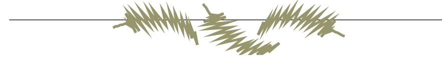
C Y P R E S S
ASSET MANAGEMENT, INC.



MARKET COMMENTARY **January, 2020**

The S&P 500 closed the decade on a high note, finishing 2019 with a 31% total return. While we do not expect market returns to approach these levels in 2020, the fundamental outlook for stocks has actually strengthened.

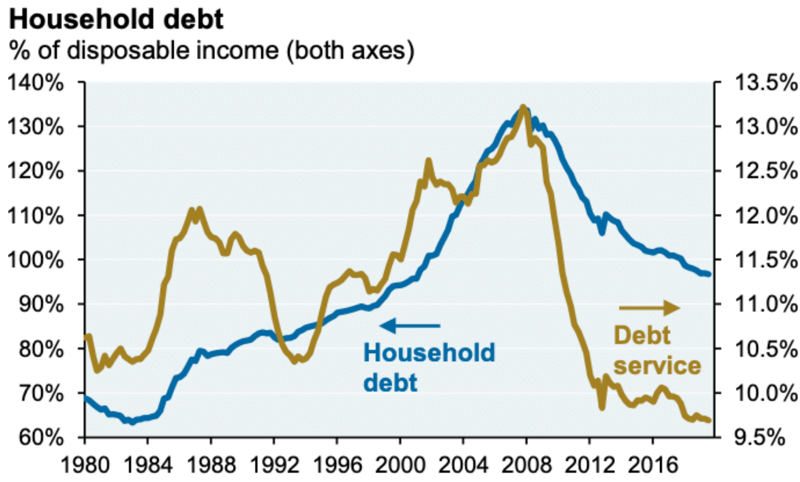
2019 was a contentious year for markets. Headline risks proved to be hazardous for investors, as those who stayed the course or bought on negative headlines prospered and those who sold or remained on the sidelines waiting for bluer skies lost out. The market has climbed a wall of worry throughout this 11 year bull market, but 2019 was an extreme case: escalation of the trade war, inversion of yield curves, global recessionary fears with many of the experts predicting recession, a flatlining in earnings growth, geopolitical strife from the Potomac to Hong Kong and the Middle East, and controversy over Fed interest rate policy. Companies and markets continue to thrive in the midst of all these challenges and uncertainty.

Positive Fundamental Backdrop

Looking into 2020, the backdrop for equity markets has improved. Slow but steady economic growth, low inflation and low interest rates, and supportive Fed policy all create a positive environment for growth and for risk assets:

1. After cutting rates three times in the second half of the year, the Fed has promised to remain "lower for longer" and has also committed to use all its tools to lift inflation above its elusive 2% target rate. If successful, an increase in the inflation rate would lift nominal GDP and be good for revenue growth and corporate profits. Globally, we are in the midst of a major stimulus cycle as the Fed and other central banks are cutting rates and expanding balance sheets to lift global growth and to prevent deflation.

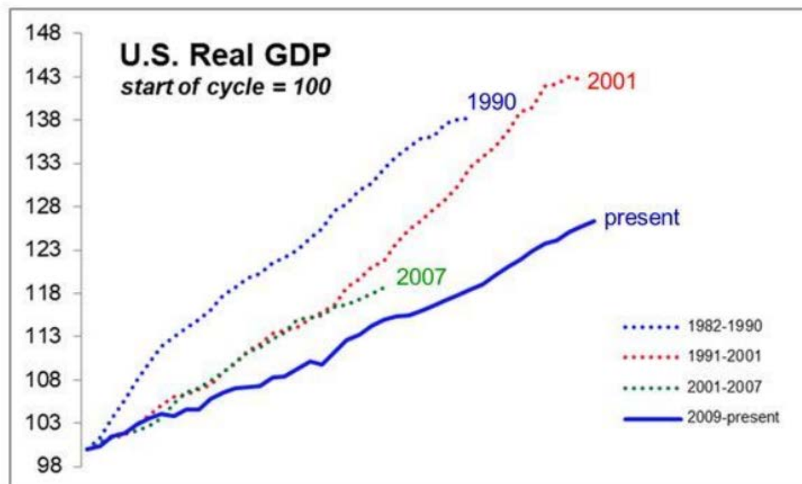
2. The U.S. consumer is not only healthy but seems to be getting stronger and more fit as the economic expansion continues. The consumer represents about 75% of U.S. economic activity. The consumer is confident, and in outstanding financial shape. The strength in the U.S. labor market and in consumer balance sheets offsets some persistent weakness in manufacturing. Unemployment is at the lowest levels in 50 years, and wages are rising for everyone including the bottom income quartiles. Household debt service obligation to disposable income is at the lowest level in 40 years (low rates have helped) and household debt as a percent of disposable income has steadily worked its way back down to 2002 levels.



All this means that the next recession is still years away, barring a dramatic turn in events. The steady spend of the consumer is the primary driving force behind this long economic expansion, already the longest in U.S. history as of mid-2019, and the reason it still has legs.

A long consumer binge extending from the early 1980's up to the financial crisis in 2008, in combination with over spending and over investment by businesses led to both the tech bubble of the late 1990's and the housing bubble that preceded the great financial crisis. Both events were of historic proportion and both led to recessions.

In contrast, this time the consumer has de-levered and improved his balance sheet over the past 11 years (as has our banking system) and business spending and investment has been frustratingly restrained. So, we do not see the typical "boom bust" cycle that has led to most recessions and to market tops. Slower growth means longer and more sustainable growth and a resilient domestic economy and stock market. The past decade will not only be remembered for its historic bull market, but as the only decade without a recession since record-keeping began in the 1850's.



Valuation: Half Full & Half Empty

Equity Market valuations are elevated but still reasonable given historically low interest rates and easy monetary policy. As investors became more comfortable that interest rates will rise slowly and not too far, current valuations may not appear to be unfavorable.

S&P 500 companies have been regularly returning significant amounts of cash to investors through a combination of share repurchase and dividends. Relative to the low level of competing yields, equities remain attractive. The 10-year treasury yields 1.8%, well below the total cash return of most S&P 500 companies. Moreover, equity valuations will also be aided by a resumption of mid-single digits earnings growth in 2020.

Ups and Downs vs. Bubbles and Crashes

The current generation knows only bubbles and crashes, but the 1980's and 1990's were a period of ups and downs. While valuations in certain sectors of the market are rich, we are nowhere near where we were in the dot-com tech bubble or the sub-prime fueled housing bubble.

This remains a reasonable market that cares about value and demonstrates rationality. It has been regularly purging excessive valuation and sector mini bubbles as it goes along. For example, the biotech mania of 2015 ended in a sharp 40% correction, "unicorn" IPOs without sustainable business models were punished by a skeptical market that cared about earnings and cash flow (Uber, We Work, Slack et al.), and the highflying cloud software stocks have gone through periodic pullbacks. And unlike the late 1990s, large cap tech stocks today are generally high cash returning machines (Apple, Microsoft, Google, Amazon, Facebook but also companies like Adobe and Salesforce). This is an underappreciated fact in the market.

Every bull market experiences volatility and pullbacks and this extended bull is no different. Since 2010 there have been 16 pullbacks of 5–10% and 6 corrections of over 10%. Ups and downs, rather than bubbles and crashes. So, the odds are that twice this year we will see a pullback in stocks that calls into question the viability of this bull market. With each such decline, investors are told that the bull market has finally run out of steam and that recession is looming. This market reminds us of the 1980s and 90s and the predecessor secular bull markets of the 1950s and 60s.

Conclusion: The Bull Picks Up Speed, Can He Still Run for Distance

There still remain significant risks in the year ahead: the U.S. Presidential election, confrontation with Iran, ongoing trade and tariff skirmishes, and continued uncertainty about global growth to name a few. Certainly, the election is the biggest uncertainty. Markets like Trump because he cut taxes and pushed government deregulation. He is viewed as broadly pro-business and positive for markets. A few of the frontrunners for the democratic nomination are open proponents of socialism, posing a greater than typical election year negative risk for markets. Even short of such a dramatic shift, a significant hike in tax rates and re-regulation would hit U.S. equities hard.

This bull market, however, is more likely to end from euphoria than from socialism. A wall of worry has sustained this bull market for 11 years. 2019 was a year of elevated headline and geopolitical risks and

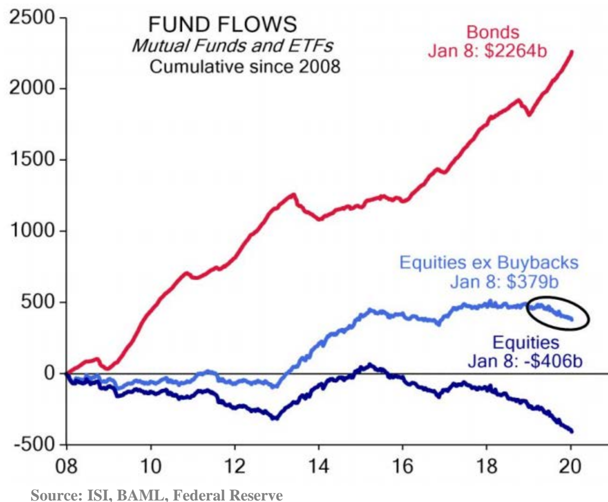
declining market volatility. The VIX market volatility index has declined more than 40 % from where it was last summer. As we begin the new year, some of these fears have receded and the investment skies have brightened, and glimmers of investor exuberance and greed have appeared. They are worth monitoring. The wall is a little less formidable, the investor a little less cautious.

We are far from euphoria, but investor euphoria can develop slowly over time or suddenly. In the words of legendary investor John Templeton: "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Global Economic Outlook & S&P Earnings - December 2019

Global Economic Outlook & S&P Earnings – December 2019 (S&P 500 @ 3,245)	2013	2014	2015	2016	2017	2018	2019	2020e
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	3.7%	3.8%	3.2%	3.3%
U.S.	2.2	2.4	2.4	1.6	2.3	2.9	2.2	2.3
Euro Area	-0.4	0.8	1.5	1.8	2.4	1.9	1.2	1.1
Japan	1.5	0.0	0.6	1.0	1.8	0.8	1.0	0.4
Developing Asia	6.6	6.4	6.2	6.2	6.4	6.3	5.5	5.6
China	7.7	7.3	6.9	6.7	6.8	6.6	6.1	6.0
Latin America	2.5	1.0	-0.5	-1.2	1.2	1.0	0.8	1.5
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	4.7	4.7	4.1	4.5
S&P 500 Aggregate EPS	109	118	117	118	131	162	165	175
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.9%	11.0%	23.7%	1.9%	6.1%
PE Ratio (December 2019 price @ 3,245)							19.7	18.5

Sources: IMF, ISI Group, BAML



Federal Funds Target Level

Date	Increase	Decrease	Level (%)
2019			
10/31		25	1.50-1.75
9/19		25	1.75-2.00
8/1		25	2.00-2.25
2018			
12/20	25		2.25-2.50
9/27	25		2.00-2.25
6/14	25		1.75-2.00
3/22	25		1.50-1.75
2017			
12/14	25		1.25-1.50
6/15	25		1.00-1.25
3/16	25		0.75-1.00