is an election year. Our belief is that focus will be on the implementation of Phase 1 this year and the heavier lifting of intellectual property transfers, subsidies provided to Chinese companies, digital trade and data policies (all of which likely requiring a change in Chinese law) will be an ongoing slog (think "Phase 3", "Phase 4", etc.).

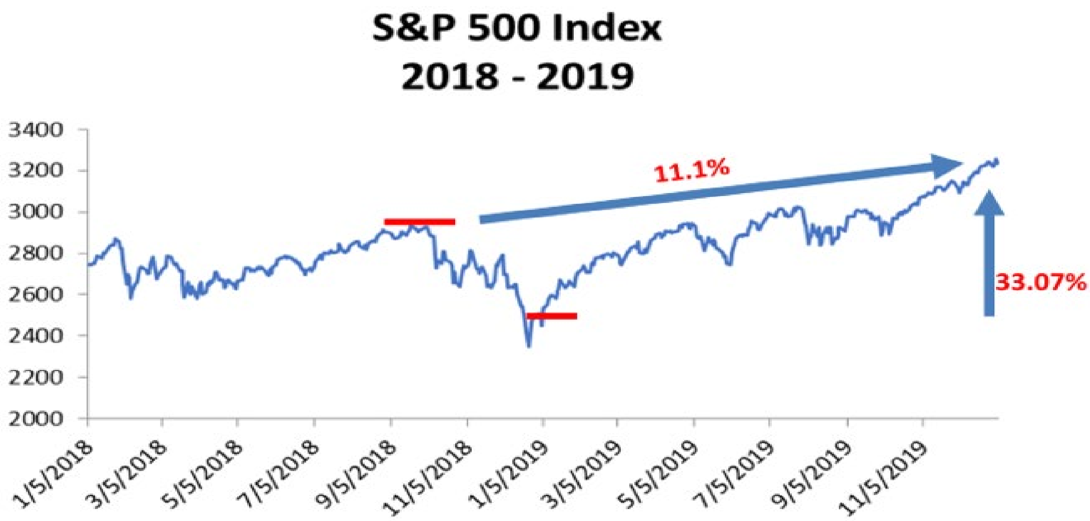
## US Markets: 2019 in Perspective

The total return of the S&P 500 in 2019 was 33.07% (this includes the price return plus the dividend). For our part, we have taken pains to explain to investors how this return was derived. Perspective on this is important to prevent the common mistake investors make in projecting the recent past forward—at least mentally.

Our Outlook videos in October included the suggestion that even if the markets stayed flat throughout the rest of the year (which they did not!), that investors would experience improving year-over-year returns by virtue of what the markets did in Q4 2018 (which was fall, precipitously). Clients were obviously pleased with portfolio returns in November and December; however, it is important to understand that 2018 ended in a "trough" and that much of 2019 was a reversion-to-the-mean bounce-back.

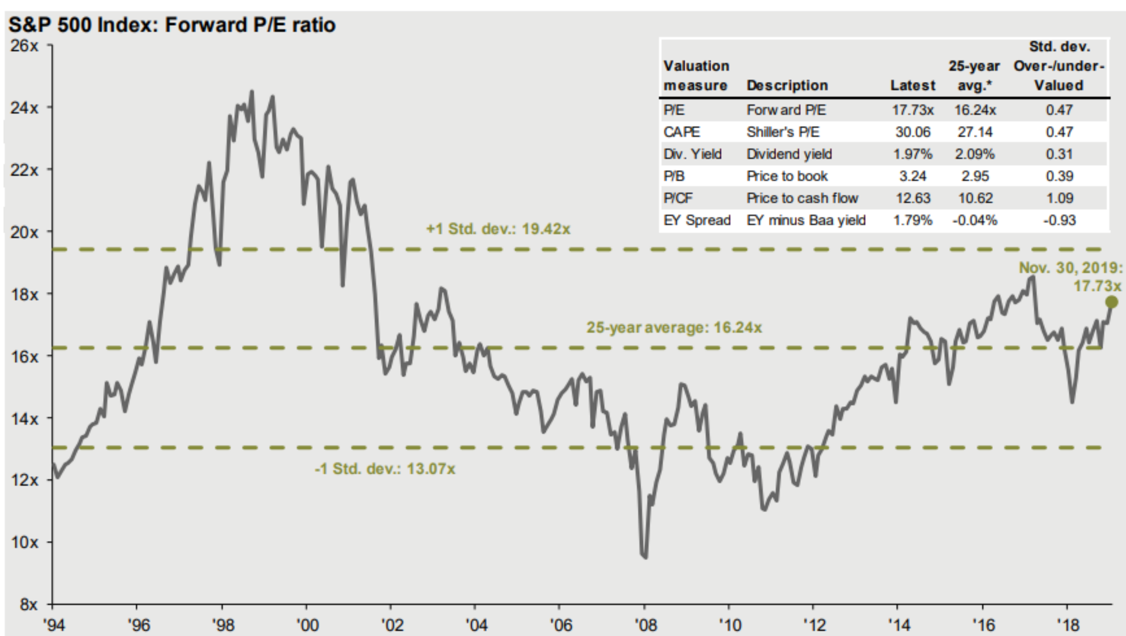
**Recency Bias** and Availability Bias are two Behavioral Finance terms which describe two "cognitive" biases in play now. Recency Bias is the tendency of most people to remember events which happened recently, while having more difficulty recalling events from further back in time. If something "just happened", we attach a higher probability than is warranted that it will continue to "happen" or be reflective of the near future. Throughout the fourth quarter last year we were peppered with improving outlooks of a China deal, relief from further Fed tightening, positive consumer data, and new market highs almost daily. So, when looking at a 12-month investment review which shows portfolio returns well into the double-digits, most folks do not easily recall the negative returns they absorbed in 2018, or the white-knuckle 20% slide in the S&P 500 four quarters ago.

**Availability Bias** parallels Recency Bias in that it focuses our attention away from the "big picture" perspective needed to make rational investment decisions. Today's media-saturated environment floods our senses with "news" 24/7. Availability Bias arises when we try to retrieve information quickly to form a viewpoint. Our retrieval is often affected by the most repeated headlines and news stories. Throughout the fourth quarter and into this year, media "2019 market reviews" we have sampled highlighted market returns and the returns of individual stocks, many of which were up 40%, 50% and more in 2019. Often, these stories downplay, or even omit the fact that these same stocks were down 25% or 30% the prior year.




Don't get us wrong—2019 was a good year for equity investors. However, a realistic accounting of returns should generally not start in a trough and end in a peak. The "calendar year" is an artificial construct, as we have pointed out before. Extending the calendar year back to omit the correction, we arrive at something closer to long-run return averages. The chart nearby does just that by illustrating S&P 500 returns from 9/21/2018 through year-end 2019.

Stocks are not cheap here. The S&P 500 currently trades at about 114% of its 20-year forward P/E average. However, the same concept applies here—20 years ago places us at frothy market levels. When you extend past this period to look at 25-year averages, the markets look expensive by most ratios we consider to understand valuation. Markets don't decline just because they are historically expensive.




| Valuation measure | Description | Latest | 25-year avg.* | Std. dev. Over-/under-Valued |
|---|---|---|---|---|
| P/E | Forward P/E | 17.73x | 16.24x | 0.47 |
| CAPE | Shiller's P/E | 30.06 | 27.14 | 0.47 |
| Div. Yield | Dividend yield | 1.97% | 2.09% | 0.31 |
| P/B | Price to book | 3.24 | 2.95 | 0.39 |
| P/CF | Price to cash flow | 12.63 | 10.62 | 1.09 |
| EY Spread | EY minus Baa yield | 1.79% | -0.04% | -0.93 |

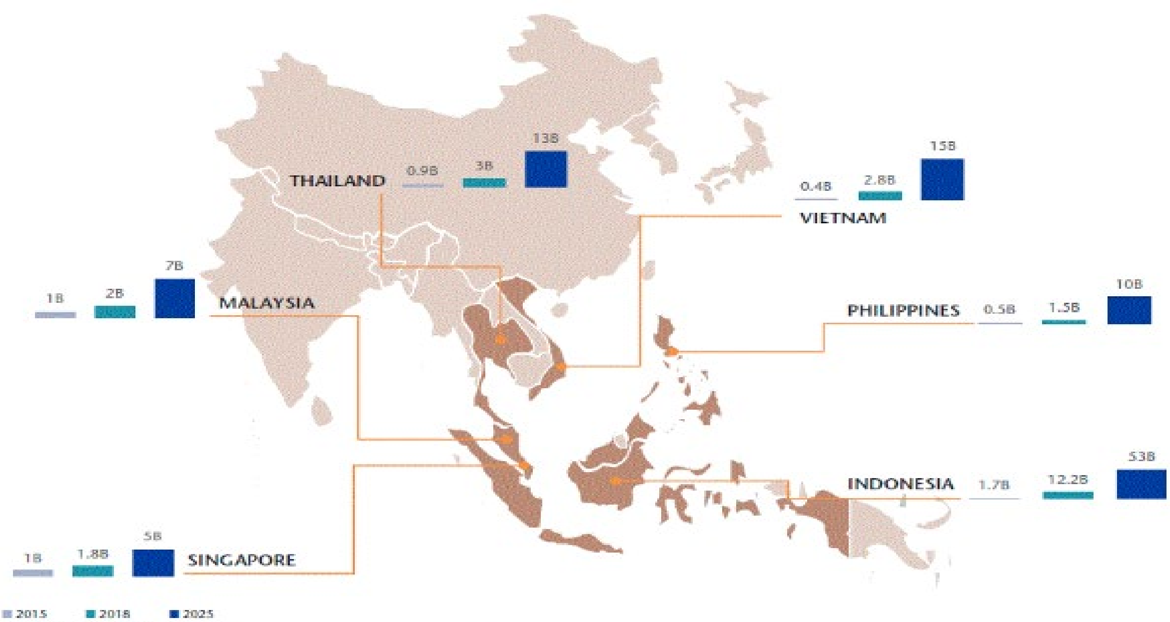
Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1994, and FactSet for November 30, 2019. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
*Guide to the Markets – U.S.* Data are as of November 30, 2019.

Markets advance through either a P/E multiple expansion, which we witnessed in 2019, or through an earnings expansion (raising the E in P/E). Multiple expansions anticipate higher earnings growth ahead. The good news here is that the truce over trade with the Chinese and the cumulative 0.75% rate cut last year should both provide enough breathing room for better business investment growth, if the truce lasts, allowing us to see a resumption in earnings growth in the year ahead. However, 2019's market advance, with currently expensive price multiples, should persuade clients that their expectations should be brought in-line with long term averages—which are below double digits.

## Non-US Equities

As you will recall from previous CCR Outlooks, we began a pivot away from non-US equities (or, a tactical pivot *to* US equities) roughly four years ago with the elimination of discrete Emerging Markets holdings in our model portfolios. This pivot culminated with a sharp reduction of developed non-US funds and ETFs over the last 18 months. Today we are taking a step in the opposite direction.

Many, including CCR Wealth Management, have been narrating the slowing global growth for several years. Today we see a process of stabilization. Against this backdrop, we are seeking growth opportunities, but with a very specific mandate. In decades past, it was enough to seek the higher growth of developing economies through broad-based indexes or funds. "Emerging Markets" was a sufficient category description to invest in because, in large part, China's economic growth fueled industries and natural resource production around the world. Today's global ecology, in our view, is different. When we look for growth, certain areas of the world stand out. Much has been written about the slowing Chinese growth rate over the years (notwithstanding the recent increase in China's growth estimates by the IMF). But high growth in China exists when we exclude heavy industries and construction. Indeed, we see the most compelling growth stories outside the US to be found in Asia's rapid development of e-



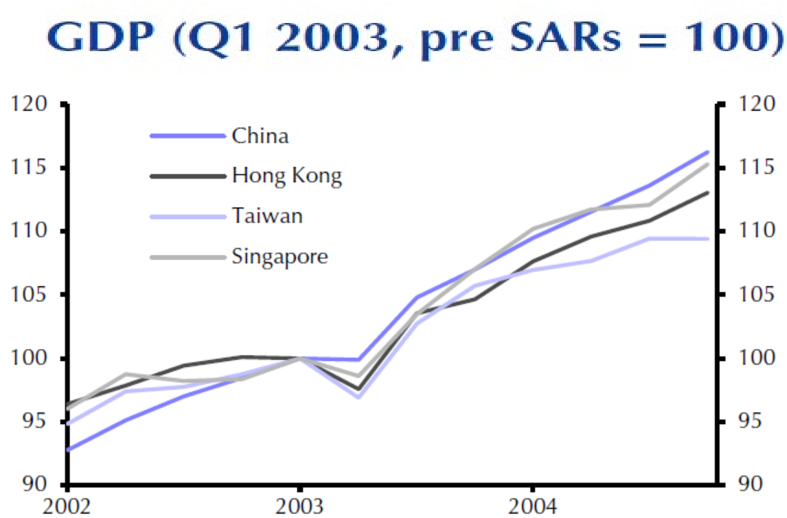

Sources: Google and Temasek, 2018

There is no guarantee any estimates or projections will be realized.

SOUTHEAST ASIA E-COMMERCE MARKET SIZE (GMV, US$B) commerce. Names like Alibaba and Tencent have already become well-known to US investors and have fueled e-commerce to account for 20% of retail sales in China as of 2018 (compared with 10% of retail sales in the US)[1]. E-commerce was 2-3% of retail sales in Southeast Asia in 2018, but gross merchandise sales are expected to increase fourfold in the next 6 years to $102 billion from $23 billion according to a joint study by Google and Singapore's Temasek Holdings in November of 2018.

We have screened investment opportunities to take advantage of this and other "local" organic growth opportunities. Among our screens, we have sought to eliminate Latin America, Russia and Eastern European exposures. We have also sought to minimize manufacturing and exporters, while emphasizing technology, consumer cyclical, financial and healthcare sectors. At approximately 10% of a total equity allocation, the positioning is modest, but we believe it will be a long-term compliment to an otherwise US-centric portfolio.

All of us at CCR Wealth Management would like to thank you, our clients, for your continued confidence, and we wish you a happy and prosperous New Year! On a closing note, news of the Coronavirus originating in Central China emerged just as we finished writing this piece. Rapid and unexpected exogenous developments like this are always a part of investing. Our first thoughts are for the rapid containment and the alleviation of illness and uncertainty for the people affected by this public health concern. Of course, we will continue to follow the situation closely. Our investment thesis has not changed, given what we know. Immediate media analysis has likened the situation to the outbreak of the SARs virus seventeen years ago. We will end with a recent quote from Capital Economics: "*The spread of the new coronavirus across Asia and into the US is clearly a major public health concern, but we suspect that its economic effects will be modest. Even the significant economic disruption related to SARs turned out to be temporary and experts expect this disease to be less deadly and better contained…the mortality rate of this illness seems to be far lower. And the Chinese authorities have been relatively open and proactive in trying to contain the virus, in contrast to the initial secrecy surrounding SARs*".




[1]Source: KrASIA, 30 January 2019