Independence Asset Advisors

MarketMatters

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Fourth Quarter at a Glance

Global equity markets were broadly positive in the fourth quarter, with the MSCI All Country World Index producing a 9.0% total return.

Emerging market equities were the best performing asset class during the period, up 11.8%, but on an annual basis, the MSCI EM Index lagged most of the other major global equity indices.

Energy infrastructure and U.S. REITs were negative during the fourth quarter, but the Alerian MLP Index ended the year on a high note after leading all major global asset classes with an 8.5% return in December.

Fourth quarter fixed income results were broadly positive, albeit muted.

Investment grade U.S. taxable and municipal bonds gained 0.2% and 0.7%, respectively, while high yield bonds and bank loans gained 1.7% and 2.6%; a result of their higher correlations to the U.S. stock market, which gained 9.1% during the fourth quarter.

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*Source: eVestment Analytics

> "It's been a great year to be invested, almost irrespective of what you were invested in."
>
> – Michael Bell, J.P. Morgan

2019 Full Year Market Overview & Key Themes

In contrast to the gloomy outlook at the beginning of the year, the results for 2019 were almost entirely positive. Regardless of asset allocation and/or investment selection, most investors fully recouped their fourth quarter losses and were up for the year.

Global equity markets delivered exceptional returns to investors in 2019, with the MSCI All Country World Index gaining 26.6%, the best result since 2009.

The favorable global equity market results were precipitated and then sustained by broad monetary accommodation. Many developed and emerging market economies cut interest rates in 2019 in an effort to maintain growth momentum. This included the U.S. Federal Reserve, which slashed its key borrowing rate by 0.75%. This unexpected flow of central bank liquidity supported strong gains throughout the year and more than offset what would have otherwise been overwhelming headwinds, including but not limited to:

- Global trade/tariff war
- Unresolved Brexit negotiations
- Multiple yield curve inversions
- Global manufacturing recession
- Global economic growth deceleration

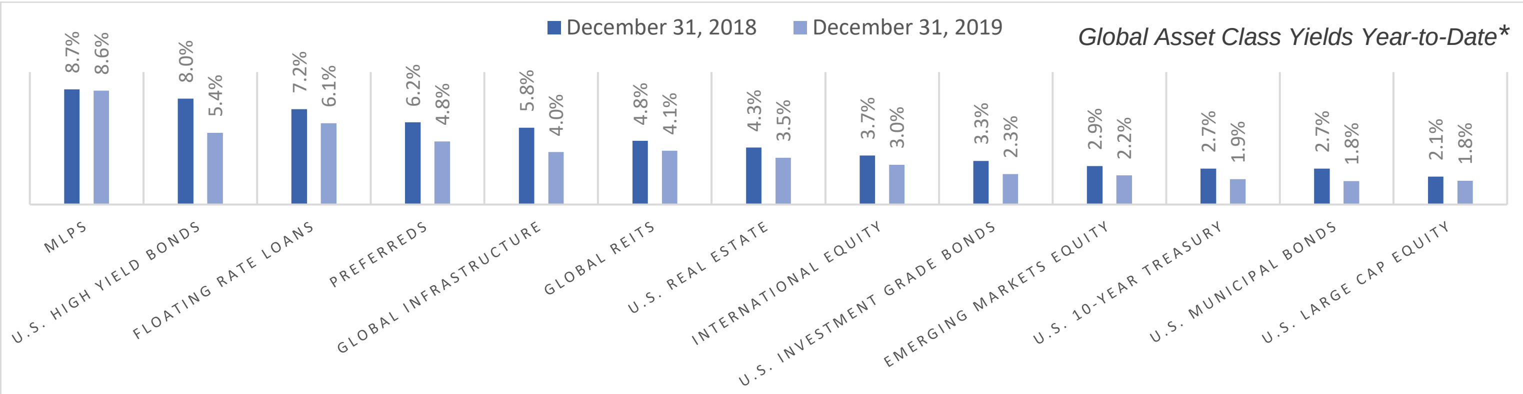
U.S. stocks were the best performing asset class in 2019, with large, mid and small capitalization indexes gaining 31.5%, 30.5% and 25.5%, respectively. In all, the S&P 500 Index posted 36 all-time high closing price levels in 2019, with the record price of 3,240 recorded just three trading days before the new year. The first record was set in the second quarter, with better-than-expected corporate earnings results and eased trade tensions propelling the S&P 500 to its best April since 1987. Records were then set with regularity after Chairman Powell indicated that the Fed would "act as appropriate to sustain the expansion." This comment heralded a "bad news is good news" sentiment, and resulted in the best June return since 1955.

Foreign equity markets were more heavily pressured by the global trade war compared to U.S. markets, and were more susceptible to geopolitical uncertainty. Many economies experienced growth deceleration or stagnation amid a broad manufacturing recession, which triggered monetary accommodation. Despite climbing a "wall of worry" throughout the year, foreign equity markets still ended 2020 up 21.5%, as reported by the MSCI All Country World ex-U.S. Index. International developed equities maintained a 6-8% advantage over emerging markets equities through the first 11 months of the year, but the divergence narrowed to 3.6% by year-end, with the MSCI EAFE Index and MSCI EM Index gaining 22.0% and 18.4% in 2019, respectively.

Fixed income markets rallied alongside global equities in 2019, but as bond prices moved higher, yields moved lower. The best performing fixed income investment was corporate high yield bonds, which gained 14.3%. Bank loans also performed well despite Fed rate cuts, gaining 8.6%, which more than offset the 3.5% loss sustained during the fourth quarter 2018 sell-off. There was no noticeable pickup in default rates across fixed income markets in 2019 but prices did generally move higher. Global bonds were positive for the year, but their return was suppressed by higher sovereign bond yields and a stronger U.S. dollar.

Rates/Economy
The 10-year Treasury ended 2019 at 1.9%, or 0.5% higher than mid-year, but remained 1.3% below the 2018 high of 3.2%. With nominal yields at 1.9%, and inflation at 2.3% (core CPI), the real yield, or the measure of purchasing power, was -0.4% at year-end. December marked the 126th month of the current U.S. economic expansion, which far exceeds the historical average of 48 months (recessions usually last 15 months). However, this is one of the weaker expansions, as measured by cumulative real GDP growth since the prior peak.

2019 Global Yield & Asset Class Review



*Global Asset Class Yields Year-to-Date**

➢ U.S. Equities

U.S. equities were the best performing investment in 2019. U.S. large cap stocks snapped back after losing 17.3% during the fourth quarter of 2018, reporting incremental gains in 10 of the next 12 months, and returning 31.5% overall, including dividends. Growth handedly outperformed value for the year, despite offering historically high prices and lower yields. The Russell 1000 Growth Index finished the year with a P/E of 23.1x, which is 6.0x above its historical average, and only 0.3x below U.S. small cap stocks. In terms of sector valuation, only Financials, Healthcare and Industrials offered reasonable pricing by year-end, with Consumer Discretionary and Information Technology considered highly overvalued. The S&P 500 Index yield was 1.8% at year-end, or 0.3% lower, year-over-year.

➢ Midstream MLPs

Energy infrastructure investments began the year very well, gaining nearly 17% by the end of the second quarter. Unfortunately, the Alerian MLP Index performed less well during the second half, with losses reported in four of the last six months of the year. Despite the second half regression, the asset class ended 2019 up 6.6%. In our opinion, the perceptions of this asset class are out-of-place. When we look at energy infrastructure objectively, we see excellent fundamentals, extremely attractive valuations, greatly reduced leverage and higher coverage ratios and significant free cash flow. In our view, the U.S. midstream subclass offers the best opportunity for investors seeking capital appreciation and high income. The opportunity for managers to integrate c-corps into portfolios only strengthens our optimism.

➢ U.S. REITs

U.S. REITs surged in 2019 amid a generally healthy economy, near-record low long-term rates and price discounting heading into the year. Looking across the capital stack, common REIT equity gained 23.1%, as measured by the Dow Jones U.S. Select REIT Index.

➢ U.S. REITs (Continued)

This was achieved despite a 1.2% pullback in the fourth quarter. REIT senior securities (preferreds) posted impressive returns of 19.3%, while REIT bonds gained a respectable 12.4%.

➢ Foreign Equities

International developed and emerging markets equities performed very well in 2019, a surprising result considering the global and country-specific issues that pressured foreign indexes during the year.

The MSCI EAFE Index, which represents international developed countries such as Japan, the United Kingdom, France and Germany, gained 22.0% in 2019, with a standard deviation of 11.5%. Note this measure of risk is lower than that of the S&P 500 Index, which reported a standard deviation of 12.9%.

The MSCI EM Index, which represents emerging markets countries such as China, South Korea, Taiwan and India, gained 18.4% in 2019, but experienced considerably higher volatility relative to developed markets.

The global trade war was undoubtedly the most deflating factor for non-U.S. equity markets in 2019, but it was especially detracting for emerging markets. The tariffs imposed by the U.S. on China, in particular, resulted in a manufacturing recession, which has had a direct and profound impact on the country's GDP.

Tarriffs aside, foreign equity markets also contended with massive protests in Hong Kong, which have crippled the country's economy, along with an unresolved Brexit, major elections across Asia and Europe, and an imminent slowdown in global growth.

To counter this flurry of global challenges, most major central banks adopted an accommodative stance by cutting their key interest rates and flooding economies with inexpensive borrowing capital. By year-end, easing of monetary policies appeared to have stopped the bleeding.

➢ U.S. Investment Grade Bonds

The Barclays U.S. Aggregate Bond Index gained 8.7% in 2019, but spreads tightened considerably during the year, from 153 to 93, as prices pushed consistently higher. All subsectors of the Index are considered expensive, but at year-end the unfavorable distinction went to investment grade corporate bonds, which were priced at $109.3. This is a steep premium to pay for bonds with a duration of 7.9 years, although the tradeoff for long-term investors is a 4.0% coupon. In terms of credit, however, AA-rated investment grade corporate bonds appear to offer the best value with a 3.3% coupon, a $107.1 price and a relatively low duration of 7.4 years. Of greater concern, the BBB-rated space appears saturated, and could be susceptible to default risk.

➢ U.S. Municipal Bonds

U.S. municipal bonds gained 7.5% overall in 2019, which is the best return for the tax-exempt asset class since 2014. The return was predominately supported by BBB-rated bonds, which exhibited considerable spread tightening during the year relative to AA- and A-rated municipals. AAA-rated spreads to Treasuries tightened across maturities, with 30-year, 10-year and 5-year municipal bond yields narrowing by 12%, 9% and 12%, respectively. The tax-equivalent yield at year-end was 3.01% (based on the 1.78% municipal index yield).

➢ U.S. High Yield Bonds & Bank Loans

High yield bonds rode the coattails of the S&P 500 Index in 2019, participating in 45% of the stock market's gain, or 14.3%. The correlation to equities remained high throughout the year, and the Barclays U.S. Corporate High Yield Index participated in each of the three primary pullbacks. Defaults remained low throughout the year, but ticked higher to nearly 3% by year-end.

Bank loans performed surprisingly well in 2019, especially considering the Fed's 0.75% interest rate reduction. The S&P LSTA Index gained 8.6%, defaults declined 0.2% to 1.4%, and loans are trading at a nearly $4 discount to par ($100); duration risk remained zero and the yield is 6.1%.

*Sources: JP Morgan Guide to the Markets, Eaton Vance Monthly Market Monitor, Dow Jones Indices, FactSet.

2020 Global Market Outlook

➢ Global Economic Takeaways

- We are less pessimistic heading into 2020, relative to our outlook at this time last year.
- Consensus suggests global growth will continue to slow, but the synchronized monetary easing initiative could result in a global reacceleration.
- Consensus forecasts 2020 global GDP growth of 2.5%, with the U.S. growth slowing to 1.7% from 2.3% in 2019.
- Emerging markets growth is forecasted to improve at the margin to 4.2%.
- The global trade war, especially the unresolved tariff conflict between the U.S. and China, will continue to influence global equity markets whether or not a resolution is reached.
- It is too soon to presume how the military conflict between the U.S. and Iran may impact global markets, but oil prices will likely be affected.

➢ Equity Market Takeaways

- U.S. equities are overvalued, with the exception of value stocks, which could limit the upside.
- Foreign equity markets offer better value and higher yields relative to our domestic equity markets, but unresolved geopolitical issues could continue to suppress returns.

➢ Fixed Income Market Takeaways

- Investment grade bonds will remain expensive and spreads will narrow further as prices continue to rise.
- Higher risk fixed income offers little margin for error – consider rotating out of high yield bonds and into bank loans.
- The large-scale credit risk to BBB-rated bonds is something to be mindful of in 2020.

➢ U.S. Equities

Looking ahead to 2020, it appears unlikely that gains will be as robust as they were in 2019. Beginning the year with P/Es near or at all-time highs will make it more challenging for growth and core managers to outperform. Guidance suggests the forward 12-month P/E ratio for the S&P 500 is 18.4x. This is higher than the 5-year average of 16.7x and above the 10-year average of 14.9x. Current estimates from FactSet show 0.2% earnings growth in 2019, with revenue growth of 3.9%. For 2020, analysts are projecting earnings growth of 9.4%, which we believe is optimistic.

➢ Foreign Equities

The headwinds that pressured non-U.S. equity markets in 2019 appear to have eased, albeit only slightly. The monetary intervention by most foreign central banks seems like a step in the right direction to reverse the negative growth trend that resulted primarily from the global trade war. Both international developed and emerging markets equities are attractively priced and offer higher rates of income. The outlook for foreign equity has improved slightly for 2020.

➢ Energy Infrastructure Equities

On paper it seems like the perfect time to add capital to energy infrastructure investments. However, we are hesitant to advise this action because the asset class appears misjudged. This current environment of uncertainty, especially within the retail investor market, can make the asset class even more susceptible to headline risk and fund outflows. We believe a modest allocation to U.S. midstream is appropriate, with a majority of the allocation to volatility-reducing c-corps, will reward investors with an opportunity for capital appreciation and +6% yields in 2020.

➢ REITs

The real estate market shows signs of significant transition after a 10-year bull run, and we are seeing signs of late-cycle operating fundamentals. Market-wide public pricing appears "full" from our perspective, with the exception of spreads to Treasuries. However, deep net asset value (NAV) discounts persist in select companies, especially within traditional core segments. That said, these discounts may not reflect realistic pricing based on growing CapEx requirements. It is a tricky time for REITs, and the current late-cycle environment reinforces the importance of working with a high-quality specialist manager who can move across the capital structure to find the best deals.

➢ U.S. Investment Grade Bonds

Municipal bonds are attractive in terms of their coupon (4.6%) and duration (5.3 years), which are both better than what is being offered on the taxable side. Municipals and corporate bond defaults are also near historical lows, and there is a good balance between supply and demand. However, municipal bonds are extremely expensive, with an average price of $111.8 ($105.6 for the Barclays Aggregate Index). Moving down in credit quality or going out further in maturity improves price, but with investors stretching for tax-exempt yield, the lower quality bond market is becoming flooded and susceptible to default risk. On the taxable side, we worry most about a large-scale credit adjustment on BBB-rated bonds to high yield debt; retail investors would be negatively impacted.

➢ U.S. High Yield and Bank Loans

High yield performed well in 2019 due to its correlation with U.S. stocks. In 2020, we expect returns to be lower and volatility to be higher. Against this back drop, and considering high yield bond spreads are approaching historical lows (360 current / 241 low / 2147 high / 462 average), we see a shift in favor of lower returns and greater risk for this asset class in the year ahead. In addition, investors will be paying upwards of $104.6 for high yield bonds rated above CCC. As for bank loans, with an average yield of 6.1%, no duration risk, and as one of the only undervalued asset classes, we view them as more attractive relative to high yield bonds. However, bank loans are susceptible to lower interest rates and defaults.

Quarterly Focus: Gross Domestic Product

Gross Domestic Product, or GDP, is one of the most recognizable terms in finance.

It serves as a key indicator of a nation's economic heath, as it represents the value of all goods and services produced over a specific period of time (quarterly or annually). Due to its uniformity of measurement, GDP serves as a reliable comparison of productivity across countries and time periods.

Data is used by economists to determine whether an economy is growing, stagnating, or experiencing a recession (typically two consecutive quarters of declining GDP). Investors may utilize GDP when evaluating the stock market, as a "bad economy" usually means lower earnings and lower stock prices.

The components of GDP include:

- Personal & Public Consumption
- Public & Private Investment
- Government Spending
- Net Exports on Goods/Services

In the United States, GDP is calculated on a quarterly basis, and while this rate offers a period measurement of how well the economy is faring, it is annual GDP that is considered the benchmark for determining the size of a nation's economy.

There are two variations of GDP:

1) Nominal GDP is the measure of the annual production of goods and services calculated at actual price without considering the effect of inflation.

2) Real GDP factors in inflation and deflation, or the overall rise and fall of price levels.

Economists generally use Real GDP when analyzing economic trends. Since GDP is a monetary value, it is subject to price changes in the economy during a specific period of measurement. If GDP is not adjusted for price changes, it would not be possible to analyze whether an increase in GDP, for example, was attributable to expansion in production or an increase of prices, or both. Thus, it would no longer serve as a reliable comparison of productivity across countries and across time.

The U.S. has maintained the top position in the ranking of GDP since the end of World War II. Second is China, then Germany and India. The Nominal GDP of the top 10 countries represents 66% of the world's economy.