COMPASS INVESTMENTS LLC

Market & Investment Update

January 6, 2020

2019 Summary & Review

2019 was an excellent year for investors in most asset classes. However, a year ago markets and investor sentiment were in very different positions relative to today. In late December of 2018, equity markets were in the midst of a 20% drawdown following concerns about the Federal Reserve increasing interest rates and the potential for a global economic slowdown and potential US recession. Last December there was little evidence of an impending recession, but rather a market that was repricing risk to account for higher interest rates and trade-related uncertainties impacting growth. Subsequently, most markets enjoyed a very strong 2019 (Table 1) despite lingering concerns for most of the year about trade tensions and an economic slowdown.

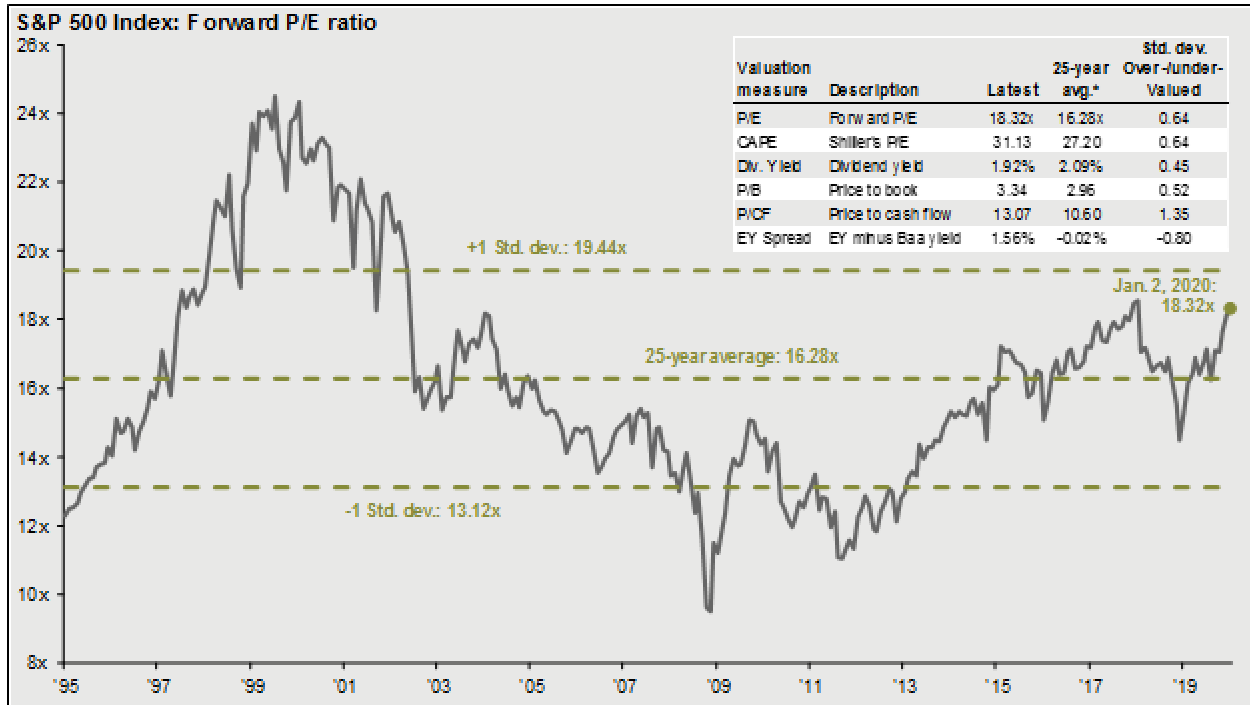
Table 1: Asset Class Returns

Category	Representative Index	Q4 2019	Full Year 2019
US Large Cap Equity	S&P 500	9.1%	31.5%
US Small Cap Equity	Russell 2000	9.9%	25.5%
Foreign Developed Equity	MSCI EAFE	8.2%	22.0%
Emerging Market Equity	MSCI Emerging Markets	11.8%	18.4%
US High Yield Fixed Income	ICE BofAML High Yield	2.6%	14.4%
US Fixed Income	Barclays Aggregate Bond	0.2%	8.7%
Cash Equivalents	ICE BofAML 3 Mo Deposit	0.4%	2.2%

2020 Key Areas of Focus:

From a valuation perspective, US equities are trading modestly above their long-term averages (Chart 1) across most metrics, with the exception of the earnings yield which continues to imply that equities remain attractive relative to bonds. Higher than average valuations do not necessarily mean that markets will have a bad year. However, when prices are elevated there is vulnerability to the downside should some risk factors such as increased trade tensions or rising interest rates come back into investor focus.

Chart 1: U.S. Equities Appear Modestly More Expensive than the 25 Year Average



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.32x	16.28x	0.64
CAPE	Shiller's P/E	31.13	27.20	0.64
Div. Yield	Dividend yield	1.92%	2.09%	0.45
P/B	Price to book	3.34	2.96	0.52
P/CF	Price to cash flow	13.07	10.60	1.35
EY Spread	EY minus Baa yield	1.56%	-0.02%	-0.80

Source: JPMorgan Guide to the Markets

Key sources of economic and market influence for 2020 could include:

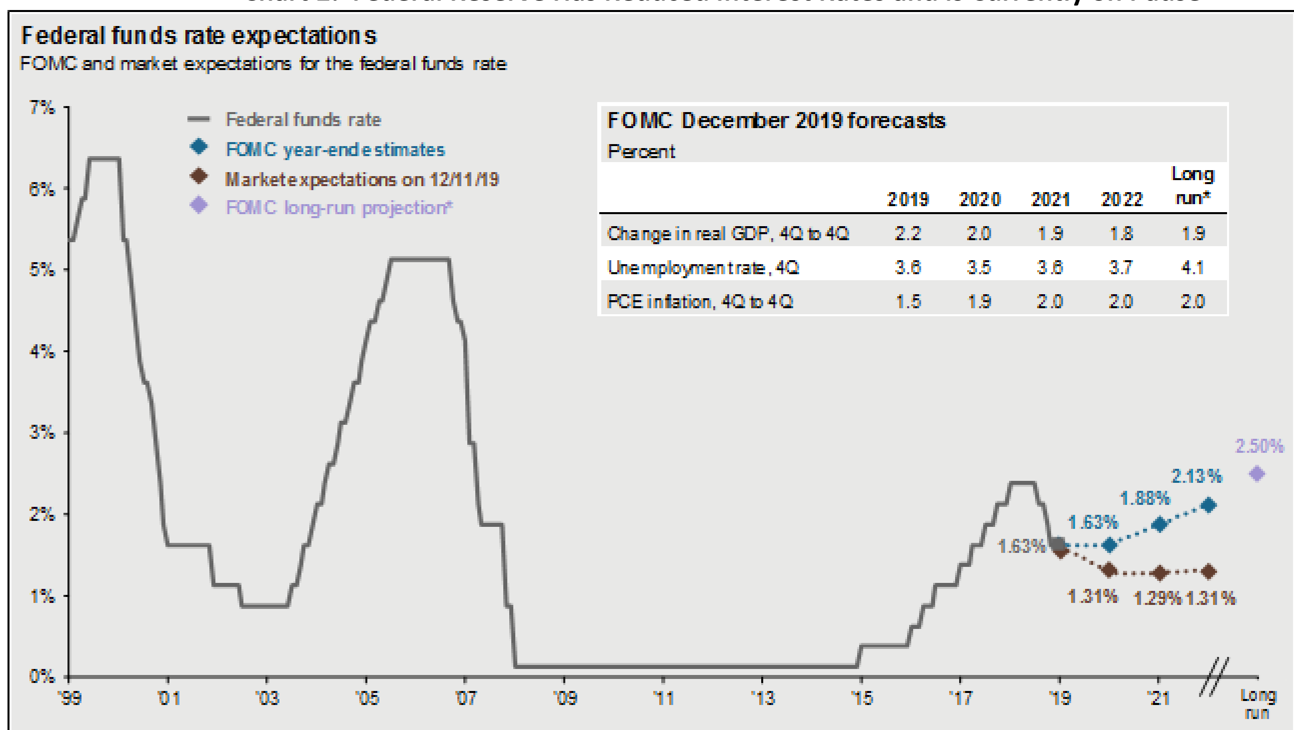
1. U.S. Politics / 2020 Election – There is the potential for increased regulation and taxes from some Democratic candidates for President (as well as the potential for increased Democratic control in the US House and Senate), which could constrain growth or simply negatively influence consumer and business sentiment. There isn't much historical evidence to suggest that one particular political party is best for markets or the economy, but the sharp reduction in corporate taxes certainly aided corporate earnings over the last few years, and that could have the potential to reverse under some Democratic candidate proposals. For example, the current corporate tax rate is 21 percent, which was reduced from 35 percent in 2018. Some leading Democratic candidates have proposed increasing the corporate tax rate to 28-35 percent.

2. Geopolitical Concerns – Ongoing uncertainty regarding trade may hamper business investment in capital and labor. Like most market participants, we do not have an expectation for how or when the US-China trade war will be resolved, although we observe that markets appear to be expecting that a deal gets done. A "phase one" deal between the US & China being signed January 15th will be positive in that additional tariffs on US consumer goods will not been enacted and China has pledged to increase its purchase of US agricultural products. But, given the significant structural / philosophical differences between the US and China regarding trade (e.g., intellectual property rights), it is possible that trade uncertainty and posturing on both sides could lead to periodic episodes of both upside and downside market volatility throughout the year. Thus far, tariffs do not appear to have materially weighed on consumer sentiment or consumer prices, but continued uncertainty could slow economic growth as businesses delay investments.

In addition, as 2019 ended, escalating tensions between the U.S. and Iran have dominated the news cycle following a drone strike in Iraq on a key Iranian military leader. While Iran does not play a large role in the global economy, escalating conflict in the Middle East could disrupt oil markets and drive oil prices higher which would have the effect of an economic headwind.

3. Federal Reserve Policy – The final meeting of 2019 for the Federal Reserve's Open Markets Committee on December 10-11 was not a surprise to markets as the Fed remained positive on economic conditions and overall monetary policy. The policy rate was left unchanged at 1.50-1.75% after having been reduced by 0.25% at the October meeting. In a speech in November, Federal Reserve Chair, Jerome Powell, noted that, "the current stance of monetary policy is likely to remain appropriate and well positioned so long as current generally good conditions persist." Although markets may not get the additional rate cuts they are expecting, the Fed has indicated that they will remain responsive and accommodative.

Chart 2: Federal Reserve Has Reduced Interest Rates and is Currently on Pause

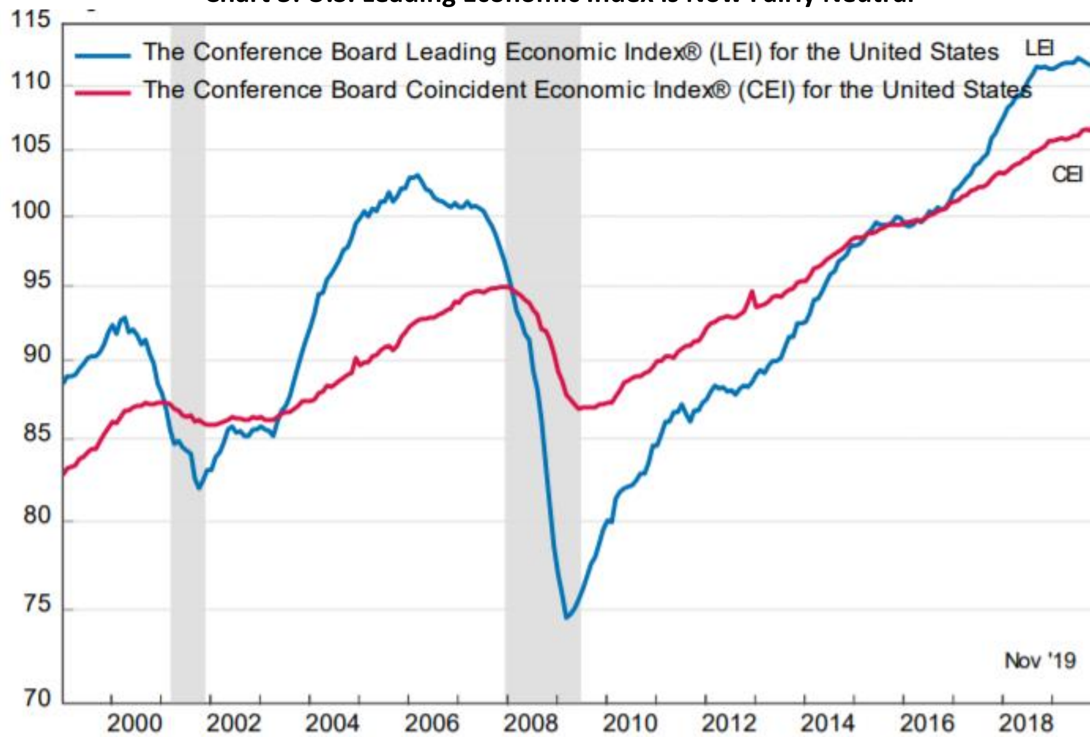


	2019	2020	2021	2022	Long run*
Change in real GDP, 4Q to 4Q	2.2	2.0	1.9	1.8	1.9
Unemployment rate, 4Q	3.6	3.5	3.6	3.7	4.1
PCE inflation, 4Q to 4Q	1.5	1.9	2.0	2.0	2.0

Source: JPMorgan Guide to the Markets

4. Economic Growth – There are growing parallels today to 2016. At the time, there were concerns that the economy was approaching stall-speed or even recession, and we were actively in a corporate earnings recession. Leading economic indicators (LEI's) were showing increased potential for future recession. The election brought lower taxes and increased consumer confidence which extended the economic cycle and pushed markets significantly higher. Today feels similar to 2016 because the LEI's are beginning to stall (chart 3) again and we have witnessed an earnings decline during the third quarter of 2019. However, US households remain healthy and confident, and the labor market has remained firm (chart 4), but with less potential capacity for job gains relative to 2016. Hiring has slowed over the last few months, but jobless claims remain very low. While the US economy remains healthy today, indicators of growth have slowed.

Chart 3: U.S. Leading Economic Index is Now Fairly Neutral



Source: The Conference Board

Chart 4: U.S. Initial Jobless Claims

5. Corporate Earnings – The estimated earnings decline for the S&P 500 for Q4 2019 is -1.5%. If accurate, it will follow an earnings decline of approximately 4 percent in the third quarter. Markets are again looking past this potential soft-patch, and for 2020 Factset is reporting the bottom-up analyst earnings estimates for the S&P 500 index (which reflects an aggregation of the median earnings per share (EPS) estimates for all of the companies in the index) of $178.57, implying approximately 10% growth in 2020.

Thank you for your support and we look forward to continuing to serve you in 2020 and beyond. We wish you and your families a healthy and prosperous New Year.

Past performance may not be representative of future results. All investments are subject to loss. Forecasts regarding the market or economy are subject to a wide range of possible outcomes. The views presented in this market update may prove to be inaccurate for a variety of factors. These views are as of January 6, 2020 and are subject to change based on changes in fundamental economic or market-related data. Please contact your Financial Advisor in order to complete an updated risk assessment to ensure that your investment allocation is appropriate.