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Fourth Quarter Investment Commentary
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"Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night." - Seth Klarman, hedge fund manager.

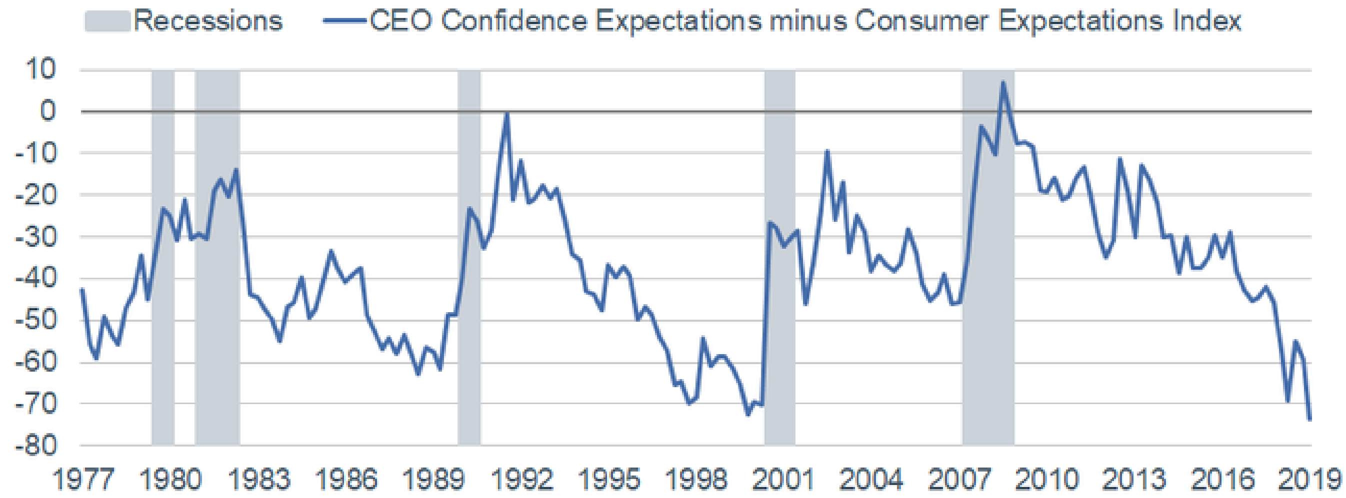
The Year in Review

- S&P 500, Dow, Nasdaq, Wilshire 5000, Home Prices – All-Time Highs
- Expansion: longest in history (125 months)
- Federal Reserve abruptly shifted monetary policy, reducing short-term rates by 75 basis points (0.75%)
- Escalation in trade war with China
- Treasury yield curves inverted mid-year. (Short-term rates higher than long-term rates.)
- Corporate earnings declined in three of the past four quarters.
- GDP growth slowed.
- President Trump impeached by the House of Representatives

Economic and Market Review and Update

Economic growth slowed in 2019 as manufacturing and business activity weakened amid trade uncertainty. The International Monetary Fund (IMF) lowered its 2019 global GDP forecast for 2019 to 3.0%. Global growth slowed from 3.8% in 2017 as global trade, which until recently had been a significant engine for the global economy, retrenched in response to increased trade tariffs imposed in early 2018.

Business confidence was particularly hard hit due to sluggish global growth, persistent trade policy uncertainty, and subdued corporate profitability. CEO confidence is currently at levels last seen during the global financial crisis in 2008. However, consumer confidence remains near historic highs. Consumer confidence has been driven by solid employment and income growth, and higher net worth from rising home prices and increasing equity markets. The gap between business and consumer confidence is very wide historically (see chart below). A wide gap in these series has typically preceded recession in the past.



Source: Charles Schwab

Recession fears heightened during the summer months as the yield curve inverted, manufacturing activity contracted, and trade rhetoric escalated. Consumer spending remained strong, offsetting the weakness in business spending and manufacturing activity.

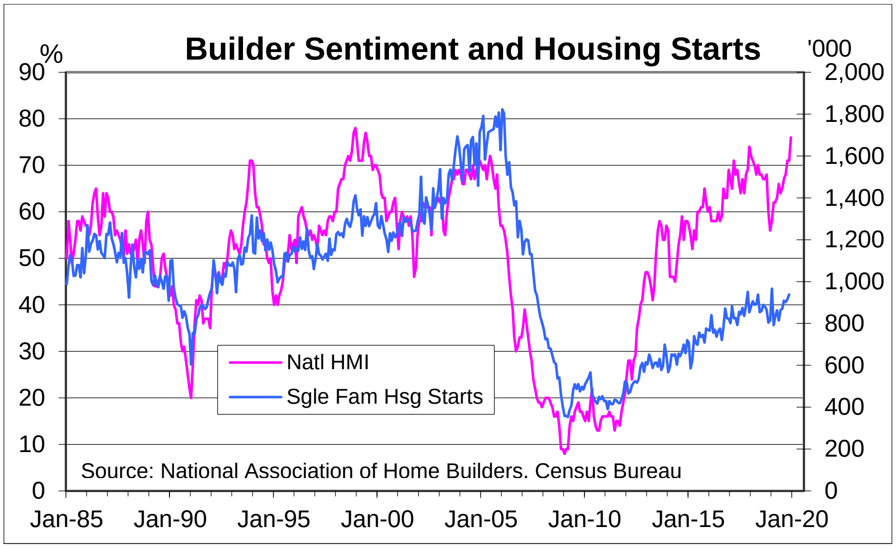
Central banks around the globe responded to economic weakness by reducing interest rates and increasing purchases of bonds to add liquidity to the economy. The Federal Reserve reduced short-term interest rates from 2.25%-2.5% to 1.5%-1.75%. In many parts of the globe, interest rates are negative, which is unprecedented. Historically, lower interest rates stimulate interest-sensitive spending and tend to boost financial assets. But lower rates have not increased business confidence, primarily due to trade uncertainty.

Despite central banks' best efforts to stoke economic growth, much of the liquidity appears to be inflating equity markets. Not only do equities appear stretched relative to corporate profitability (see below) and economic growth, but the Fed's ongoing liquidity interventions continue to benefit the wealthy, who have assets invested in the market.

The unfortunate reality is that these policies have only acted as a transfer of wealth from the middle class to the wealthy and created one of the largest *"wealth gaps"* in modern human history.

The U.S. and China recently announced a "phase one" trade deal. The U.S. has agreed to reduce some tariffs on Chinese goods while China has agreed to increase purchases of American agriculture, energy, and manufactured goods. While this is positive in that the two sides appear to have reached some agreement, the details are vague, and there are many issues that have not been addressed. The financial markets have responded positively. The question is whether or not this will alter business confidence to a significant degree.

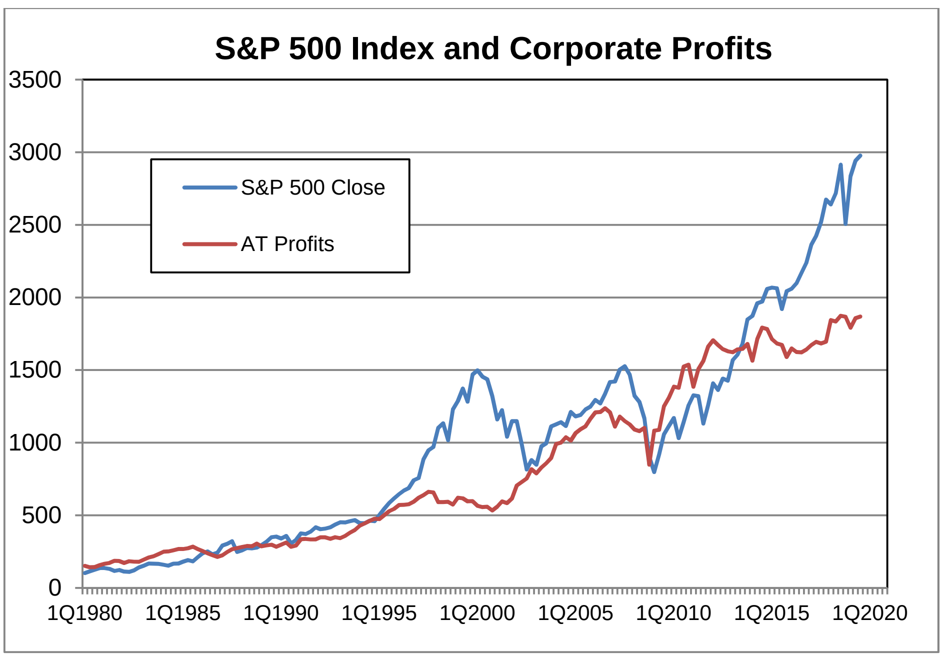
A recent survey of small business shows that the mood of small business owners has improved over the last month, largely due to an improved outlook for their earnings. This may be a precursor for better growth in 2020. Some measures of global manufacturing activity appear to be stabilizing. Housing activity is also improving. (see chart below)



As mentioned previously, the weakness in business investment and manufacturing has not spilled over to the service side of the economy, nor led to higher unemployment. Job growth has slowed, but the unemployment rate has remained at a 50-year low of 3.5%. Economic growth is not expected to rapidly accelerate from here. Although employment growth is a lagging indicator, early signs that weakness is spreading to the consumer will be increased layoffs, shrinking temporary employment, and a reduced workweek.

The majority opinion believes the economy will begin to recover in 2020, corporate earnings will increase and the equity market will have another strong year. The S&P is on track to increase +29% this year. Following the six times in the past the S&P increased by +29% or more, the S&P increased +19% on average the next year.

Our caution lies in the disconnect between corporate earnings and the equity market. Over time, equity markets reflect the value of the companies that comprise the market. There are times when the value of earnings and the market price diverge, eventually revert toward each other.



The last time there was such a divergence between earnings and the S&P 500 was during the dot com bubble. Since 2012, the value of economy wide profits has been range bound. However, the value of the market has now far exceeded earnings. The historically-wide spread suggests either profits will need to catch up to the market or stocks will correct to move in line with profits. (see chart above)

What to Watch for in 2020

1. Will China comply with the terms of the "Phase One" trade deal or will the trade war heat up again?

2. Will earnings growth recover and will high valuations become a concern for markets?

3. Will high consumer confidence converge with low levels of CEO confidence? Will factors dampening business fixed investment lead to reduced hiring and layoffs?

4. Does inflation become a concern, causing interest rates to rise?

5. Does the Fed shift policy one way or the other or keep rates steady?

6. What will the result be of the 2020 election?

7. Does a credit-related event cause a market liquidity crunch?

Closing Comments

The end of the year is always a time to look back on the financial markets as well as look ahead to the new year. It is difficult, if not impossible, to make accurate forecasts of how well equities and bonds will perform, but that does not stop portfolio managers, analysts and others to attempt to do so. We were surprised not only by the strength of the equity markets in 2019, but also with bond market performance as central banks continued to reduce interest rates. What is in store for 2020 involves some deep analysis of the facts, which will ultimately lead to predictions that will ultimately be proved to be wrong. Right before Christmas, Bloomberg TV had a guest who said, "It may be time for value stocks to join the party", or something to that effect. I am not sure that I would want the equity markets to be described as a party, but that is only my opinion.

We look forward to being your partner again this year and very much appreciate the trust you have put in WMA in the past. To all of you, we wish a healthy and prosperous New Year.

Kevin | Paul | Matt | Diane

Kevin S. McGrew | Paul L. Watkins | Matthew D. Ison | Diane C. Dercher

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