Sterling Advisors

REVIEW & OUTLOOK – 4Q2019

This Review & Outlook includes commentary on Sterling Advisors' three investment strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available from Sterling Advisors.

Closing Prices 12/31/2019	
DJIA	28,538.44
S&P 500 Index	3,230.78
Barclays Intermediate U.S. Govt.	2,235.92
Russell 1000 Value	1,347.66
Russell 1000 Growth	1,770.52
NASDAQ	8,972.60
U.S. Treasury Bond	
Current Yield 10-year Bond	1.9175%
Current Yield 30-year Bond	2.3896%

Source: Bloomberg

The Market Environment

U.S. equities finished 2019 near all-time highs, capping off their best annual performance since 2013. Fears of recession have abated, leading investors to pay meaningfully higher prices for shares that were collectively sold just a year ago. This phenomenon, called multiple expansion, is occurring as a result of the Federal Reserve's renewed accommodative monetary policy, persistently low bond yields, and the recent de-escalation of trade and tariff tensions with China. Large Cap U.S. stocks, represented by the S&P 500 Index, advanced 9.1% in Q4 and 31.5% for 2019. Bonds also enjoyed a banner year, evidenced by the Bloomberg Barclay's Aggregate Bond Index's 8.7% gain.

A key inflection point in market sentiment occurred when the Federal Reserve retreated from a path of increasing interest rates at this time last year. Increases in rates were initially embraced by financial markets, as part of a healthy normalization process, until evidence of trade-war induced contraction in the manufacturing sector began to appear in economic data. Chair Jerome Powell gave assurances of patience in policy decisions amidst the turmoil, later following through by reducing interest rates three times in 2019. The 1.92% yield on a 10-year U.S. Treasury (the highest among developed markets), is just slightly richer than the 1.82% dividend yield on the S&P 500. This makes U.S. bonds an attractive alternative for many foreign investors facing negative yields and puts dividend-paying stocks in a comparatively attractive position vs. fixed-income securities for investors seeking returns that outpace inflation.

With respect to trade tensions with China, averting the Dec. 15th comprehensive tariff increase by agreeing in principle to a "Phase One" deal cleared a path for financial markets to continue their upward momentum into year-end. Cyclical stocks benefitted most notably from this news, reflecting hopes of a reacceleration in business activity. The impact of tariffs on the technology, manufacturing and agriculture industries have created a drag on business confidence and corporate earnings – a prominent reason why 2019 S&P 500 earnings are expected to decline modestly from the prior year. Looking ahead, we anticipate traders and investors will shift their focus to the likelihood of a more substantive trade agreement with China before the presidential election in November.

Turning to the internals of the financial markets in Q4, volatility remained subdued while brisk sector rotation reflected investors' changing appetite for risk. Small cap stocks outperformed large caps in the fourth quarter, yet fell short of large caps' robust returns for the full-year. Growth stocks bested value stocks in the quarter, year and decade – leaving the performance gap between growth and value strategies at a historical extreme. Despite the dreadful performance of several notable IPOs, the tech-heavy NASDAQ Composite Index led the way among major U.S. stock indices with a 36.7% gain in 2019, reflecting investors' renewed animal spirits and preference for offense over defense. Stock market breadth strengthened as funds have flowed out of smaller, more defensive, sectors and into cyclical sectors more heavily represented in major indices. Foreign stock markets have joined the rally in recent months with many making a long-awaited new high, providing some relief to ex-U.S. investors after a period of sluggish relative returns.

Large Cap Value

Value stocks registered strong gains in the fourth quarter, evidenced by the 7.4% total return of the Russell 1000 Value Index. Although this mark fell short of the S&P 500's 9.1% quarterly gain, we did see a more competitive return from value stocks in Q4 vs. the trend of the previous year. The strategy's average cash position of 6-8% in the quarter reflects our expectation of increased volatility in 2020 due to macro risks. As is often the case, the best investment opportunities present themselves during bouts of volatility, and our investment team remains prepared to act if and when these periods of turmoil occur. As a whole, value stocks provided respectable gains during a time of decisively risk-on investor behavior.

Our team of portfolio managers added two new positions during the quarter, representing the agriculture and financial services industries. We view these new purchases as upgrades to the strategy's holdings that can prosper in a changing interest rate environment, providing investors with inflation protection and consistency of earnings. The strategy's Energy holdings were reduced through the sale of a domestic oil and gas company, and profits were taken with the partial sale of a leading apartment REIT. As always, these decisions were made at the group level, and reflect our top-down macroeconomic view coupled with the output of our quantitative screening process.

Several investment themes that remain well-represented in the Large Cap Value Strategy include:

- Exposure to defense contractors with an emphasis on those offering cyber-security and technology services to government agencies.
- Continued ownership of managed care, pharmaceutical and other health care companies based on strong earnings momentum coupled with strong relative valuation.
- Remaining patient owners of attractively priced banks and insurance companies, expressing our view that earnings can surprise to the upside as interest rates normalize over time.
- Avoiding additional exposure to energy companies, mainly due to troublesome industry debt levels and deteriorating earnings.

Large Cap Core

Markets had a tremendous fourth quarter to cap off a very impressive 2019. From an investment standpoint, large, mid and small capitalization stocks all finished higher. Stock prices during the quarter continued to benefit from multiple expansion as the Federal Reserve ballooned their balance sheet once again. The Fed's balance sheet grew by over $80b per month. A Fed balance sheet that started at $3.8T to reach $4.2T in a few months and changed the course of markets and asset prices altogether. It's hard not to imagine this influence on stock prices. The important thing to realize is the Fed has started to understand they're not conducting monetary policy for the U.S. but for the rest of the world as well. The three best U.S. sectors were Technology, Communications and Financials with a 48%, 31% and 29% return respectively. The biggest stock in the index, Apple, was up a whopping 86%. All sectors were positive in 2019, but the biggest sector laggard was Energy only up 8%. We continue to focus on the highest quality companies.

Where do stock markets go from here? From a technical standpoint, the move up on the S&P 500 index indicates a fully valued market at current levels. From a support standpoint, support is near 3150, which was a minor double top prior to the latest move to new highs. Below that, the December lows at 3070 provide stronger support. Have the stock markets pulled forward gains from 2020 into 2019? From a sentiment standpoint, bull-bear spread ratios are at bullish extremes. Meaning everybody has piled into stocks. The readings we currently see and compared to similar readings in history, tells us to be prudent, focus on good entry points and stick to our risk management discipline. Given current levels, 2020 might be nothing like 2019, with flat equity markets or a market downturn of meaningful magnitude sometime throughout the year. We continue to monitor and prepare.

The U.S. economy continues to progress quite well from multiple indicators we monitor. Full expensing of capital expenditures for five years and the tax cut on repatriated corporate profits should continue to drive economic growth. In the simplest terms, capex spending supports productivity growth and productivity growth is a major driver of GDP. Also, the combination of rising wages, lower taxes, and falling gasoline prices has fueled after tax, after-inflation income. Also, the Federal Reserve, European Central Bank, Bank of Japan and Peoples Bank of China all are unlikely to raise rates in 2020. As a result, many signs are pointing to the global expansion continuing. As it stands now, China and the U.S. continue to get through their trade issues and work towards structural reform also a positive catalyst.

The Federal Reserve has been stimulating the economy these last few months by expanding their balance sheet and pumping liquidity to avoid deflation or a recession. Also, in a new twist in policy, they stated that they want higher inflation, maybe even above its previously stated goal of 2%. Looking forward, less tax receipts and an expansion of government debt, the U.S. dollar should get slightly weaker on a relative basis in the intermediate term. The U.S. dollar bottomed during the middle of 2008 and coincided with a major peak in commodity prices at the same time. The dollar rallied for eight years between 2008 and 2016, which pushed commodity prices lower. We are starting to see evidence that commodity markets may be starting to change direction on a relative basis. We're watching for new opportunities.

Just in case there is increased volatility in 2020, our team has found opportunities by monitoring a market of stocks and not just tracking the stock market as a whole. Individual stock selection will be critical to success moving forward in our opinion. Some individual stocks look great and are racing to new highs, but the past several weeks have also revealed some potholes, too. There's not been a lot of stock breakdowns, and we continue to think most of these initial pullbacks will end up finding support. But that support could falter quickly as exchange-traded funds and mutual funds liquidate holdings. One can only sell what has ample liquidity in times of distress. Our team continues to look at the best risk-adjusted returns to protect accumulated capital and minimize risk.

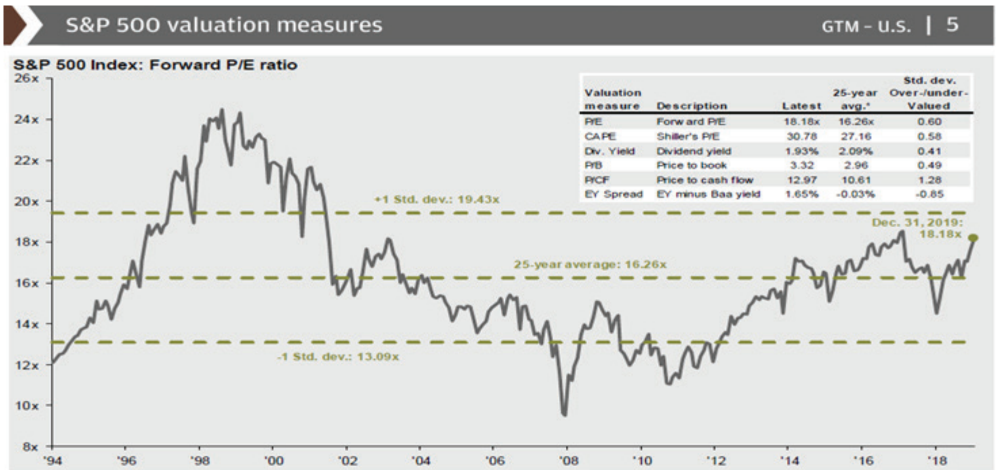
Fixed Income

The Barclays Bloomberg U.S. Aggregate Bond Index held relatively steady in Q4 2019, posting +0.18% total return over the period. That modest number capped an otherwise stellar year for core U.S. fixed income performance with the same bond index advancing +8.72% last year. The strong results coincided with 10-Year U.S. Treasury yields falling 77 basis points (0.77%) over the 12-month span, which translated to similarly lower yields across most domestic debt securities (Bloomberg). The confluence of several factors in 2019 pushed U.S. yields lower (i.e., bond prices higher). The U.S. Federal Reserve's decision to lower the Fed funds rate three times in 2019 pulled short-dated yield lower throughout the year. This past quarter, the Fed committed to holding the benchmark rate steady at its current setting and allow incoming U.S. data to dictate its next move. Its patient, cautious approach heavily contributed to Q4 2019's more tepid returns. Fed Chair Powell also signaled a desire to see inflation consistently at or above 2% (based on Core Personal Consumption Expenditure readings) before raising rates again. Therefore, many market participants (us included), believe the bar for the next rate hike is high. It should be noted that the Fed has started to re-expand its balance sheet at a pace of $60 billion per month in an effort to quell a volatile U.S. repo market. While the Fed has stated its recent asset purchases should in no way be viewed as a new round of quantitative easing aimed at stimulating the economy, it's hard to ignore the similar effects these cash injections are likely having on the U.S. economy, nonetheless.

In the intermediate and long portion of the U.S. yield curve, stubborn inflation data, falling global growth expectations, and enormous demand for U.S. yields, which appear quite high relative to many of our sovereign peers, are fueling large demand for U.S. government debt. The factors serve as powerful yield suppressants, making it difficult for U.S. government debt to discover meaningfully higher yield levels. These factors appear firmly entrenched in the short run and should persist in 2020, which informs our benign rate expectations for the year ahead. Therefore, if U.S. yields should rise modestly (i.e., 2-2.25% 10-Year U.S. Treasury yields), we would view that as an attractive window to put fixed income cash to work. Furthermore, high-yield credit spreads remain at historically tight levels (i.e., the extra yield offered by below-investment grade issuers relative to U.S. Treasury yields at the same maturity is very low). This high-yield environment supports our emphasis on investment grade (i.e., high quality) fixed income securities in our portfolios. In most cases, investors are not receiving compensation commensurate with the uncertainty and default risk associated with low-rated and nonrated issuers. We prefer to use our conservative fixed income portfolio construction to deliver a reliable income stream and a ballast in the event of slower-than-expected economic growth.

Outlook

With the robust gains of 2019 now in our rear-view mirror, we turn our attention to the likelihood of a further advance in the year ahead and how to best manage the current set of risks. Despite the S&P 500 Index now trading at a relatively high historical valuation, we continue to be optimistic the current bull market can extend its longevity. This outcome will likely rely on the backdrop of benign interest rates continuing and a reacceleration in corporate earnings to prevent stock valuations from drifting too far above historical norms. We see both of these conditions as probable in 2020, which should provide support for stocks, particularly those with growing dividends and consistent earnings. It cannot be overstated that until bond-yields rise significantly, the total-return potential of equities is attractive for a portion of an investment portfolio for all but the most risk-averse investor. With that said, we acknowledge current valuations have most likely pulled forward some future price appreciation potential – leading to a tug-of-war between an improved macro backdrop and higher valuations. To us, this means investors should expect more traditional stock market returns of 5-10% in the years to come, with dividend-yield playing a more significant role in a portfolio's total return. See the following chart, depicting the forward price-to-earnings ratio of the S&P 500 at 18.18 as of Dec. 31, 2019, nearly 12% above the 25-year average.



Source: JP Morgan Guide to the Markets, 1Q 2020

We do anticipate higher levels of financial market volatility in 2020 for a variety of reasons. Potential triggers of a stock market correction include an unexpected spike higher in interest rates, geopolitical unrest, a setback in trade negotiations, or uncertainty leading up to the presidential election in November. Given these risk factors and the complacency created by the calm conditions seen in 2019, we anticipate the probability of a stock market correction prior to the presidential election is somewhat elevated. Bonds investors should also temper their expectations as a result of what is likely to be an environment of continued subdued yields and little monetary policy change. As active managers of both asset classes, this will be a crucial time to manage risk by keeping client portfolios focused on the highest quality issues, in the face of uncertain outcomes and full valuations.

The message of the markets in the fourth quarter was one of multiple expansion fueled by fleeting fears of recession. The backdrop of pessimism, combined with an accommodative Fed, easing trade tensions, and low interest rates created ideal conditions for stocks to extend the longest bull market in history by climbing yet another "wall of worry." Our outlook for the year ahead can be broadly defined as one of cautious optimism, giving the benefit of the doubt to the upward trend and continuation of the current economic expansion. With Fed policy unlikely to change dramatically in an election year, we expect that trade relations with China, the trajectory of corporate earnings, and early poll results will influence investor sentiment as in 2020. As always, we'll monitor the global economy for changes, and adjust our outlook accordingly. Please feel free to contact us with questions or to discuss your investments.

Source: FactSet & Bloomberg

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.