COLORADO FINANCIAL MANAGEMENT®

Economic & Market Review

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"There are two kinds of forecasters: those who don't know, and those who don't know they don't know." – **John Kenneth Galbraith**

SUMMARY:

It's a new decade. What can we learn from the decade just past, and from prior decades?

We enter 2020 with solid fundamentals in the economy.

Last year was an extraordinary year for returns from nearly every asset class.

What surprises are in store for 2020? We offer our first Top 10 Surprises list.

Will this be the year international equities outperform U.S.?

What does the election mean for financial markets in 2020?

As Of 12/31/19 (annual returns)	1 Year	5 Years	10 Years
60/40 Balanced World Index (VSMGX)	19.4%	6.8%	8.9%
World Equity Index (ACWI)	26.6%	8.7%	8.1%
U.S. Equities (Wilshire 5000—VIT)	30.7%	11.2%	13.5%
Foreign Equities (ACWI-ex U.S.—ACWX)	21.0%	5.5%	4.7%
U.S. Bonds (Bloomberg Barclays AGG)	8.5%	3.0%	3.8%
Global Bond Index (BNDW)	8.4%	2.3%	2.5%

Dear Clients and Friends,

I'm excited about the 2020s. Maybe it is because I have heard so much about the 'Roaring 20s' from the last century… the 'Gilded Age'. It was a period of economic prosperity, flappers, and jazz. There was the adoption of the telephone, automobiles, movies, radio, and electrical appliances. Sports stadiums and giant cinemas were built, and movie stars and sports heroes were idolized. Much of that sounds like the last decade… substitute the internet, mobile phones, and electric cars.

What will the 2020s bring us? It is hard to imagine an acceleration in technology development, but it is likely. 5G will make the internet faster. Electric cars are currently about 1% of total sales but are predicted to grow to 10% of sales by 2030. Ride hailing and deliveries will evolve and accelerate… and robotics. The greatest advancements may be in healthcare… DNA sequencing is leading to new drugs and treatments. Will cancer be cured? A treatment for Alzheimer's?

There is no shortage of predictions at this time of the year. The problem with predictions is they rarely, if ever, anticipate rapid changes. Analysts typically take the current trend and extrapolate it. This is logical and it is really hard to forecast surprises, but it is useful to try and think out of the consensus.

With that backdrop, let's review some of our predictions about 2019 and look forward to 2020.

As we entered 2019, we had a few basic assumptions that drove our strategy:

- The economy would slow but not go into recession.
- The Fed would hold interest rates steady.
- Earnings growth would be stagnant.
- Valuation was not terrible, but neither was it attractive.
- Geo-political risks were rising, and had the potential to affect the economy and markets.
- There would be no meaningful legislation in 2019, and Washington would be consumed with investigations and partisan warfare.
- Technical analysis, and our tactical advisor Ned Davis suggested there would be a retest of the December 2018 lows.

How did we do? We got the economy right, and we got earnings right. The economy grew about 2% and earnings 4%. While valuation should be an objective matter, there are different opinions on how to look at valuation. We got this more right than not as we did not expect it to drive market performance. We, by and large, got the geo-political forecast right. The market was worried all year about the trade war, Brexit, and turmoil in Washington. It created a lot of noise and anxiety, but in the end it was less important than the change in interest rates. At year's end, the new NAFTA (USMCA) was passed by the House and there was agreement on a so-called Phase I deal with China. These positives were better than expected.

The Fed, as it turned out, lowered rates three times rather than just holding steady. This was the biggest surprise of the year and was the main driver of relative returns. Because rates fell, long duration bonds outperformed. Valuations can be justified under a low interest rate environment, and optimism returned that the economy would not fall into recession. Technical analysis proved difficult to use in 2019 as there was no retest of the December 2018 lows, and corrections were quick and not very deep. Our tactical advisor NDR was dead wrong last year. This led us to be positioned a little too conservatively for the first half of the year, but most balanced portfolios still returned between 15% and 18%.

As we enter 2020, the following assumptions guide us:

- The risk of recession has receded. The economy will probably grow a little faster than last year – around 2 ¼ to 2 ½ %.
- Earnings will do better than last year, growing 5% or so (consensus is 10%).
- Valuation is stretched currently… still not so overvalued that it will cause a correction by itself, but raises the likelihood of a correction if there is bad news.
- The Fed is on hold. 10 year rates are steady around 2%.
- Some of the U.S. political and geo-political environment has improved. While an impeachment trial awaits, there is little uncertainty about the outcome. Brexit is not finished, but the path is now clear. The biggest uncertainty is the U.S. Presidential election.
- NDR and our tactical models have moved close to neutral.
- Technical analysis and sentiment is stretched – indicating a near term correction is likely.

What would be our Top 10 (Most Likely) Surprises for 2020? These are not meant to be predictions, but possibilities that are unexpected. We'll check back next year and see how many occurred. It could be the consensus is right and none of these happen, but more than likely there will be surprises and probably some we haven't even thought of.

1. Inflation rises faster than expected as a result of a tight labor market and strong economy. The Fed reverses course and raises interest rates at least one time. Long term rates (10 year Treasury) spike to 3%.

2. The economy is growing more slowly than expected. The anticipated rebound in capital spending and trade never happens. As a result, the Fed lowers rates again, and the 10 year yield falls to 1.5%.
3. Earnings growth never materializes and is in fact negative.
4. Trump imposes no new tariffs, the economy continues growing, and the stock market stays at record levels. He wins both the popular vote and the electoral college.
5. John Bolton or another surprise witness comes forward during the Senate impeachment hearing and provides testimony that leads to Trump's impeachment.
6. While natural disasters have become commonplace, something happens this year that shocks everyone… a massive hurricane, melting glacier, flood or fire. This mobilizes environmentalists and sympathizers. A green new deal becomes a rallying cry and a progressive wave leads to a Democratic sweep in November.
7. The Democrats lose control of the House of Representatives.
8. North Korea fires a rocket dangerously close to Guam or Japan.
9. The Iran problem grows into open warfare.
10. The C.U. basketball team makes it to the Final Four.

What can we expect for investment returns in the 2020s? The past is not prologue, but there are patterns that can be helpful.

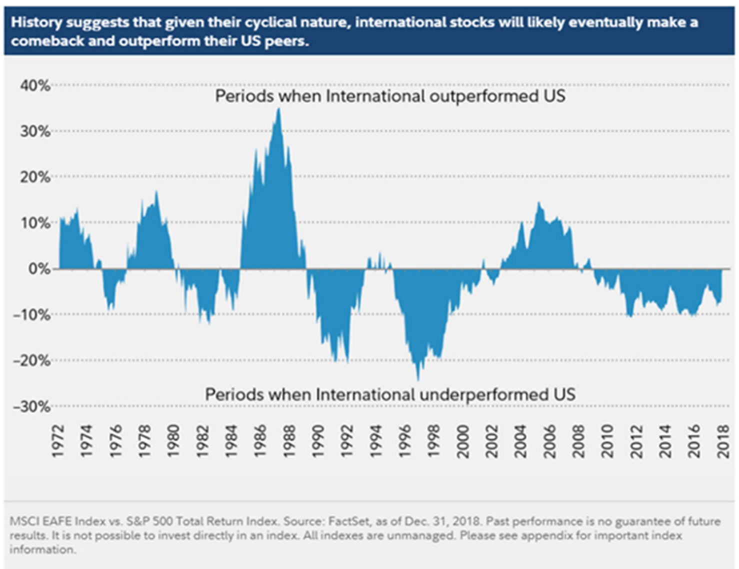
TOTAL RETURNS OF BASIC INDICES						
	Large Cap Stocks	Small Cap Stocks	BONDS	Cash Equivalents	Inflation	60/40 U.S.
	S&P 500	Russ. 2000	AGG	T-BILLS	CPI	Portfolio
1926 - 2019						
Geometric Avg Ret'n	**10.1%**	**11.7%**	**5.2%**	**3.4%**	**2.9%**	**8.6%**
Std. Dev.	19.6%	30.9%	5.2%	3.1%	4.0%	12.0%
1920s	**19.2%**	**-4.5%**	**4.2%**	**3.7%**	**-1.1%**	**13.7%**
1930s	**-0.1%**	**1.4%**	**4.6%**	**0.6%**	**-2.0%**	**3.1%**
1940s	**9.2%**	**20.7%**	**2.3%**	**0.4%**	**5.4%**	**6.7%**
1950s	**19.4%**	**16.9%**	**1.3%**	**1.9%**	**1.9%**	**12.5%**
1960s	**7.8%**	**15.5%**	**3.5%**	**3.9%**	**2.5%**	**6.3%**
1970s	**5.9%**	**11.5%**	**7.0%**	**6.3%**	**7.4%**	**6.7%**
1980s	**17.5%**	**15.8%**	**11.9%**	**8.9%**	**5.1%**	**15.5%**
1990s	**17.5%**	**15.5%**	**7.1%**	**4.9%**	**2.9%**	**13.5%**
2000s	**-1.0%**	**3.5%**	**6.3%**	**3.0%**	**2.8%**	**2.6%**
2010s	**13.4%**	**11.8%**	**3.2%**	**0.6%**	**1.8%**	**9.5%**

Having studied these returns ad nauseam, I believe there are not only patterns to these returns but there is cause and effect. For example, the go-go 1920s ended with the crash of 1929. The crash, and subsequent bungling by the world's central banks can be indirectly related to the Great Depression and even World War II. You can then see the effect on inflation… there was deflation for the decades of 1920s and 1930s. That led to 0% interest rates in the 1930s and 1940s. More recently, the 17.5% average returns for the two decades of 1980s and 1990s led to a significantly overvalued market and then the no return decade of the 2000s.

What can we learn from the last decade? Based on history, we should not expect 0% interest rates to last forever. Rising interest rates would lead to lower returns on bonds. Look at the 1940s and 1950s for clues. How about stocks? The best indicator of long term returns from stocks comes from the beginning valuation. The market P/E on 12/31/89 was 14.5x; 12/31/99 28.4; 12/31/09 19.6 – but that was skewed by the financial crisis. On 6/30/10 it was 14.1x as earnings recovered. And finally, on 12/31/19 it was 20.5x. Here's a table summarizing:

Date	P/E Ratio	Subsequent 10 Year Annual Return
12/31/1989	14.5	17.5%
12/31/1999	28.4	-1.0%
6/30/2010	14.1	13.4%
12/31/2019	20.5	??

The median P/E ratio over the period 1988 – 2019 was 18.4, so my conclusion is that returns over the next decade should be somewhat below the historical average, but the numbers do not suggest they should be significantly lower.

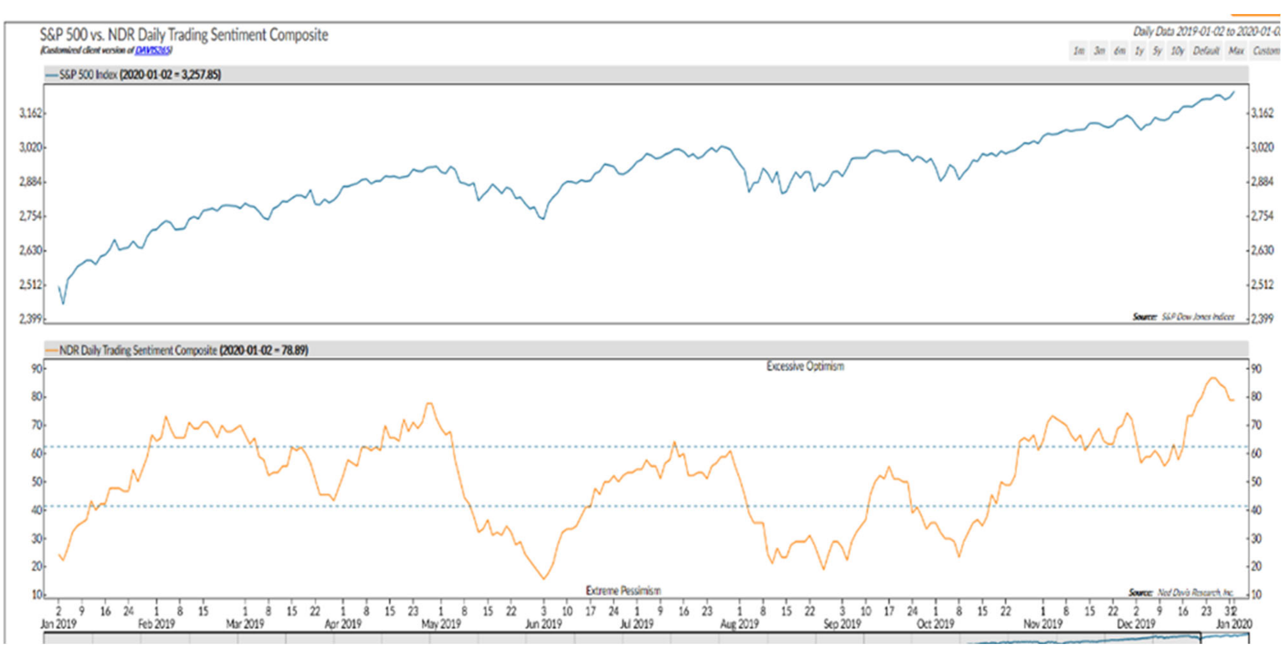


Another historical return relationship we think will be helpful for the coming decade is the relative performance of U.S. vs. international equities. Here are the returns from the last five decades.

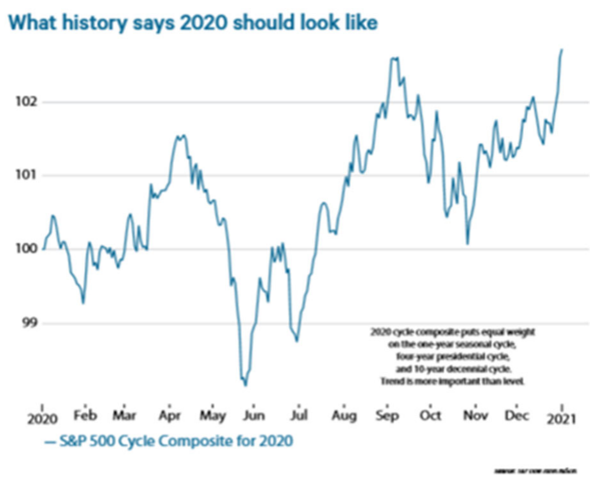
	U.S.	Int'l
'70-'79	5.8%	8.8%
'80-'89	17.6%	22.0%
'90-'99	18.2%	7.0%
'00-'09	-1.0%	1.2%
'10-'19	13.6%	5.5%

This has been a trap for investors for most of the last three decades, but we suspect that at some point the trends will change.

As is often said, it is easier to predict long term returns than near term; but it wouldn't be a year end

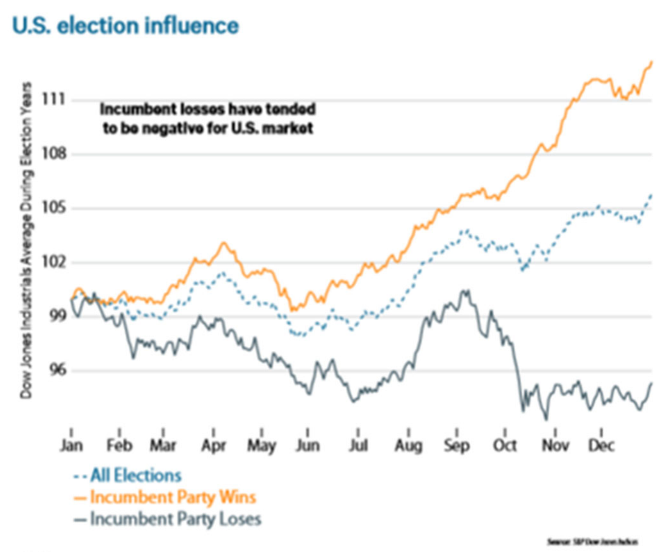


letter without some forecasts of the coming year. Earlier in this letter we described the fundamentals, which look okay to us. As mentioned, the market is extended in the near term, as shown in NDR's sentiment composite above. Assuming there is a short-term correction, what should we expect from the rest of the year?



NDR has a few useful charts that might help as shown below. The first is a composite chart of four different cycles: the economy, the Fed, earnings, and the election. This Cycle Composite indicates the market would continue to rally early in the year, correct mid year, and rally later. Also shown is a chart showing the history of the market during election years.

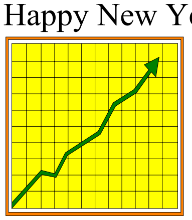
The election chart has a couple of intuitive pieces of information. What the market abhors is uncertainty. In all three scenarios shown, the market moves sideways for the first half of the year. If the incumbent party looks like they will win, the market knows what to expect and rises. If the incumbent party looks like they will lose, uncertainty rises and the market does worse. On average, the market tends to rise after the election. Note, this doesn't distinguish between whether it's a Republican or Democratic incumbent. Considering the policy differences between the candidates, I think we can expect to see some influence on the markets as we progress through this year.



One thing is for sure, some of the assumptions we have now will be wrong; and probably some of the surprises we predicted will be right. You don't get a trophy after half time. A good coach knows how to make adjustments, and that's what we will do in 2020.

As always, we welcome your questions and input. Please contact your Advisor or Client Service Manager if you need anything; and keep your eye our for an invitation to our annual All Client Investment Committee Meeting coming soon.

Happy New Year and happy returns,



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Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS (agency and non-agency).
- **Wilshire 5000:** The Wilshire 5000 Total Market Index is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data.
- **HFRI Fund of Funds Composite Index:** This index is a composite made up of multiple hedge funds via funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

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