GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Investment Insight

January 2020

2019 Global Market Review and Outlook

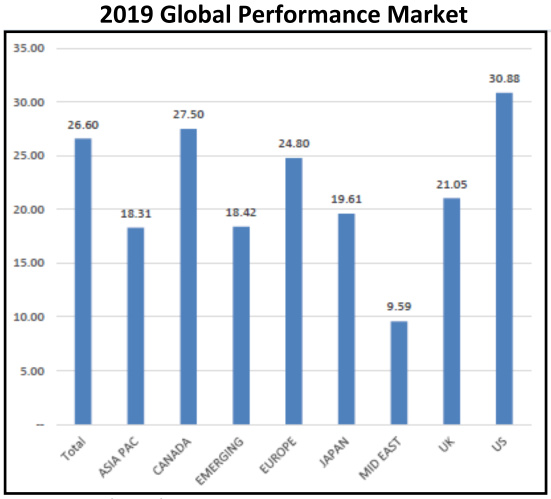
Global

Global stock exchanges had a very strong year in 2019, with many markets around the world hitting record highs. This followed the weak Q4 2018 performance. Markets were aided by low inflation rates and central bank easing across the globe. Global composite PMIs remained above 50 for the entire year, signaling economic expansion. The global manufacturing recession was more than offset by strength in the service sectors. All told, global GDP growth is on track to grow around 3.2% in 2019 (IMF estimate).

2019 saw rising geopolitical risk and social unrest in Hong Kong, Iran, Turkey, Argentina, Chile, and North Korea. Key investor worries in the year included an escalation in US/China trade tensions, Brexit uncertainty, weak manufacturing PMIs, negative yields on $17 trillion in global debt, and an inverted US yield curve. All of these risk factors saw an improvement in visibility as the year progressed.

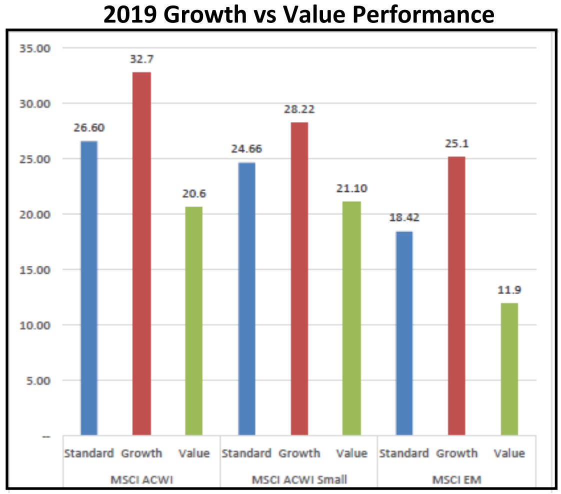
MSCI's All Country World Index rose 27% on a total return basis for the year. All of the market gains came from PE multiple expansion, as global recurring EPS was -3% in 2019. Performance was broad-based, with every sector and every major region producing double digit returns. Technology was the best performing sector, producing an impressive 47% return. Energy was the laggard, returning a still-respectable 13%. The US was the best performing region, up 31%. Large cap stocks outperformed small cap stocks. Growth outperformed value by 12%, which was the largest style performance gap since 1998 (17% gap) and 1999 (16% gap).

2019 Global Performance Market



Source: MSCI Index total returns. FactSet.

2019 Growth vs Value Performance



Source: MSCI Index total returns. FactSet.

US

The US appears to be in decent shape, for the time being. The MSCI USA index rallied 31% in 2019, on a total return basis. This followed the -14% return posted in Q4 '18. GDP is on track to grow close to 2.3% for the year. The US consumer remains resilient and the consumer confidence index at the high end of the historical range. As a reminder, consumer spending accounts for roughly 2/3 of the economy. The 3.6% unemployment rate is at a 50-year low. ISM Manufacturing

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PMI has been below 50 since August (signaling contraction), but Services PMI was strong in 2019 averaging 55.5 (signaling expansion). Roughly 60% of US GDP is tied to the service sector.

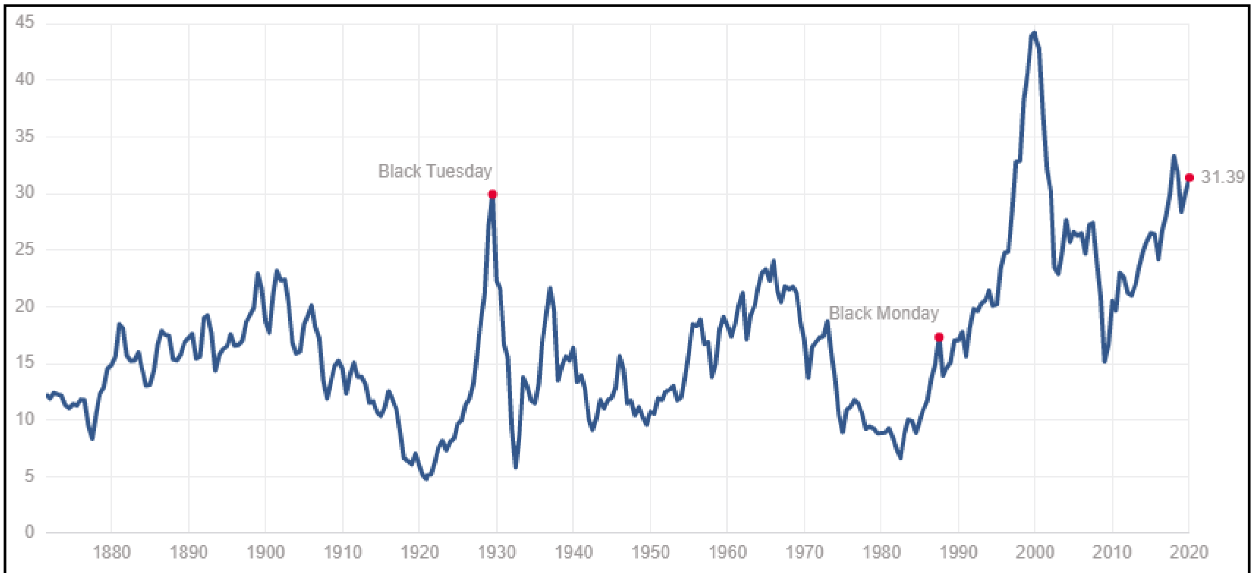
Trade tensions between China and the US were the largest financial news of the year. Regular changes to the narrative created volatility in performance, with the biggest worries surrounding Trump's proposal to add a 10% tariff on an addition $300bn worth of Chinese products. Trade worries have subsided recently, as a diluted "Phase One" trade deal is expected to be signed on Jan 15th, 2020. There are still several unknowns surrounding "Phase Two" of the China trade deal, which is expected to come in stages (if at all). Throughout the year, there were also trade threats against Argentina, Brazil, and Mexico. European tariffs are expected to be a hot topic in 2020.

The Fed was also central to the market in 2019. Following nine consecutive 25bps rate hikes, the Fed reversed course in mid-2019 (often referred to as the "Fed pivot"). Since then, the Fed has cut rates three times to the current 1.75%, introduced a new repo program, and added a $60 billion per month treasury purchase program (QE4 lite). Treasury purchases are expected to continue through Q2 '20. All of these initiatives helped reverse the inverted yield curve. Note that the Fed already has more than $4 trillion in assets on its balance sheet from QE1-QE3. Core inflation is running just above the Fed's 2% target, with US wages rising at or above 3% during the year. This makes further interest rates cuts in 2020 difficult.

US recession risk has eased for now, but it should be noted that the yield curve was inverted for much of 2019. The 10-year/3-month spread was inverted from May through October, and the 10-year/2-year inverted briefly in August. As a reminder, a yield curve inversion has preceded every recession since 1950.

Stock valuations ended the year at all-time highs based on the price-to-sales ratio and market cap-to-GDP ratio. The cyclically adjusted Shiller PE ratio also looks stretched. Over the last 145 years, the Shiller ratio has reached current levels twice: 1929 (preceding great depression) and 1999 (preceding tech bubble).

US Cyclically Adjusted Shiller PE Ratio



Source: https://www.multpl.com/shiller-pe

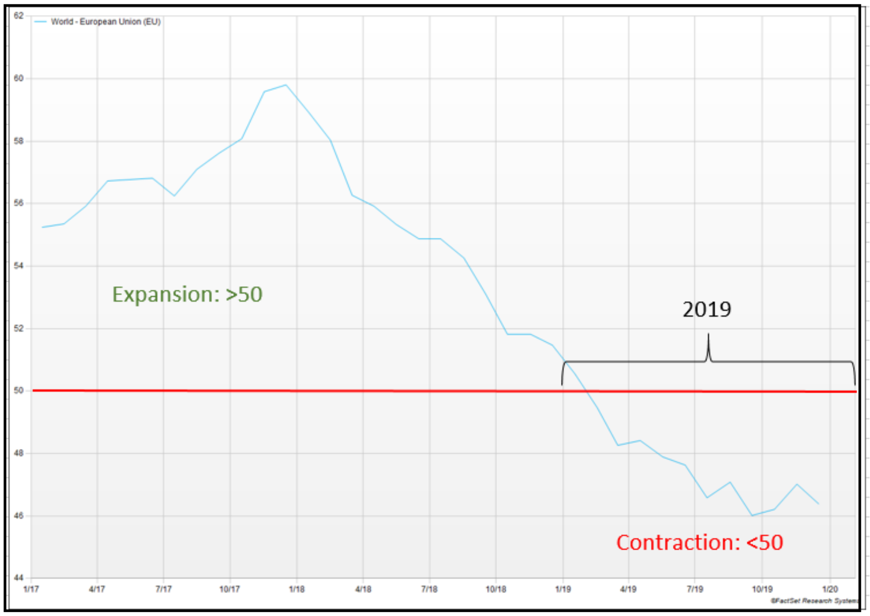
Europe

Europe was hit especially hard from global trade tensions in 2019, as it has a heavy reliance on manufacturing and exposure to the downturn in global auto production. Manufacturing PMIs for Europe are currently 46 (signaling contraction), and have been below 50 for 11 consecutive months. Worldwide vehicle sales are on track to decline by roughly 4% in 2019, driven by a falloff in in demand from China. Germany's high exposure to manufacturing and Chinese exports led to a "near recession" miss in mid-2019. Italy slipped out of technical recession mid-2109, but is still sitting on high debt levels and high unemployment. Roughly 70% of government bonds (6 trillion euros) in the Eurozone are yielding negative returns.

Despite the macro weakness, the MSCI Europe index rallied 25% in 2019 on a total return basis in USD. Eurozone GDP is on track to grow 1.2% in 2019, its sixth consecutive year of growth. Unemployment has been steadily improving, but still sits at 7.6%. Investors are hopeful that Manufacturing PMIs have finally bottomed and some level of fiscal stimulus could be coming in 2020.

Low inflation rates and Germany on the cusp of recession gave the European Central Bank (ECB) an opportunity to be more accommodative in 2019. The ECB cut rates further into negative territory in September, by a tenth of a percentage point to -0.5%, and re-started quantitative easing at a rate of €240bn per annum. New bond purchases are expected "to run for as long as necessary…and to end shortly before the ECB raises rates." Inflation remains well below the ECB's "close to 2%" inflation target, which provides some flexibility for further easing in 2020. Note that the ECB has already spent more than 2.6 trillion euros ($3 trillion) on quantitative easing over the last five years. The new head of the ECB, Christine Lagarde, was appointed on November 1, 2019 and is not expected to make any major policy shifts.

European Manufacturing PMI (2017-2020)



Source: GVA. FactSet

UK

Brexit news dominated the financial landscape in the UK throughout 2019, despite being an ongoing saga since the official vote on June 23, 2016. A "no-deal" Brexit became less likely, following UK Prime Minister Boris Johnson's election win on December 12, 2019. The MSCI UK index rallied an additional 5% through year-end following Johnson's win. The UK Brexit strategy has already been delayed three times, but the country looks on track to see a departure from the European Union at the end of January, 2020. Over the course of 2019, the pound fluctuated between a low of $1.20 per USD in September and a high of $1.33 in December.

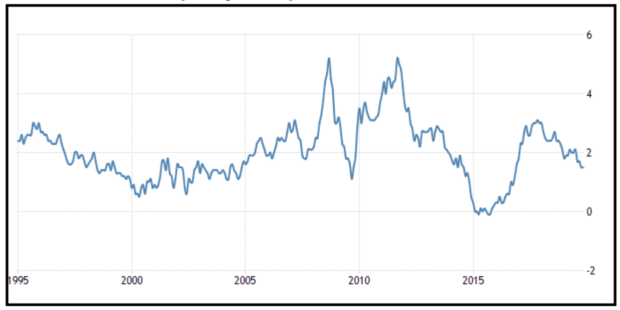
The Bank of England (BoE) kept interest rates on hold in 2019 at 0.75%. This followed the two 25bps hikes implemented in 2017 and 2018. BoE governor, Mark Carney, has hinted that additional interest rate cuts may be coming in 2020 to help boost the economy. Further easing may prove difficult, however, considering that Core CPI is already close the BoE's 2% inflation target (currently 1.7%). Note that the BoE's balance sheet was stable in 2019, but the central bank has spent £435 billion on QE since the financial crisis.

Fiscal stimulus is also on the table for 2020. The UK is on track to grow GDP close to 1.2% in 2019, and narrowly missed entering an official recession earlier in the year. Boris Johnson campaigned by promising large tax cuts and increased government spending. This would be a reversal of the nearly decade of austerity measures implemented in the UK. Unemployment remains healthy at 3.8%. Despite the Brexit volatility and low GDP growth, the MSCI United Kingdom index rallied 21% in 2019 on a total return basis in USD.

UK Interest Rates (25 years)

Source: Bank of England. Tradingeconomics.com

UK Inflation (25 years)



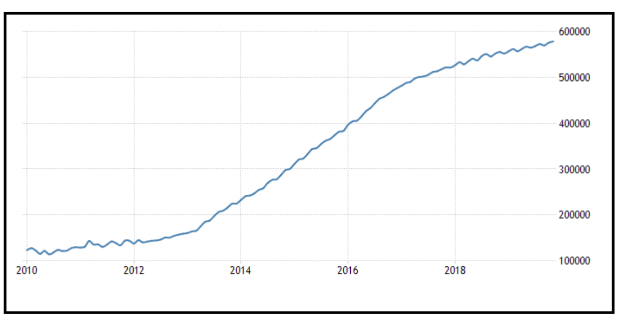
Source: Bank of England. Tradingeconomics.com

Japan

Japan's economy suffered from anemic global growth in 2019, as it is an export driven economy. The country's largest exports are autos which are on track to decline 4% globally for the year. The widely anticipated consumption tax hike implemented on October 1, 2019 from 8% to 10% is also weighing on the consumer. Japan's consumer confidence index fell as low as 36 in September, hitting a 9-year low. GDP growth declined in Q4 19, but is still expected to grow close to 1% in 2019. Despite these headwinds, the MSCI Japan index rallied 20% in 2019 on a total return basis in USD.

Both fiscal and monetary policy have been high accommodative in Japan. The Bank of Japan (BoJ) has held interest rates at -0.1% for four consecutive years. With anemic GDP growth and inflation rates well below the 2% target, the BoJ is likely to remain dovish in 2020. The BoJ has already increased its balance sheet by close to $4.5 trillion through quantitative easing over the last decade. To put this into perspective, Japan has spent a similar total amount on QE as the US, despite having an economy 1/4 the size. On the fiscal side, Prime Minister Shinzo Abe announced an additional $120bn in fiscal stimulus measures for 2020. Sizable fiscal stimulus could be difficult to implement though, as Japan's government is already the highest indebted in the world with debt-to-GDP ratio over 230%.

Bank of Japan Balance Sheet (10 years)



Source: Bank of Japan. Tradingeconomics.com

Japan Inflation (10 years)

Source: Bank of Japan. Tradingeconomics.com

China

China's GDP growth is on track to grow close to 6.1% in 2019. This will mark the 9th consecutive year of slowing growth. Trade tensions with the US dominated the financial headlines over the year. Social unrest in Hong Kong has also added to uncertainty in the region. Hong Kong is now experiencing its first recession in a decade, following two consecutive quarters of negative GDP growth (Q3 19 -2.9% and Q4 19E -2.8%).

Despite the slowdown in China, the overall economy is in decent shape. Growth is on track to come in at the low end of the government's target of 6.0-6.5% for 2019. Inflation rates remain benign, at around 3% for the year. Unemployment rate is estimated to be around 4% for 2019. Manufacturing has been weak, but composite PMIs have consistently been above 50. The MSCI China index rose 24% in 2019 on a total return basis in USD. There are still worries around China's large debt obligations, with the IMF reporting China's total debt-to-GDP now at 300% (corporate, household, and government).

China's central bank has been supportive to the economy. The People's Bank of China made 3 small cuts to the loan prime rate (LPR) in 2019, ending the year at 4.1%. The central bank also lowered the reserve requirement further for banks, in an attempt to boost the sluggish economy.

Global GDP Growth (YoY)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Est 2019	Est 2020
World	4.3%	1.9%	-1.7%	4.3%	3.1%	2.5%	2.7%	2.8%	2.8%	2.5%	3.1%	3.0%	3.2%	3.5%
USA	1.9%	-0.1%	-2.5%	2.6%	1.6%	2.2%	1.8%	2.5%	2.9%	1.6%	2.2%	2.9%	2.3%	1.8%
Eurozone	3.0%	0.3%	-4.5%	2.1%	1.7%	-0.8%	-0.2%	1.4%	2.0%	1.9%	2.7%	1.9%	1.2%	1.1%
China	**14.2%**	**9.7%**	**9.4%**	**10.6%**	**9.6%**	**7.9%**	**7.8%**	**7.3%**	**6.9%**	**6.7%**	**6.8%**	**6.6%**	**6.1%**	**5.9%**
Japan	1.7%	-1.1%	-5.4%	4.2%	-0.1%	1.5%	2.0%	0.4%	1.2%	0.6%	1.9%	0.8%	0.9%	0.5%
Brazil	6.1%	5.1%	-0.1%	7.5%	4.0%	1.9%	3.0%	0.5%	-3.5%	-3.3%	1.1%	1.1%	0.9%	2.0%
Russia	8.5%	5.2%	-7.8%	4.5%	4.3%	3.7%	1.8%	0.7%	-2.3%	0.3%	1.6%	2.3%	1.1%	1.7%
India	7.7%	3.1%	7.9%	8.5%	5.2%	5.5%	6.4%	7.4%	8.0%	8.2%	7.2%	6.8%	5.6%	6.2%
Taiwan	6.5%	0.7%	-1.6%	10.6%	3.8%	2.2%	2.5%	4.7%	1.5%	2.2%	3.3%	2.8%	2.4%	2.0%
Korea	5.5%	2.8%	0.7%	6.5%	3.7%	2.3%	2.9%	3.3%	2.8%	2.9%	3.1%	2.7%	1.9%	2.1%
South Africa	5.4%	3.2%	-1.5%	3.0%	3.3%	2.2%	2.5%	1.8%	1.2%	0.4%	1.4%	0.8%	0.6%	1.0%
Turkey	5.0%	0.8%	-4.7%	8.5%	11.1%	4.8%	8.5%	5.2%	6.1%	3.2%	7.5%	2.8%	-0.2%	2.6%

Source: FactSet and consensus estimates. World estimates are from the IMF.

Outlook: GVA is positioned to perform

Although we can't predict where global equity markets are heading, we believe the portfolio is well positioned to outperform the market in the mid-term. Our historical backtest shows that the portfolio slightly outperforms during growth markets and significantly outperforms during value rallies. On a global basis, growth has outperformed value over the last 11 years. Research studies show that value outperforms growth over the very long term. On a performance basis, we are now back to 2000 levels of growth outperforming value. The valuation spread of value stocks vs the market is also the widest since the TMT bubble. GVA's disciplined process focuses exclusively on the cheapest 20% of stocks in the world and the firm's disciplined process ensure persistent style consistency.

GVA has no insight into when this growth super-cycle will end, but we believe it is only a matter of time. Investors saw a hint of value resurgence in both Q4 2018 and September 2019. GVA outperformed, as expected, in both these markets. The following factors have been a headwind to GVA, but will turn into a tailwind once they reverse:

- Growth has outperformed value materially over the last decade.
- US has outperformed International markets significantly over the last decade.
- Valuation ratios of US vs International markets have widened.

GVA is also well positioned to outperform in down markets. The current bull market started in March of 2009 and is the longest in history. Although markets remain near all-time highs, several recession indicators have recently been flashing red. GVA's historical model outperformed the benchmark significantly in the down years following the TMT bubble (2000-2002), as well as the worst year of the housing crisis (2008).

Please reach out to us for proof statements around any of these trends.

Todd Bassion, CFA
Portfolio Manager

Sources:

Global Section

- Global recurring EPS -3% in 2019: FactSet, ACWI Index results.

US Section

- All macroeconomic data comes from FactSet.
- Fed's balance sheet at more than $4 trillion: Federal Reserve website
  - https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
- Inverted yield curve data: Federal Reserve website
  - St Louis Fed: https://fred.stlouisfed.org/series/T10Y3M
  - St Louis Fed: https://fred.stlouisfed.org/series/T10Y2Y
- Valuations at all-time highs:
  - P/S ratio: FactSet S&P 500
  - Market cap/GDP: https://www.longtermtrends.net/market-cap-to-gdp/

Europe Section

- Manufacturing PMI data: FactSet
- Worldwide vehicle sales -4% in 2019:
  - CNBC: https://www.cnbc.com/2019/11/25/global-car-sales-expected-to-slide-by-3point1-million-this-year-in-biggest-drop-since-recession.html
- Roughly 70% of government bonds yielding negative returns:
  - Reuters: https://www.reuters.com/article/eurozone-bonds-negative/almost-70-of-euro-zone-bond-yields-have-sub-zero-yields-tradeweb-idUSL5N26O1PG
- ECB has already spent more than 2.6 trillion euros on QE:
  - ECB website: https://www.ecb.europa.eu/pub/annual/balance/html/index.en.html
  - Reuters: https://www.reuters.com/article/us-eurozone-ecb-qe/the-life-and-times-of-ecb-quantitative-easing-2015-18-idUSKBN1OB1SM

UK Section

- Fluctuation of the USD/GBP: FactSet
- Core CPI data: Bank of England
  - Trading economics: https://tradingeconomics.com/united-kingdom/core-inflation-rate
- Central bank has spent 435 billion GBP on quantitative easing:
  - BoE website: https://www.bankofengland.co.uk/monetary-policy/quantitative-easing

Japan Section

- Japan's largest exports are autos: https://oec.world/en/profile/country/jpn/
- Consumer confidence index data: FactSet
- BoJ's balance sheet sits at more than $4.5 trillion:
  - BoJ website: http://www.boj.or.jp/en/statistics/boj/other/acmai/index.htm/
  - Reuters: https://www.reuters.com/article/us-japan-economy-boj/bank-of-japans-balance-sheet-now-larger-than-countrys-gdp-idUSKCN1NI07Z
- Japan's economy roughly ¼ the size of the US:
  - World Bank: https://data.worldbank.org/country/united-states
  - World Bank: https://data.worldbank.org/country/Japan
- Japan is the highest indebted nation in the world:
- World Population Review: http://worldpopulationreview.com/countries/countries-by-national-debt/

China Section

- All basic macroeconomic data comes from FactSet.