Bank of New Hampshire
WEALTH MANAGEMENT

Private Banking

Quarterly Review
January 2020
Bull Markets Don't Die of Old Age…

Market/Economic Update

With a new decade just over the horizon, investors started the festivities early this year pushing the stock market to all-time highs in the fourth quarter riding the back of an accommodative Fed policy, tight labor markets, and the potential for some progress to be made on the China trade situation. Stocks were also bolstered by the lack of potential seen in other asset classes as interest rates remained negative in most of the Eurozone and Japan while commodities continued to languish on a multi-year basis due to the global slump in manufacturing. Despite the longevity of this decade long market cycle and some mixed messages from the economy along the way, last year proved that bull markets don't die of old age so long as corporate profits can continue to generate modest growth.

As global manufacturing contracted during the second half of the year, investors followed the earnings growth which brought them to large cap U.S. stocks and the technology sector more specifically. The S&P Technology sector rose +50.29% for the year with Apple (+88.97%) and Microsoft (+57.57%) leading the way. A significant part of this advance occurred during the fourth quarter with evidence of some easing in the trade tensions with China that had created uncertainty in the market for a good part of the year. It is noteworthy that the decline in manufacturing was overcome by strength in technology and services as our economy has become better diversified over the last few decades. The tech sector in the U.S. accounts for 21% of the S&P 500, far greater than our counterparts in Europe and Japan which has been an important factor in attracting capital to our markets. Another healthy sign is that the manufacturing contagion never found its way into the jobs reports so strength in consumer demand continued to be very positive throughout the year.

Heading into an election year, we don't see major changes coming from either the Federal Reserve who are typically reluctant to raise rates ahead of an election, or from the Trump Administration on trade as key advisors Kudlow and Mnuchin are both seasoned market veterans who will likely be less aggressive in pushing for tariffs over the next several months. The market is not historically cheap at 18.5x calendar 2020 earnings, but investors will continue to buy stocks in a modest growth environment when the earnings yield for the S&P 500 is more than 300 basis points above the benchmark ten year Treasury yield. It is an environment where stock valuations are not that attractive from a historical standpoint because returns over the last decade have been very strong pushing valuations into more expensive territory. With that said, this doesn't become problematic until a catalyst presents itself that will restrain earnings growth. While there will be no shortage of political fireworks and more volatility along the way this year, investors can still earn a respectable return commensurate with the level of earnings growth once all of the dust has settled.

—Charlie Mathews, CFA

Equity Markets

The S&P 500 finished 2019 up +31.31% for the year, it's best return since 2013 and the longest bull market in history continues on its way. The Nasdaq closed the year with a return of +36.11%, while the Dow Jones Industrials return was a strong +25.24%. Technology stocks provided the most fertile ground with a 50% return for the year, driving the Nasdaq Index to new highs. The S&P 500 also moved to a new high of 3,240 as the year was coming to a close which is a direct contrast to the previous year. In 2018, we were in the midst of a correction where many felt we may have been at the beginning of a bear market and now, after several months of churning our way back, we close out a very strong 2019 fourth quarter in which 33% of the total return for the year was achieved between October and December 2019. It was nice to see some momentum return to other segments of the market, as the Russell 2000 Small Cap Index rose +24.80%% and the S&P 400 Midcap Index was up +26.55. International stocks lagged a bit with the EAFE Index up +23.58% and the MSCI Emerging Markets up a more modest +19.87% The U.S. equity market continues to offer solid returns compared to foreign investments and we believe this will be the case going forward as corporate balance sheets are well positioned and there is meaningful competitive advantage in the tech sector.

There has been some yield curve steepening over the last few months as the Fed has completed its rate increases for now and gently eased policy during the second half of the year. Investor focus for 2020 may continue to shift towards the interest sensitive financial sector as well as smaller stocks which have traditionally done better during periods of central bank accomodation. There were early signs of this shift during the quarter as both these areas of the market performed better than the S&P 500. Investors await the resolution of the US-China trade war while watching tensions in the Middle East with some measure of trepidation. At home in the U.S., investors are focused on politics with the 2020 election taking center stage in the wake of the upcoming impeachment trial. Our outlook has not changed for the short term though we expect markets will be volatile in response to geopolitical issues around the globe. Corporate earnings estimates, which at the end of the day are the best measure of economic health, will be the primary driver of equity returns. Quite simply, we don't see signs of deterioration on that front. We continue to favor higher quality, blue chip stocks that can use competitive advantage to generate growth in this market environment.

—Robert Magan, CFA

Credit Markets

The major factors affecting US fixed income in 2019 were the global flight to quality, the shift in the Fed policy to a dovish bias, a deceleration in US GDP growth, and a slowing global economy in general. The continuing decline of negative sovereign yields in many developed nations caused an increased appetite for positive yielding US debt, pushing prices of US bonds higher, and yields lower. Positive flows into bonds as well as easing yields and tightening spreads led to a winning year in terms of performance. Longer duration issues performed best with 7-10 year maturities up +11.6% for the year. Corporate bonds coming due in 1 to 10 years had a total return of just under +10% while government debt of the same maturity returned just over +5.25%. Lower quality trumped high quality with intermediate BBB-rated bonds coming in at +11.4% compared to higher quality AA-rated debt at +6.9%.

Credit Markets continued

Investors put a record $94 billion into tax exempt bonds in 2019, topping the previous high of $81 billion in 2009, which in turn led to stellar performance in the sector. While the 2017 federal tax cuts meant lower income investors had less reason to invest in tax exempts as after-tax yields on corporate debt left many better off than on a net of tax basis, the legislation capped deductions allowed for state and local taxes (SALT tax) which led higher-income investors in those states to invest heavily in tax exempts as their taxes increased. The broad S&P Municipal Bond Index returned +7.26% which reflected the strong demand for these issues.

As fear of US and European recessions heightened in the summer and fall months, the Fed turned dovish and moved to gently ease rates. This caused dramatic flows out of money funds into longer dated, higher yielding corporate and municipal debt. The year began with a relatively flat treasury curve and the 3-month Treasury Bill yielding 2.36%. It reached a high of nearly 2.5% in March, but the Fed's three rate cuts in the second half of the year pushed money market rates down, and the 3-month bill bottomed to 1.5% in early December giving the curve a little bit of steepness. We don't see significant movement from here as the Fed will likely refrain from further action in an election year.

A decade of easy monetary policy has allowed bond issuers to accumulate record levels of debt. Businesses have increased debt to reward stock holders in the form of stock buybacks and increased dividends. As the economy showed promises of continued growth, the fear of recession waned and quality investors again sought higher yields in lower quality investment grade bonds (BBB's) and higher-quality junk bonds (BB's). Corporate debt as a percentage of GDP is at record highs, and this increase in leverage makes them vulnerable to downgrades should the business cycle finally turn and corporate balance sheets wobble with lower earnings. In addition, the relatively tight yield spreads to similar maturity Treasury issues reduces the longer term investment potential of lower quality bonds going forward from here.

As we head into another year where recession seems unlikely but growth modest, we continue to favor higher quality investment grade debt and look specifically for situations where corporate fundamentals are trending positively. We recognize that there will be continued demand for positive yielding debt given global interest rate levels, but are cautious on a long term basis as bonds do not offer compelling value at this time. It likely will be a year where a low to mid single digit return is more likely for bonds as fundamentals appear on track and Fed action is unlikely.

—Dona Murray