STILL PRESSING AHEAD…AND MOSTLY HIGHER

There are now just 21 trading days remaining in 2019, to date one of the single best calendar years in recent capital markets history. Were global markets to just mark time – finishing December mostly unchanged for the month – annual returns on broadly diversified portfolios would be the highest of any year since the strong post-recession rebound of 2009. That year, a broadly diversified portfolio (60% global equities, 40% taxable bonds) produced gains of roughly +24%. Notably, global equity markets have produced little in the way of what passes for normal levels of "fear" this year. Intra-year price declines of -10% (or greater) are a common characteristic of equity markets; in 2019, the worst cumulative declines logged by U.S. and global equity markets (-7% and -8%, respectively) did not shake investors' collective optimism.

Little changed last month in the way of the underlying fundamentals that, to a large extent, drive prices in security markets. Concerns about a slowing global economy and prospects of a U.S. economic recession in 2020 have lessened since mid-year. U.S. and China trade talks, we are led to believe, are heading toward at least a *Phase I* agreement that will lessen the uncertainties that had eroded business confidence and capital spending earlier this year. Greater economic certainty has mostly shifted discussions away from the need to further decrease U.S. interest rates, and investors have seemed unconcerned that corporate earnings for all of 2019 are little changed from those of 2018.

Themes and stories for the month of November included:

- Investor sentiment remained mostly positive for equities, with global equities returning +2.4% in November. U.S. Equities resumed their leadership role last month (+3.8%, Russell 3000 Index), bringing YTD results to +27.3%. One telltale sign that investors have grown more optimistic: Small Cap stocks (+4.1%) outpaced the Large Cap segment of the U.S. equity market. Investors remain hopeful (are already assuming) that a Phase I trade deal with China is successfully agreed to soon. Already high equity valuations (e.g., Price-to-Estimated Earnings) pushed higher still in November. The S&P 500 Index, for example, was selling at a 24-month high Forward P/E of 19.2x near month-end.

- Developed Market Equities (*MSCI EAFE)* posted a relatively modest return (+1.1%) compared to U.S. equities, in part due to declines in the value of the Euro and the Japanese Yen relative to the U.S. Dollar. Emerging Market Equities returned +0.9% in November, weighed down in part by weak performance in Latin American markets (-4.6%). On the positive side, Emerging Asia equity markets finished the month up nearly +2% with stocks in China (+3.5%) leading prices higher.

- As recession fears continued to abate last month, yields moved slightly higher (7-10 basis points) on most U.S. Treasury bonds. The benchmark 10-year Treasury now yields 1.78% (versus a late-Summer low of 1.47%). There is now very little expectation that the benchmark Fed Funds Rate will be changed when the Federal Reserve next meets in mid-December. The U.S. central bank remained active in the short end (the "repo market") of the bond market last month, buying $15 billion of T-bills on a weekly basis to inject additional liquidity into the banking system. There is a growing consensus that the repo market will face another bout of volatility at year-end as banks and other financial institutions boost cash balances to meet regulatory capital requirements. We believe there remains little risk, however, that this volatility spreads into other portions of the bond market.

- The taxable and tax-exempt bond markets are on track to generate their best annual total returns (income plus price increases) in years. Specifically, the taxable bond market has returned +8.8% YTD (Bloomberg Barclays US Aggregate Index) and is on track to produce its best annual outcome since 2002. Likewise, the tax-exempt bond market is now +5.3% YTD (Barclays 1-10 Year Muni Index) and is headed toward its best total return since 2011. Just as equity valuations leave little room for "error" (i.e., an adverse market reaction to earnings shortfalls versus investors' rosy expectations), current bond market yields (2.3% taxable; 1.4% tax-exempt) are stingy by any measure and portend below-average future returns in these asset classes.

- It remains hard to find signs of stress in the corporate bond market, with investment grade credit spreads reaching a YTD low during the month and high yield issuer default rates still in-line with long-term norms. However, with yields on leveraged loans mostly following short-term interest rates lower, decreased investor demand (i.e., net outflows from funds investing in these instruments throughout 2019) continued to exert comparatively greater pricing pressures for this specialized fixed income asset class last month.

The most obvious risk that *could* derail bullish market sentiment in December and early 2020 remains tensions between the U.S. and China. President Trump recently signed legislation that is supportive of the protesters in Hong Kong. Chinese officials questioned the intentions of the U.S. and promised unspecified "strong countermeasures." Meanwhile a fresh round of tariffs on imports from China is currently set to go into effect on December 15th unless suspended prior to that date.

Markets can and do experience big moves across periods as short as 21 trading days, and year-end market dynamics (managers' repositioning of their portfolios to stake out positions for the year ahead; tax-motivated trading; reduced liquidity during the year's final week) can amplify near-term price swings. So, stay tuned; "It ain't over 'till it's over".

Investment Strategy Group
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