TFC FINANCIAL
The Financial Counselors

COMMENTARY | 4Q 2019
January 2020

OUR VIEW

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2019 In Review

Equities reached record highs in 2019, a welcome rebound after a tumultuous end to 2018. The avoidance of the worst-case outcomes feared at the end of 2018 contributed to the surprisingly strong market performance. Central banks turned from a tightening to an easing bias, China took steps to stimulate economic growth, and the U.S. and China declared a truce in a trade war that slowed growth in both countries.

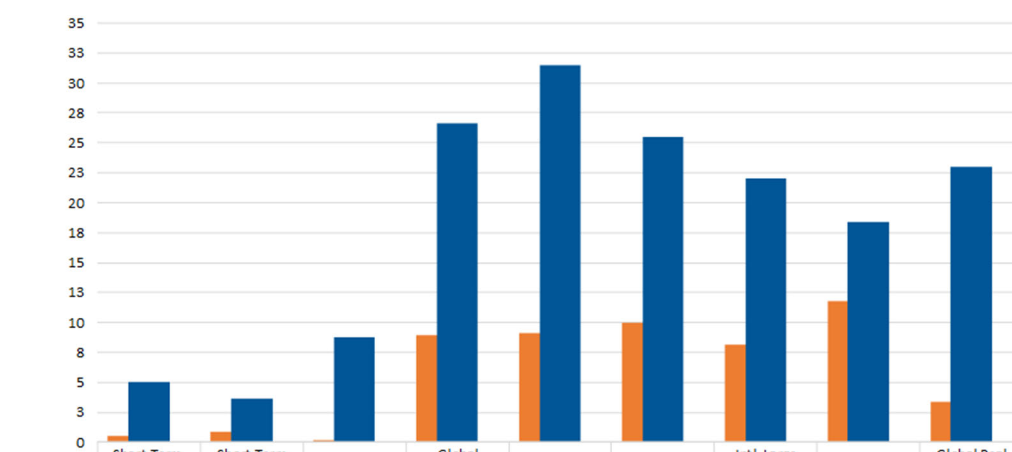
Global equities, as represented by the MSCI All Country World Index, rose by more than 26% for the year. U.S. large company stocks were relative outperformers, with the S&P 500 gaining more than 31%. U.S. large company growth stocks outpaced U.S. large company value stocks by nearly 10% for the year. U.S. small company stocks gained more than 25%.

Developed international stocks, as measured by the MSCI EAFE Index, rose more than 22%. Emerging markets stocks staged a strong 4th quarter rally to gain more than 18% for the year.

From a sector perspective, technology and communications services were market leaders, while energy and healthcare trailed the market.

Falling interest rates were a positive for the bond market, with intermediate and long-term bonds providing both capital appreciation and coupon income. Longer dated corporate bonds benefited from both falling rates and narrowing credit spreads to return 14% for the year.

Quarter To Date Returns 12/31/2019



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	0.5	0.8	0.2	9.0	9.1	9.9	8.2	11.8	3.4
YTD	5.0	3.7	8.7	26.6	31.5	25.5	22.0	18.4	23.0
Full Cycle*	2.7	2.4	4.1	4.6	8.6	7.5	1.6	0.9	3.6

* Full Cycle is the annualized return from October 2007 peak to present.

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TFC client portfolios benefited from the strong year in the market. In relative terms, TFC's value-oriented holdings lagged behind their growth counterparts. TFC's bond holdings, most notably mutual funds that included intermediate and long-term bonds, contributed positively to relative performance.

TFC's asset allocation approach is designed to provide clients with diversified equity investments across regions, economic sectors and investment styles. We are wary of "all or nothing" investment approaches, consequently TFC portfolios are "tilted" toward value but do not completely avoid growth stocks. Although recent performance is behind TFC client benchmarks, the gap between TFC and benchmark performance was considerably narrower than the dramatic overall gap between value and growth.

Market Outlook

Our overall economic outlook is reasonably positive. The U.S. consumer continues to be a source of growth, with unemployment low, consumer debt largely under control and wages and asset values rising.

The market pessimism that concluded 2018 was replaced by considerable optimism to conclude 2019. The phase one trade agreement between the U.S. and China de-escalates a destructive trade war and should provide a boost to global growth in 2020. The decisive U.K. election victory for Boris Johnson's Conservative Party over the Jeremy Corbyn-led Labour Party provides the majority in Parliament needed to "Get Brexit Done." The U.K. election results reduce the likelihood of a "crash-out Brexit." Investors are also relieved that Corbyn will be replaced as leader of the Labour Party. Positive news on trade also emerged in North America, with Republicans and Democrats agreeing on the terms of a free trade agreement to replace NAFTA. Bipartisan support for the U.S. – Mexico – Canada Agreement (USMCA) paves the way for an early 2020 ratification. Fed policy heading into 2020 is also dramatically different than was the case a year ago. The Fed is likely to stay on hold until after the 2020 election, in contrast to the tightening bias in place entering 2019.

We also expect Chinese economic stimulus to contribute to global growth in 2020. However, the message from China's Central Economic Work Conference is that China's leaders are prioritizing stability and sustainability of economic growth over reflation. Consequently, the contribution to global growth may fall short of prior reflation cycles. It is good news that Chinese policymakers will place less of an emphasis on deleveraging than was the case in 2018, implying a more relaxed outlook for credit growth. Banking sector reform, long overdue, is underway.

Monetary policy is also constructive for global economic growth. The U.S. Federal Reserve is likely to remain on hold during the election-year and central bank policy is expansionary in much of the world. However, central banks have more influence on the short end of the yield curve. The long end of the curve was pushed higher by improved geopolitical and growth outlooks, while the short end remained anchored by monetary policy. The steepening yield curve resulting from higher long-term rates is a positive development for banks, but not necessarily a positive development for many borrowers.

We do worry that the positive developments to end 2019 made investors overly optimistic about the outlook for 2020. Elevated valuations among U.S. growth stocks leave little room for disappointment.

Our overall economic outlook is reasonably positive. The U.S. consumer continues to be a source of growth, with unemployment low, consumer debt largely under control and wages and asset values rising. Corporate earnings growth should rise, in some cases from depressed levels. We gravitate to the point of view of BlackRock's Rick Rieder, who recently projected that 2020 will be a "1.8ish" kind of year. Rieder's expectation is for U.S. real GDP growth of approximately 1.8%, inflation of about 1.8% and 10-year Treasury yield of 1.8%. That not too hot, not too cold scenario creates expectations of positive but unspectacular growth for equities and a mixed outlook for bonds.

We do worry that the positive developments to end 2019 made investors overly optimistic about the outlook for 2020. Elevated valuations among U.S. growth stocks leave little room for disappointment. Bullish sentiment may fade quickly if reality falls short of expectations. In the words of J.P. Morgan's David Kelly, the phase one trade deal with China represents a "fragile cease fire rather than a durable peace." Tensions between the U.S. and China are likely to resume after the 2020 election. Business spending may rebound to a lower degree than expected if corporate CEOs view the trade truce as temporary. With tensions with China temporarily on hold, President Donald

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Trump could turn his ire toward other countries. European trade imbalances and underinvestment in NATO may be Trump's next target, as it seems unlikely that he'll abandon trade issues entirely during an election year. The latest developments in Iran and Iraq are examples of the unexpected geopolitical issues that could cause an interruption in the latest stage of the bull market. Election-related volatility is also to be expected as November approaches.

We expect some of the left-behind segments of the market to stage a recovery in 2020. The significant valuation disparity between value and growth stocks seems unsustainable. Manufacturing stocks, which are a major component of value indexes, should benefit from Chinese stimulus measures and the easing of trade tensions. Financial stocks, also a major component within value indexes, would benefit from a steeper yield curve and moderate economic growth.

In our view, there is greater potential for a positive surprise from Europe than has been the case the last couple of years. Export-centric European stocks, which trade at a higher than normal discount to U.S. stocks, would benefit from a manufacturing rebound. German consumer spending appears to be improving in response to rising wages. A weaker dollar would also help European stocks.

Short-term bond yields are likely to be restrained by central banks, while longer-term bond yields are likely to drift upward. The risk-reward trade off in longer-term bonds is less attractive than was the case a year ago, but a well-diversified allocation to bonds remains a necessary counterweight to equity risk.

Portfolio Positioning

From a positioning perspective, TFC is positioned roughly in line with long-term strategic targets for stocks, though we will be thoughtful in maintaining enough portfolio liquidity to address known cash needs over the next six to twelve months. Heightened volatility is likely to be an unfortunate reality for 2020, particularly as election-related headlines mount during the second half of the year. We expect modestly reaccelerating global growth and contained recession risk in 2020, which supports the neutral weight to equities. The potential risks discussed above reinforces the importance of fixed income investments and the need to incorporate diversifying investments within equity allocations. TFC continues to favor shorter-term/investment grade credits, but also invest in intermediate-term bonds that provide desirable diversification.

We are striving to make client portfolios more resilient, in response to an environment in which economic growth is falling short of post-war peaks and in preparation for a future bear market.

We know that the steep downturns of 2000 and 2008 remain fresh in investor thinking. 2019 was a great year for equities, following a sudden market correction in the 4th quarter of 2018. A correction or a bear market is certainly possible in 2020, even though that isn't our most likely scenario. However, we think it is important to point out that we see few parallels to the major bear markets of 2000 and 2008. In comparison to 2008, there isn't a real estate bubble, bank leverage is far lower than was the case a decade ago, and regulators have considerably more visibility into derivatives usage. The nature of the technology industry has changed since the dot-com boom/bust and equity valuations are far from the distorted levels of 1999.

We have made meaningful portfolio changes in recent years. We are striving to make client portfolios more resilient, in response to an environment in which economic growth is falling short of post-war peaks and in preparation for a future bear market. Our thinking has been influenced by the pervasive disruption we are seeing in the global economy and investment markets. A T. Rowe Price study last year estimated that more than 30% of the S&P 500 was undergoing disruption, a number that surely will rise in the coming years. In the words of Fidelity's Anne Richards, "this time isn't different but is faster." TFC's approach to value investing is evolving in part as a response to disruption. We continue to expect the time-tested value investment approaches of Benjamin Graham and Warren Buffett to pay off in the long run. However, we think that a strategy of simply buying "cheap" stocks may not be a sustainable approach to value investing. The pace of change, in large part because of technology, is such that many of today's value companies may be "cheap for a reason." It is increasing important to identify companies that are resistant to disruption or are

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We'll close with some timeless wisdom from Oaktree Capital's Howard Marks: "Move forward, but with caution. The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the market."

effectively responding to disruption. Consequently, TFC has increasingly invested in funds that go beyond simple price metrics to determine company "value."

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We will discuss the topic of disruption as part of TFC's 2020 Outlook webinar, which is scheduled for January 28 at 12:00 p.m. Please check your emails for instructions on how to register, and we'll post the webinar on our website for those unable to attend live. If you did not receive an email, please let us know.

As always, we welcome your comments and questions.

Sincerely,

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