VINITY

Michael Friedman, CFA | Director of Asset Management

## In a Nutshell

This past year we saw an impressive run-up in risk assets and safe havens alike. This, along with no change in earnings, has pulled valuations for the S&P 500 Index above its long-term average. We will need to see earnings growth this year to justify the current index level and move higher from here. We don't think the market is showing signs of overheating, and if companies hit their earnings targets this year, the current environment is certainly sustainable. From an economic perspective, we don't see significant near-term recession risk and think this cycle can continue with the trend in the U.S. of lengthening economic expansions. The Federal Reserve has signaled no significant change to its interest rate policy over the next couple years, continuing the lower for longer stance, which favors stocks. The current economic landscape is positive, and the consumer is in a strong position. The unemployment rate is matching levels not seen since the late 1960's and growth in average hourly earnings above 3% is at levels we have not seen since the great recession. Further, consumers are saving more now than they were in the decade leading up to the financial crisis and household debt service as a percent of disposable income is at its lowest level in the past 40 years. Moving forward, we increasingly see opportunities overseas. From a value perspective, international developed and emerging markets are quite attractive and represent the best bang for your buck. Staying true to our philosophy of finding undervalued asset classes, we will look to bolster our international position throughout the year. An additional topic on everyone's mind is the 2020 U.S. presidential election. We will continue to follow developments over the next several months and assess potential policy impacts on our portfolios, albeit we tend to think the bark is much worse than the actual bite.

## Bubble Watch?

2019 started on the wrong foot with recession fears looming, but investors quickly shrugged off the negative sentiment, even in the wake of lackluster earnings, sending financial markets higher. Stocks and bonds in the U.S. soared to record highs this past year while markets across the globe saw generous double-digit returns. The S&P 500 Index produced its best calendar year total return since 2013, and the Bloomberg Barclays US Aggregate Bond Index produced its best calendar year total return since 2002.

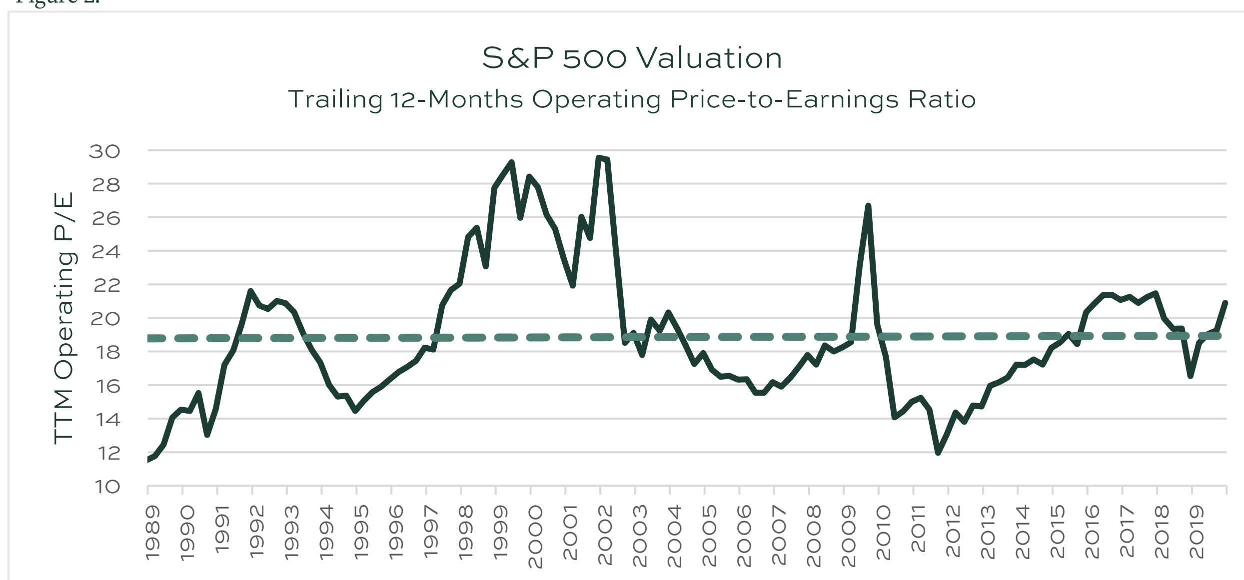
Figure 1.

Asset Class Returns
Calendar Year 2019

| Category | Index | Total Return |
|---|---|---|
| U.S. Large Cap | S&P 500 | 31.5% |
| U.S. Mid Cap | S&P MidCap 400 | 26.2% |
| U.S. Small Cap | S&P SmallCap 600 | 22.8% |
| International Developed | MSCI EAFE | 22.0% |
| Emerging Markets | MSCI EM | 18.4% |
| U.S. Bonds | BBgBarc US Agg Bond | 8.7% |

The S&P 500 skyrocketed over 30% in 2019, but earnings are expected to finish the year about unchanged. This creates an interesting dynamic leaving multiple expansion as the primary driver behind the index's rise. Multiple expansion means the price-to-earnings ratio or P/E ratio[1], a common valuation metric, increased, indicating you are paying more per dollar of earnings. Historically, the P/E ratio tends to revert to its mean value over time. When the P/E ratio rises, one of two things needs to happen to revert to the mean, earnings need to increase, or the price needs to decrease.

Figure 2.




As shown in Figure 2, the P/E ratio can remain overvalued or undervalued for extended periods but tends to revert to its mean value once overstretched in either direction. We don't think the current valuation places us in bubble territory but that the U.S. market is fully valued, and we will need to see earnings growth to continue to reach new highs. The 2020 full-year consensus estimate for S&P 500 earnings growth is 9.4%, according to FactSet. Greater emphasis will be placed on companies when they report, and guidance will play an important role as the market digests the announcements.

## Bull Markets Don't Have Expiration Dates

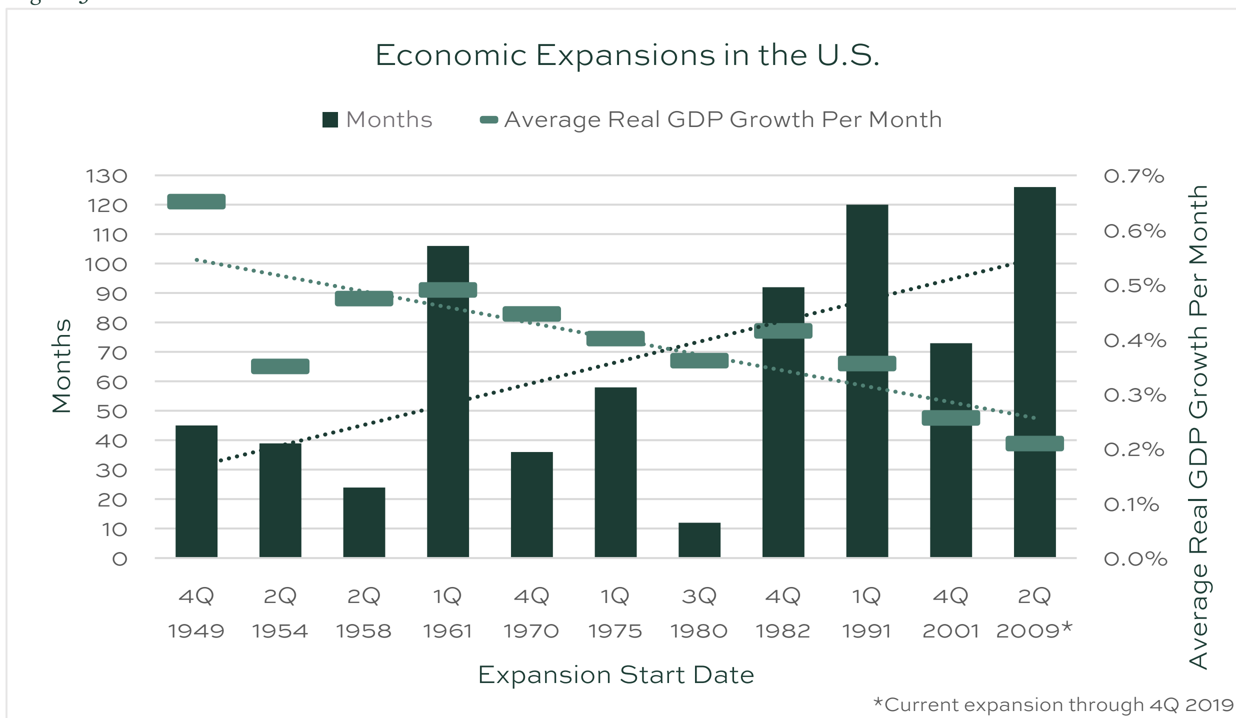
The current bull market holds the title of longest-running, so the question of when it will come to an end remains on everyone's mind. This is where we would like to remind everyone that bull markets don't have expiration dates. The number of months the bull market has run will not be a factor in what causes its eventual demise. Historically, recessions and asset bubbles or a combination of the two are what cause bull markets to stumble. We don't believe either of those environments are present currently nor pose a near-term risk to the market.

Although this is the longest-running economic expansion, it's not the strongest or fastest-growing. Over the past 70 years, the length of economic expansions in the U.S. has been increasing while the monthly

[1] P/E Ratio = Price Per Share / Earnings Per Share

average growth rate has been trending lower. These are characteristics we would associate with developed and maturing economies, not necessarily a negative trait.

Figure 3.




The average real GDP growth per month[2] during economic expansions has been declining at nearly a linear rate since the fourth quarter of 1949, per Figure 3. This corresponds with a similar increase in the duration of expansions. Although not as strong of a relationship, there has been a measurable step-up in the overall length of expansions starting in the fourth quarter of 1982. Barring a black swan, we think this bull still has more room to run.

## Federal Open Market Committee

Made up of the Federal Reserve Board of Governors and Federal Reserve Bank presidents, this is the group of men and women that set U.S. interest rate and central bank policy. This group has received much attention in recent years as investors anxiously await to scour through the minutes from their eight meetings each year in hopes of gaining insight into current and future policy moves. One of those insights is the target federal funds rate, the rate at which banks can borrow from each other overnight. This rate also sets the stage for what banks pay on deposits and the rate they charge to lend money. The Fed funds rate was cut to effectively 0% on December 16, 2008, to mitigate the financial crisis, and remained at that level until the first quarter-point hike in December 2015. It wasn't until the beginning of 2018 that the Fed began more aggressively raising the target rate. This coincided with the market meltdown in the fourth quarter of 2018, to which the Fed took a step back and embarked on a cycle of

[2] Average real GDP growth per month is the change in gross domestic product, the total value of all goods and services produced in the U.S. excluding the impact of inflation. Calculated as the percentage change in real GDP from the expansion start through the end divided by the number of months the expansion lasted.

cutting rates at the end of July 2019. The market responded positively, and as we know, the S&P 500 was up over 30% on a total return basis in 2019.

But, why is this target rate so important to investors? This can be answered quite simply: cheap money. For stock investors, interest rates are one of the inputs used in valuation. When compared to U.S. Treasury Bonds, which are considered one of the safest investments, stock investors require a premium over the rate they could earn by investing in those bonds. Referred to as the equity risk premium, this serves the purpose of compensating investors for taking on the additional risk of stocks. The required rate of return for a stock investor would then be the current yield on U.S. Treasury Bonds plus the equity risk premium. When interest rates are low, this lowers the required rate of return for stocks, and when interest rates increase, this raises the required rate of return for stocks. Through this relationship, when interest rates are low, this lowers the bar for what a particular stock would need to earn for an investor to consider it an attractive investment.

This concept can be explained through an example using the dividend discount model. This model calculates the intrinsic value of a stock by summing the present value of all future dividend payments. There are inherent limitations to this model as with any method used to value stocks, but the concept behind the model is what's important for our purposes here. We can save the debate on the merits of this model's application in the real world for a later date.

For simplicity's sake, the example we are going to use is the Gordon growth model, which is a variant of the dividend discount model that assumes dividends will grow at a constant rate in the future.

Figure 4.

Gordon Growth Model

$$V = \frac{D_1}{r - g}$$

$V$ = Intrinsic value
$D_1$ = Expected dividend next year
$r$ = Required rate of return
$g$ = Dividend growth rate

Let's assume we have a stock trading at $100 per share that will pay a dividend next year of $5 per share, and the dividend is expected to grow 4% per year in perpetuity. For this example, an investor would assign a 5% premium over the long-dated U.S. Treasury Bond, currently yielding 3%, for a total required rate of return of 8%. Using these inputs, we compute an intrinsic value of $125 per share, indicating this stock is currently trading at a discount to its fair value. Now, let's assume the Fed raises interest rates, and the yield on the U.S. Treasury Bond increases to 5%. Our new required rate of return is 10%. Using these inputs, we compute an intrinsic value of $83.33 per share, indicating this stock is trading at a premium to its fair value.

Figure 5.

| | Current Environment | Yield Increases 2% |
|---|---|---|
| 30-Yr U.S. T-Bond Yield | 3% | 5% |
| Equity Risk Premium | 5% | 5% |
| Required Rate of Return | 8% | 10% |
| | | |
| Intrinsic Value | $125 | $83 |
| Current Stock Price | $100 | $100 |
| Implied Upside/Downside | $25 | -$17 |

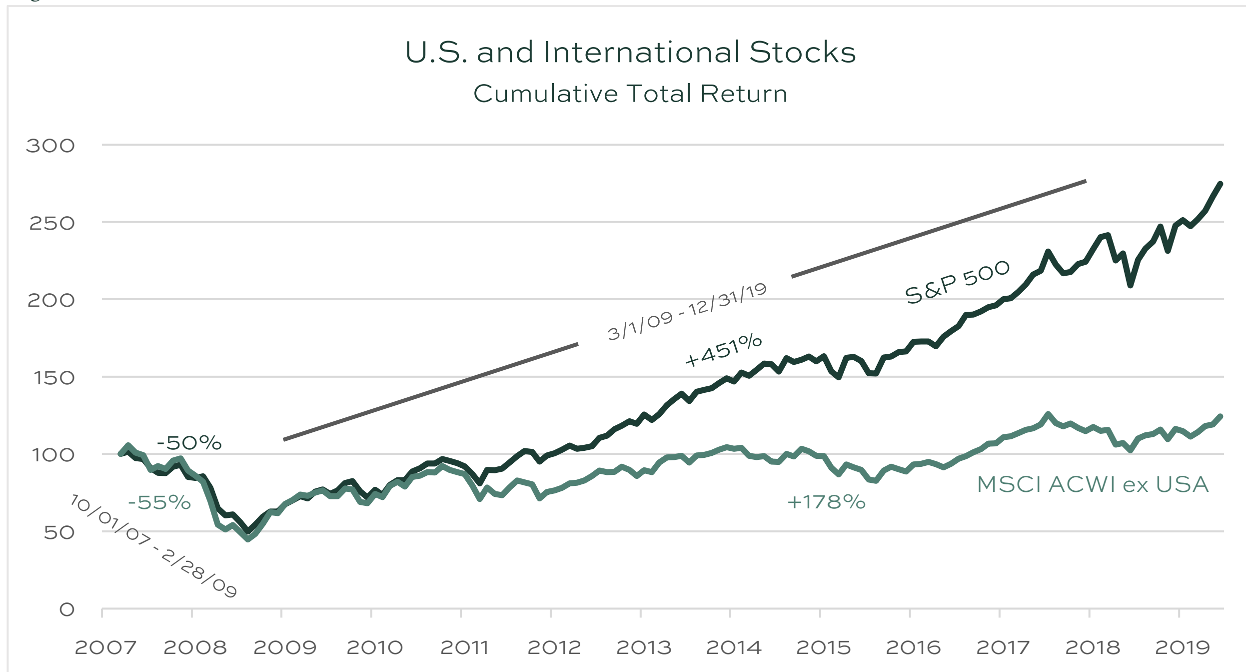
As demonstrated in Figure 5, holding all other variables equal, an increase in interest rates produced an entirely different outcome for the fair value of the stock. We think this relationship had much to do with the almost 20% market decline in the fourth quarter of 2018 and the subsequent 30% plus rally in 2019.

Looking ahead, the Fed funds futures market is pricing in a 0.25% rate cut by the end of this year and no change in 2021 and 2022. The Federal Open Market Committee, as of the December 2019 meeting, is projecting no action this year and a 0.25% hike in both 2021 and 2022. With the market and Fed both projecting minor to no change this year, fundamentals will have to drive growth in 2020.

## In Search of Value

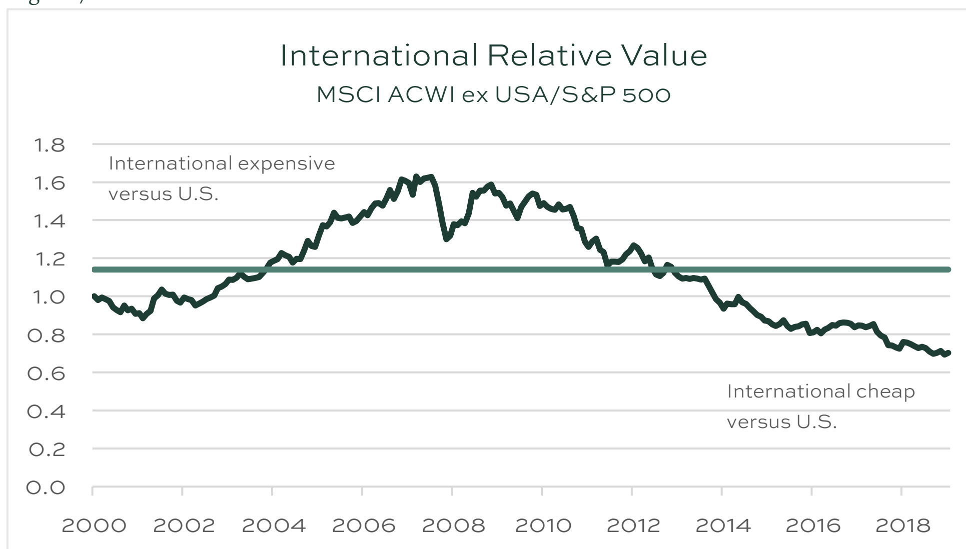
With the U.S. market fully valued, we see opportunities elsewhere around the globe from a relative value perspective. Although U.S. markets have enjoyed great success over the past decade, the same level of success can't be said for other markets around the globe. Since the market bottom on March 9, 2009, through the end of 2019, the S&P 500 Index has returned 273% more on a cumulative total return basis relative to the MSCI ACWI ex USA Index, which measures the performance of stocks in both developed and emerging markets outside the U.S.

Figure 6.




Further, when looking at relative performance for U.S. stocks versus their international counterparts, international is cheap compared to the historical average. Figure 7 explains this relationship over time. A value of 1.0 is neutral while a value of 1.2 indicates international is trading at 120% of U.S. stocks while a value of 0.8 indicates international is trading at 80% of U.S. stocks. On average, over the past 30 years, international trades at 114% of U.S. stocks compared to the current environment where international is trading at 70% of U.S. stocks.

Figure 7.




We are currently overweight international in our portfolios, particularly international small- and mid-caps, along with emerging markets. In search of value across the global opportunity set, international tops our list of most undervalued. Adding to our conviction are structural shifts in China and India leading to growth of the middle class in the largest emerging markets. Additionally, less analyst

coverage for the smaller international stocks and higher information barriers when compared to U.S. listed companies, opens the opportunity for skilled analysts and portfolio managers to further add value in those asset classes. We continue to like international and will look to increase our allocation during the year.

---

**Figure 4.** The Gordon Growth Model is subject to numerous assumptions, and the output is highly sensitive to the inputs selected, changing those variables may produce an entirely different outcome. **Figure 5.** This is a hypothetical example and is not representative of any particular stock. **Figure 7.** Relative value is calculated by taking the growth of $1 in the MSCI ACWI ex USA Index divided by the growth of $1 in the S&P 500 Index each month.

The views expressed are through the period ending December 2019 and are subject to change at any time based on market or other conditions. This material does not constitute a recommendation of any particular investment strategy or product. Although the information included is compiled from sources believed to be reliable, its accuracy cannot be guaranteed, and The Vinity Group nor its affiliates assume liability for loss due to reliance on this material and/or such views expressed herein.

Past performance is not indicative of future results. Indexes are unmanaged and you cannot invest directly in the index.

**S&P 500 Index:** Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **S&P MidCap 400:** Measures the performance of U.S. mid-cap equities and is comprised of 400 companies across sectors. **S&P SmallCap 600:** Measures the performance of U.S. small-cap equities and is comprised of 600 companies across sectors. **MSCI EAFE Index:** Measures the performance of large- and mid-cap equities across 21 developed markets countries, excluding the U.S. and Canada, and covers approximately 85% of the free float-adjusted market capitalization in each country. **MSCI EM Index:** Measures the performance of large- and mid-cap equities across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country. **MSCI ACWI ex USA Index:** Measures the performance of large- and mid-cap equities across 22 developed markets, excluding the U.S., and 26 emerging markets countries, and covers approximately 85% of the global equity opportunity set outside the U.S. **Bloomberg Barclays US Aggregate Bond Index:** Measures the performance of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market and includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

Sources: Bloomberg Barclays Indices, FactSet, J.P. Morgan Asset Management, MSCI, National Bureau of Economic Research, S&P Dow Jones Indices, YCharts.

Investment advice offered through Vinity Financial Group, a Registered Investment Advisor.