INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FOURTH QUARTER 2019: JOY TO THE WORLD

Joy to the world, now we sing
Let men their songs employ
Joy to the world, now we sing
Repeat the sounding joy
--Isaac Watts

Investors caroled their way through the fourth quarter, as global stock markets continued to bestow lavish gifts onto shareholders. Animal spirits joined with the Christmas spirit, as trade tensions lessened, global central banks affirmed their accommodative ways, and economies around the world showed nascent signs of bottoming and possibly turning up.

Stocks domestic and international, small cap and large, developed and emerging, all gave market participants returns hovering around 10% for the three-month period. Bond and real estate equity returns were essentially flat for the quarter, while commodities finally showed some life, up 5%.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	9.1%	30.5%
US Small Cap Stocks	Russell 2000	9.9%	25.5%
International Developed Markets Stocks	MSCI EAFE	8.2%	22.0%
Emerging Markets Stocks	MSCI EM	11.8%	18.4%
Real Estate Securities	MSCI US Real Estate	-0.8%	25.8%
Commodities	Bloomberg Commodities Futures	4.6%	6.1%
Bonds	Bloomberg Barclays US Aggregate	0.2%	8.7%
Cash	FTSE 3-month UST Bill	0.5%	2.0%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

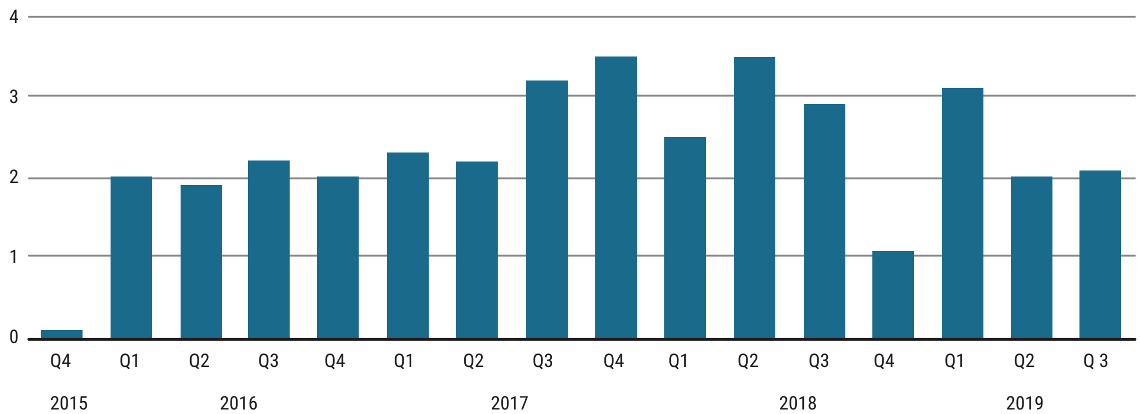
For the full year, returns were robust across almost all asset classes. While US markets produced the highest returns, international markets also generated very substantial appreciation, as did real estate. Fixed income returns were boosted by the Fed's easing monetary policy. Commodities showed more modest growth, in a low-inflation world. Taken all in all, asset classes sang a soaring melody with pitch-perfect harmonization, giving a substantial lift to global investors' portfolios.

ECONOMIC MEH

Joy to the world
All the boys and girls
Joy to the fishes in the deep blue sea
Joy to you and me
--Hoyt Axton

Given such out-sized, joy-inducing returns, one might have expected underlying economies to have exhibited considerable strength. The data, however, do not bear that out. US GDP grew at a tepid pace of 2.0%, as weak business capital expenditures offset healthy employment and consumer spending data.

Real GDP: Percent Change From Preceding Quarter
Seasonally Adjusted at Annual Rates



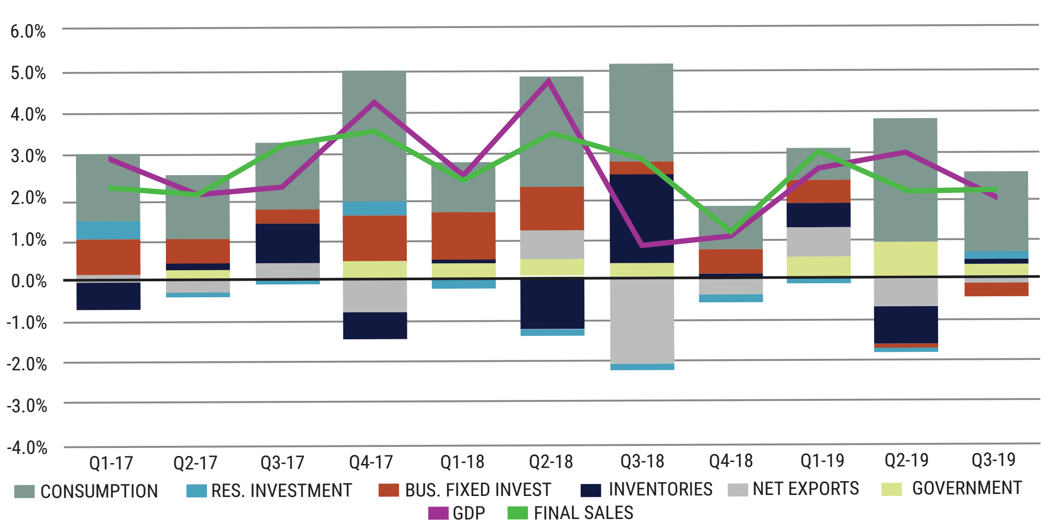
SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS

This moderate economic performance is in line with average economic advances over the course of the decade.

Unemployment, at 3.5%, is at a 50-year low, as most people who want to find a job, can. And wage growth, which lagged through much of the post-global financial crisis recovery, has picked up, rising 3.0% over the past year. Monthly job growth averaged 180,000 in 2019, less than in 2018 but nonetheless healthy. More people working, and earning more, is a pretty good prescription for consumer spending (which accounts for about 70% of US economic activity).

Students of economics learn that GDP—the broadest measure of economic activity—is composed of consumption, government spending, investment, and net exports (GDP = C + G + I + NX). According to the Bureau of Economic Analysis, personal consumption has been doing its part, advancing 3.2%, and government spending added 1.7%. However, private investment spending fell 1.0% (business investment was particularly weak), and net exports dropped 0.8%.

GDP Growth
Quarter/Quarter% Annualized With Sector Contributions



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS, FHN FINANCIAL

Analysts generally believe that trade worries influenced business investment spending as well as net exports. The trade gap widened, with imports rising faster than exports.

The US domestic economy has long been driven primarily by consumer spending. That said, business spending and trade are more sensitive to changes in the economy (greater elasticity, in economics-speak). Consumers exhibit healthy spending and savings; it will be interesting to monitor consumption trends if the labor market softens. Contrariwise, it will be interesting to monitor business capital expenditures if trade tensions abate further.

THE FED: THE WIND BENEATH THE MARKETS' WINGS

I have drunken deep of joy,
And I will taste no other wine tonight.
— Percy Bysshe Shelley

Investors drank deeply indeed from wine bottles of joy, throughout 2019. Returns for US large cap stocks topped 31%, and US small cap returns weren't far behind at nearly 26%. Yet corporate profits for the S&P 500 have been weak, with third quarter earnings dropping 1.3% from the year-ago quarter. Profits are expected to drop by 1% in the just-ended fourth quarter and, overall, earnings are expected to be roughly flat for the full year, before rising 9-10% in 2020.

So, while it is axiomatic for investors that corporate profits drive stock prices, there must be another explanation for the extraordinary rise in stock prices last year. We think that explanation is straightforward: it's all about the Fed. If investors are cautioned not to fight the Fed—and they are—then the focus in 2019 was a sharp pivot in interest rate policy the Fed engineered. Exiting 2018, a year in which the Fed raised rates four times, the US central bank was poised to raise rates at least two additional times in 2019. But a rash of weaker economic data, and perhaps a plunge in stock prices in the fourth quarter of 2018, led the Fed to rethink its interest rate posture. The Fed first amended its stance to indicate it was pausing; then, as global economic data suggesting a deceleration filtered in, it moved to ease interest rates. Ultimately, 2019 saw three cuts in interest rates, which the Fed characterized as a "mid-cycle adjustment."

US 10-Year Treasury Yield in 2019

SOURCE: FACTSET

The benchmark 10-year US Treasury bond began the year at 2.7% and ended the year at 1.9%, hitting a low of 1.5% in the summer amid recession concerns.

In addition to dropping interest rates, the Fed responded to weakness in the overnight lending market with liquidity-enhancing purchases of Treasury bills. While careful to deny that this was a reinstatement of prior "quantitative easing" operations, the Fed nonetheless has been adding $60 billion per month to its balance sheet.

In short, an easy, accommodative Fed is an ideal tonic to equity markets, and to risk assets generally. Within this context, markets' levitation in 2019 is not so surprising.

A NEW DECADE BEGINS WITH THE YEAR OF THE RAT

"Joy is what happens to us when we allow ourselves to recognize how good things really are."
— Marianne Williamson

The Chinese zodiac tells us that 2020 is the year of the rat. While this sounds unpromising, in Chinese mythology rats are a sign of wealth and surplus.

Ten years after the global financial crisis, the conditions that gave rise to the longest postwar economic expansion—and a powerful bull market in US equities—remain in place. The Fed and other central banks remain extraordinarily accommodative. Unemployment is at half-century lows. Consumers are opening their wallets, even as they are saving more. Inflation is quiescent. Corporate profit margins are high, and businesses are generating strong cash flow. Millennials, the largest generation in American history, are advancing into their prime years for household formation, marriage, child-bearing, and home-buying.

Looking around the world, trade tensions appear to have eased. Brexit is approaching a resolution. Every year millions of people emerge from poverty, gain access to fresh water, and get connected to the Internet. Innovations in technology are leading to better data analysis and decision-making and greater efficiency. Developments in communications have created a more interconnected world. Advances in medicine are helping people conquer illness, improve their health, and lead longer lives.

There's a lot that's right in the world, and a lot that's not right but getting better.

Even as we recognize how good things are, investors make a mistake when they don't recognize risks as well as opportunities. Here are some of the economic risks we are monitoring:

- **Geopolitics**: Hot spots around the world today include North Korea, Venezuela, and numerous locations in the Mideast. They, along with currently unidentified regions, could create exogenous shocks that derail the economy.
- **Manufacturing**: Global manufacturing is weak, notwithstanding some signs of bottoming in China and Europe. In the US, the December ISM manufacturing report notched a 10-year low.
- **Politics**: The 2020 US presidential election brings an element of uncertainty, and will underscore divisions in the nation.
- **Leverage**: Low interest rates have encouraged corporations and governments to borrow liberally. If financial conditions become less easy or economies decelerate, expect to see more defaults and higher credit spreads.

A 2020 VISION

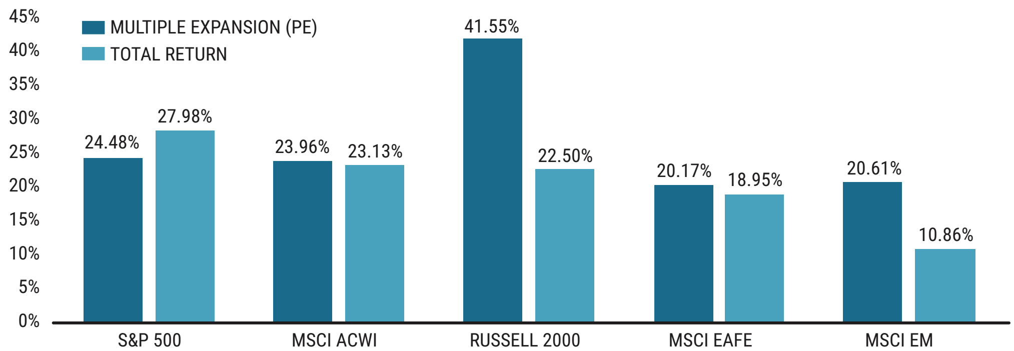
A thing of beauty is a joy forever.
— John Keats

A roaring bull market is a joy-giving thing of beauty. But, contrary to the great poet Keats, it doesn't last forever. Notwithstanding—might it last a little longer?

As noted above, current elevated market levels have resulted from the actions of global central banks. The US stock market began 2019 at a valuation of 13 times estimated earnings and ended 2019 at a valuation of 18 times estimated earnings. The vast majority of the market's steep rise in 2019 was driven by higher valuations rather than higher earnings.

For US small cap stocks and international stocks, more than 100% of their appreciation came from multiple expansion; earnings themselves actually declined.

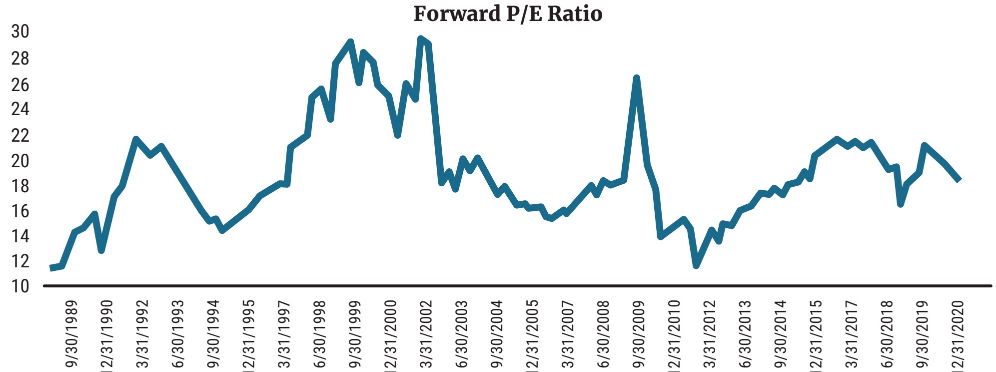
Multiple Expansion Drove Stock Appreciation in 2019



SOURCE: DIREXION, BLOOMBERG FINANCE, L.P.

Said another way, US and global equities became more expensive. Putting the US market's current valuation of 18 times projected 2020 earnings in historical perspective, we note that it is higher than long term averages (the late 1990's were an enormous outlier).

Forward P/E Ratio



SOURCE: S&P DOW JONES

Some pundits believe that low interest rates justify such a valuation. While there may be some truth to such an argument, we also note that those estimated earnings include analysts' projections of 2020 profit growth of 9-10%.

We are not without concern that 2020 profit expectations are optimistic, and may need to be adjusted downward. That said, the economic backdrop is moderately constructive, the Fed remains our friend and loyal supporter, and last year's interest rate cuts are still working their way through the economy. The federal government budget is stimulative, last year's market overhangs—trade disputes and Brexit—have lost some of their sting, and last summer's recession worries have receded.

Once again, there's a plausible argument to be made that the outlook for stocks is better than the outlook for bonds. While all forecasters achieve 20:20 vision only in hindsight, 2020 could end up being a year to repeat the sounding joy. Fa la la la la to all.

PEAPACK PRIVATE
Wealth Management

500 HILLS DRIVE, SUITE 300, BEDMINSTER, NJ 07921
TEL (908) 234-0700 • WWW.PEAPACKPRIVATE.COM