ACM Quarterly Market Commentary - Fourth Quarter 2019

> ***"…the economy and the capital markets will eventually recover. It will simply take time. When we look back at this period ten years from now, it will be clear that this was an obvious time to take advantage of depressed prices and investor pessimism."***
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> **- ACM Quarterly Market Commentary, February 5, 2009**
> (*Published a month before the 2009-2019 bull market began*)

<u>This commentary includes</u>

(1) brief review of the fourth quarter and year-ending December 31, 2019
(2) reflection and contextualization of performance over the past decade
(3) capital markets preview to the decade ahead

Q4 2019 & Year-End Review

A strong fourth quarter capped off a very good 2019 for investors. Global stocks gained nearly 9% in the quarter to finish the year with a total return of 26.6% – its best year since 2009.

By region, the U.S. stock market boasted a 31.2% return, outperforming overseas markets for the sixth consecutive year. Bonds did little last quarter, yet their gains for the full year were still generous with U.S aggregate bonds and municipal bonds, returning 8.7% and 7.4%, respectively. Commodities had a strong fourth quarter thanks to an improving global economic outlook, but returns for the Bloomberg Commodities Index were a modest 5.4% on the year. Among individual commodities, gold prices were a pocket of strength last year with an 18% rise. Finally, alternatives continued to plod along with modest gains. A blend of relatively uncorrelated alternative mutual funds would have generated about a 4% return in 2019.

Portfolio activity was light during the quarter as it was throughout the year. We finished the year more or less as we started, with a slight overweight to equities away from fixed income (respective to target allocations), and with only modest exposure to inflation-sensitive assets and alternatives. Generally speaking, that is how a diversified investor should have been positioned last year for strong absolute returns.

2009-2019 Reflections

As we close out one decade and start another, let us examine the investment markets of the past ten years.

Bottom line, it was a good period to be a stock investor.

We began this letter with a forward-looking quote from our 2009 Quarterly Market Commentary, written just one month before this bull market began. Candidly, our optimism back then was not without caution, and we certainly did not predict such a smooth ride for U.S. stocks. The S&P 500 gained 256% over the past ten years, which represents an annualized return of 13.5%. Compare that to the modest 3.7% annualized returns of U.S. aggregate bonds during the same period. The strong performance of U.S. stocks was in contrast to more tepid returns overseas as foreign developed markets and emerging markets posted annualized returns of only 5.5% and 3.7%, respectively.

While U.S. stock returns over the past decade did not match that of the 1980s or 1990s, it sure beat the prior decade of the 2000s when annualized returns were actually a negative 1%. That decade included two different bear markets, each of which cut stock prices by about half. Fortunately, investors have had to weather little volatility since then. Based on closing prices, not once did the S&P 500 correct by more than 20% during the past decade, resulting in just one down year in 2018 when the index was off a mere 4.4%. In fact, the Sharpe Ratio (returns relative to volatility) for the S&P 500 Index during the 2010s was the best we have seen since the 1950s. Another important characteristic of the U.S. stock market over the past ten years is the dominant performance of growth stocks. The Russell 1000 Growth Index bested its value and small-cap counterparts by more than 100% - in annual terms that reflect 15.2% annualized returns for growth stocks, versus 11.8% returns for both the Russell 1000 Value index and the small-cap Russell 2000 index.

Looking back from an economic perspective, the U.S. has enjoyed 126 months of economic expansion, now the longest in U.S. history, but it also continued a trend of successively weaker expansions with average real GDP growth of just 2.3%. Nevertheless, the U.S economic expansion stands in contrast to the near economic stagnation of most other OECD countries during the decade, which in large part explains the much better returns from U.S. stocks. Another notable development during the past decade was the slowdown of Chinese economic growth. China's real GDP growth has recently fallen below 6% as compared to more than 12% at the beginning of the decade. This decline, in part, explains the weak performance of commodities during the decade, as the Bloomberg Commodity Index declined by 4.7% annually. Also, contributing to lower commodity prices in the energy sector, was the impressive increase in U.S. crude oil production, which is now approaching 13 million barrels per day versus just 5.3 million barrels per day in 2009. Lower commodity prices combined with a languid economic expansion played a major role in perhaps the biggest surprise of the decade, continued low inflation. Despite unprecedented and ongoing central bank stimulus here and abroad, the rate of inflation in the U.S. remained in check with an average annual CPI of 1.8%. Ten years ago, most economists were concerned that excessive quantitative easing could spark much higher rates of inflation. We shared this concern, seeing it (incorrectly) as a likely second half of the decade risk. Modern monetary theorists might disagree, but we still continue to worry about higher inflation in the future. However, given all the forces at play that have kept it in check, we would not expect it to be an issue anytime soon.

2020-2030 Preview

Our decade ago inflation warning reminds us of the folly of making such predictions. Nevertheless, it is helpful for investors to look well into the future and develop some long-term expectations.

So, what might this new decade look like for investors?

As we see it today, stock returns will once again outpace bond returns by a fairly wide margin. With the ten-year U.S. Treasury starting this year around 1.8%, give or take, that is the annual rate of return bond investors should expect in this new decade. Bonds will always have their place as a refuge from stock market declines and as a protector against deflationary shocks, but beyond that their returns will be low. On the other hand, we expect another good decade from stocks. ACM's models point to about 6% long-term expected return from global stocks, with a range between 2% and 10%. Theoretical models aside, as it stands today, we envision returns being toward the high end of that range. Who knows how long this bullish combination of a Goldilocks economic expansion and low interest rates can continue? Perhaps for years to come.

The market's advance since 2009 still pales in comparison to its bullish super-cycle from 1982 to 1999 in terms of both duration and magnitude. If we take a step back and think about the stock market in terms of twenty-year rolling periods, the current 20-year annualized rate of 5.4% for U.S. stocks is actually below the average during the post-WWII era. It is also well below that of the twenty-year gains reached before the bear markets that began in 2000 and 2008. In terms of valuation, the price multiples of global stocks are not unreasonable (though the U.S. stock market may be getting pricey). When compared to such low interest rates here and abroad, stock prices globally (and even in the U.S.) are more than reasonable – they are actually cheap. As long as low interest rates can persist for a number of more years, we think that stocks will continue to thrive.

Another interesting characteristic of the ongoing U.S. bull market is that investor participation has not increased. In fact, more money has been pulled out of U.S. equity mutual funds and ETFs over the past ten years than added. Even last year with the U.S. stock market surging to new highs, equity funds suffered net outflows of $180 billion. Meanwhile, low yielding bond funds and money market funds took in net flows of nearly $1 trillion. We believe this bull market will not likely end before investors first succumb to FOMO (fear of missing out) and eventually stampede into the stock market. However, with so many wary investors still remaining on the sidelines, it just might take another decade of good returns to trigger this capitulation – recall that the dot-com bubble that triggered the 2000-2002 bear market was nearly twenty years in the making. In terms of this bull market's character in the upcoming decade, we are in more of a mean reversion mindset. We think U.S. value stocks will at least keep pace with their growth counterparts and that overseas stock markets will start to outperform the U.S. given that relative valuation discounts are wide in both cases. Time will tell. Regardless of our predictive bravado, we are confident that we can profitably navigate the investment landscape of the next decade with our well-diversified portfolios guided by a disciplined approach that combines measures of both valuation and price trends.

Thank You.

Thank you to our clients and referring relationships for placing continued trust in our investment management expertise. Last year marked the 50-year anniversary of Ackerman Capital Management and its predecessor firms. With all that has transpired in the U.S. and around the world during that time, we can still trace a number of client relationships all the way back to 1969 when Ackerman Associates established the first hedge fund in Dallas. We have enjoyed working with all of you over these past five decades and look forward to navigating the new decade ahead together.

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Celebrating Fifty Years 1969-2019

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