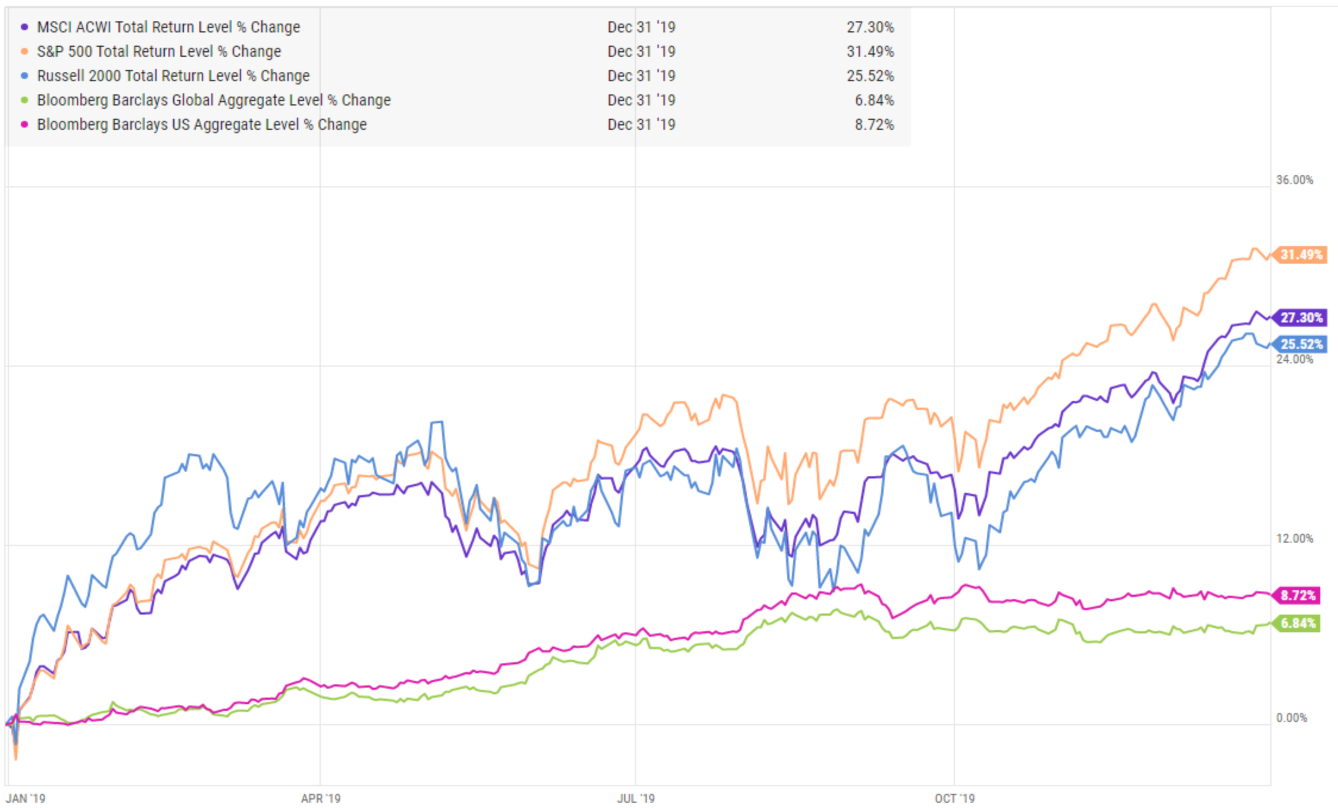
2019 Year in Review

Despite repeated warnings from financial media pundits, portfolio managers, and economists of a forthcoming global slowdown (even a contraction), financial markets roared upwards in 2019. Supportive central banks and still robust risk-appetites were generally seen as the major catalysts for a blockbuster year in stocks and bonds, as the MSCI All Country World Equity Index gained 27.3% on a total return basis, while the Bloomberg Barclays Global Aggregate Total Return Bond index returned 6.8%.

Markets and U.S. Economy

As has been the case throughout much of the post-Great Financial Crisis recovery, U.S. markets continued to dominate overseas markets. The S&P 500 index, on a total return basis, notched a 31.5% gain in 2019, while the Russell 2000 Total Return index gained 25.5%. These indices gained 9.1% and 9.9% in the fourth quarter, respectively. The duration-driven rally of 2019 petered off in the fourth quarter but was still enough to propel the Bloomberg Barclays U.S. Aggregate Total Return Bond index to a 8.7% gain (but just 0.20% in the fourth quarter).



Source: YCharts

The U.S. Federal Reserve seemingly played a crucial role in the outperformance (relative to global markets) in both U.S. equities and U.S. fixed income—a midyear dovish pivot drove equities higher and bond yields lower, and what a difference a year makes. Even a cursory glance at Fed data shows how stark this pivot was. The closely followed Fed "dot plot", which is an aggregation of various Fed governors' future expectations for the Federal Funds Rate, changed drastically from December 2018 to September 2019:

Source: Bloomberg, U.S. Federal Reserve

Fed officials not only lowered their expectations for the Federal Funds Rate into 2020 and beyond, but also delivered three 25 basis point rate cuts in 2019 (August, September, and October), bringing the policy rate from a midpoint of 2.375% at the end of 2018 to 1.625% at the end of 2019.

The rate cuts and newfound dovish outlook propelled stocks higher, despite weakening underlying fundamentals, once again vindicating many money managers' assumptions that the Fed would intervene to support asset prices. At the end of the fourth quarter 2018, according to data analyzed by FactSet, the S&P 500 had a forward P/E ratio of 14.2 (below the 5-year and 10-year averages) and analysts were projecting nearly 8% earnings growth in calendar year 2019. Fast forward to the 4Q 2019 FactSet report, and the S&P 500 trades at 18.0 times forward earnings—which is above the 2018 forward P/E as well as the 5-year and 10-year averages—while analysts are projecting very meager earnings growth of 0.3% for calendar year 2019. In other words, 2019's incredible returns were driven almost entirely by P/E multiple expansion versus earnings growth—largely thanks to the Fed.

Fixed income markets, like equity markets, were also greatly impacted by Fed moves in 2019. The yield on the 10-year Treasury note was 2.69% on December 31, 2018 and fell 77 bps throughout the year to end 2019 at 1.92%. As a result, long duration fixed income instruments outperformed short duration. Credit also performed admirably in 2019 as the reach for yield continued for another calendar year. According to a CreditSights' analysis of Bank of America's Intercontinental Exchange (ICE BofAML) fixed income indices, U.S. Investment Grade bonds returned

14.2%, led by the BBB tranche with 15.9% gains. U.S. High Yield bonds performed similarly, up 14.4% led by the BB tranche with 15.7% returns. Interestingly enough—and something we are watching closely—Investment Grade investors went down the quality spectrum to chase yield (hence BBB outperformance vs. A, AA, and AA tranches), while High Yield investors sought quality within the space (e.g. BB outperformed the CCC tranche by 660bps, and the B tranche by 130bps). Another likely contributor to this phenomenon is Investment Grade investors reaching down into the High Yield bucket to pick up additional yield—providing a boost to BB bonds.

Turning to the main street economy, the U.S. is poised to deliver around 1.7% annualized GDP growth in the fourth quarter according to both the *Wall Street Journal*'s monthly Survey of Economists and the blue-chip consensus gathered by the Atlanta Federal Reserve. This follows 3.1%, 2.0%, and 2.1% growth in the first three quarters of the year, respectfully. If the fourth quarter consensus number materializes, the U.S. will have grown about 2.2% in 2019, according to the *WSJ* survey, lower than 2017 and 2018 but still better than other major developed economies. Manufacturing PMIs are pointing towards a continued struggle in the sector; however, for 2019 the U.S. consumer held up well.

International

Generally speaking, both international and emerging market equities and fixed income performed well in 2019, though they underperformed relative to U.S. financial markets. The MSCI EAFE Total Return Equity index rose 22.7% in 2019, followed by the MSCI Emerging Markets Total Return Equity index which gained 18.9%. In the fourth quarter, the MSCI EAFE index (up 8.2% on a total return basis) trailed global equity markets (up 9.1% on a total return basis), while Emerging Market equities rose 11.9%. On the fixed income front, international developed bonds (as measured by the Bloomberg Barclays Global Aggregate ex-US Index) underperformed global fixed income markets, returning 5.1% in 2019, while Emerging Market bonds (as measured by the JPMorgan USD Emerging Markets Bond ETF, EMB) returned 10.3%.

As in the U.S., international developed and emerging market central banks also pivoted on the policy front. Though very few, if any, were in line with the U.S. in terms of 2018 tightening, 2019 saw central banks shift to a decidedly more dovish tone almost in unison.

The shift was a major catalyst in driving financial assets to cycle highs; however, international main street economies continue to struggle. In the International Monetary Fund's (IMF) October 2019 World Economic Outlook, the Fund lowered its 2019 global growth projection to 3.0%, 0.20% below its July update and 0.60% below 2018 growth (3.6%). The International Money Fund (IMF) is forecasting a paltry 1.2% growth in the Euro area for 2019, which has seen key economies like Germany flounder in the midst of a manufacturing recession (the IMF forecasts 0.5% growth in Germany). In the Pacific, the Fund sees 0.9% growth in Japan in 2019 and 6.1% in China; international developing countries are expected to grow just 3.9% in aggregate in 2019, one of the worst readings in recent years. As we have written about in the past, global central bank dovish-ness bodes well for financial assets like stocks and bonds; however, its impact on main street economies is far less optimistic, as in the case of Japan and to a lesser extent, Europe.

STAR™ Spectrum Model Changes – 4Q19

During the fourth quarter 2019, Partnervest recalibrated the individual U.S. Sector allocations that are held in a majority of the STAR Spectrum Models.

The Models held both Consumer Discretionary (XLY) and Consumer Staples (XLP) due to our belief that that U.S. Consumer would drive returns in 2019. While both of these positions were contributory to the portfolios, Consumer Discretionary (XLY) was replaced by Financials (XLF) in October 2019 in response to diminished U.S. Consumer weight.

In December 2019 our commodities exposure via North Square Oak Ridge Global Resources & Infrastructure Fund Class I (INNNX) in the Alternative section was cut from the Models with. the proceeds invested back into our other Alternative holdings: Goldman Sachs Absolute Return Tracker Fund (GJRTX) and Infinity Q Diversified Alpha Fund (IQDNX). Both of these holdings have multi-asset exposure and are well diversified in the Alternative space.

STAR™ Spectrum Strategy Outlook

All in all, 2019 will go down in the books as a standout year for financial assets as recession fears and growth slowdown stories were seemingly negated entirely by central bank pivots and easy money policies. The summer recession fears were mostly reversed in the fourth quarter—yield curves steepened (and un-inverted) and risk assets plowed forward as market participants digested what dovish central banks meant for the supposed pending recessions. While we are grateful for this year’s market gains, there are risks looming on the horizon that we are watching closely and considering as we continue the 2020 forecasting and outlook process. We will provide more information on the results of the forecasting process, as well as any potential Model changes, as they are finalized.

Sincerely,

Partnervest
STAR™ Spectrum Investment Team

DISCLOSURE

This commentary is published by Partnervest Advisory Services LLC and is provided free of charge. Any stated or implied recommendations herein are of a general nature. Clients should consult with their investment advisor representative for advice concerning their particular situation and consider their own financial circumstances and goals carefully before investing. The information presented was obtained from sources and data considered to be reliable, but its accuracy and completeness is not guaranteed. It should not be used as a primary basis for making investment decisions. Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not indicators or guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Opinions, beliefs and/or thoughts are as of the date given and are subject to change without notice. Past performance is not indicative of future returns and there is always a risk of loss of principal with any strategy. Due to varying needs and circumstances, allocations and performance of individual accounts may differ from their corresponding model. This commentary is designed to be general in nature and reflects our overall opinion. All asset classes or securities may not be in your particular portfolio nor within the targeted allocations. Any securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. This is NOT a solicitation for the sale or an offer to buy any security. Indices do not reflect actual portfolios or trading and the stated returns do not include investment management fees, transaction fees, dividends and other earnings and the timing of investment decisions, thus, they are not necessarily indicative of the allocation or return that an actual managed account in the future will or would have achieved. Partnervest strategy performance, if depicted, is net of fees. For additional details on this, or any of the investment strategies offered by Partnervest, please consult your investment Advisor. Investment management services provided through Partnervest Advisory Services LLC. Subadvisory Services and research provided by Anfield Capital Management, LLC.