

INVESTMENT REPORT



LYNCH FINANCIAL GROUP LLC
— Retirement Wealth Management —

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www.LynchFinancialGroup.com

Investment Review and Outlook

The S&P 500 Index surged 9% in the fourth quarter. Its 31% total return was its second-best year since 1997.

European stocks gained 9.9% in the fourth quarter and 24.9% for the year. Emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.8% for the year.

The core bond index was flat in the fourth quarter but gained 8.6% for the year. This was its best annual return since 2002.

The key driver for the 2019 stock and bond returns was the Federal Reserve's sharp U-turn toward accommodative monetary policy.

There are reasons to be cautiously optimistic for financial markets in 2020.

We welcome questions or comments regarding this newsletter at- jlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.

Fourth Quarter 2019 Key Takeaways

Among global equity markets, larger-cap U.S. stocks were once again at the top of the leader board. The S&P 500 Index posted gains in every quarter and surged 9% in the fourth quarter to end the year at an all-time high. Its 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose 25.4% for the year.

Foreign equity markets were also strong. European stocks gained 9.9% in the fourth quarter and 24.9% for the year. After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.8% for the year.

The core bond index was flat in the fourth quarter but gained 8.6% for the year. This was its best annual return since 2002. Below-investment-grade bonds also fared well in 2019. High-yield bonds gained 14.4% and the floating-rate loan index rose more than 8.6%.

Why did both stocks (risky assets) and bonds (defensive assets) appreciate sharply in 2019? The key driver was the Federal Reserve's sharp U-turn toward accommodative monetary policy. This was followed by other central banks across the globe. Coming into 2019, the Fed was indicating it expected to continue to

Opportunities and Risks Over the Medium Term

Looking beyond the next 12 months, over a medium-term (5–10 year) time horizon, the range of outcomes is still wide, but our confidence around our base case is higher. We see significant headwinds to the performance of both U.S. stocks and core bonds. The downside risk relative to their potential return is high. Hence, we are tactically underweighted to both asset classes.

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Benchmark Returns (Periods Ended 12/31/2019)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	9.0%	31.3%
Russell 1000 Growth iShares	10.5%	36.1%
Russell 1000 Value iShares	7.4%	26.3%
Mid-Cap Benchmarks		
Russell Midcap iShares	7.0%	30.3%
Russell Midcap Growth iShares	8.1%	35.1%
Russell Midcap Value iShares	6.3%	26.8%
Small-Cap Benchmarks		
Russell 2000 iShares	9.9%	25.4%
Russell 2000 Growth iShares	11.4%	28.5%
Russell 2000 Value iShares	8.5%	22.2%
Other Benchmarks		
Vanguard Developed Mkts Idx	8.3%	22.0%
Vanguard Emerging Markets	11.3%	20.1%
Vanguard REIT Index	0.6%	28.8%
Vanguard Total Bond Mkt Index	0.0%	8.6%
Credit Suisse High Yield Index	2.6%	14.0%

Investment Review and Outlook (Cont.)

raise interest rates. This led investors to fear that higher rates could tip the U.S. and global economies into recession, bringing an equity bear market with it. The ongoing U.S.-China trade conflict didn't help matters.

Ultimately, the Fed ended up cutting rates three times in the second half of 2019. Late in the year, it also started expanding its balance sheet again via purchases of Treasury Bills in order to boost banking system reserves and inject liquidity into the short-term lending markets. Other major central banks also cut rates and/or provided additional stimulus to the markets during the year. This lessened recession fears.

Meanwhile, inflation (and inflation expectations) remained at or below central bank targets. This lifted concerns that interest rates would be hiked anytime soon, and the bond market rallied.

U.S. equity investors responded to the Fed policy reversal and stimulus much as they have during the past 10 years—by bidding up stock prices and valuations. A détente in the U.S.-China trade war late in the year (the “phase one” deal) was an added boost to market sentiment. Importantly, earnings growth did not drive U.S. stocks higher; the majority of the S&P 500's return came from expanding valuations. Thus, the valuation risk in U.S. stocks, which we've highlighted for some time now, has only gotten worse.

There are reasons to be cautiously optimistic for financial markets in 2020: Monetary policy is easy, recession risks seem to be receding, and some geopolitical risks have abated. That said, we are watching a number of potential short-term risks. Given we think recent positive developments have largely been incorporated into prices and valuations are stretched for U.S. stocks and bonds, markets are particularly vulnerable to any disappointment or negative surprise. If that comes to pass, we stand ready to take advantage of any potential opportunities that come of that volatility.

Market and Performance Recap

Our portfolios generated strong returns for 2019, a bullish year for nearly all financial markets. The positive broad-based returns marked a dramatic (and welcome) turnaround from 2018, a year in which nearly all asset classes faltered.

This year's surprising returns were fueled by a U-turn in monetary policy, as policymakers shifted gears to support a weakening global economy. After tightening financial conditions (raising short-term rates) four times in 2018, the Federal Reserve reversed course and began implementing a more dovish monetary policy (lowering short-term rates three times). Other major central banks also cut rates or provided additional stimulus to the markets via quantitative easing during the year, lessening global recession fears.

What's Next for 2020?

After a year like 2019, the obvious question looking ahead is how much higher can equities go? For many years, assets have been flowing into U.S. stocks on the back of a strong U.S. dollar and the United States' perceived safe-haven status relative to other global economies. In this respect, 2019 was largely an exclamation point on the decade's investment pattern.

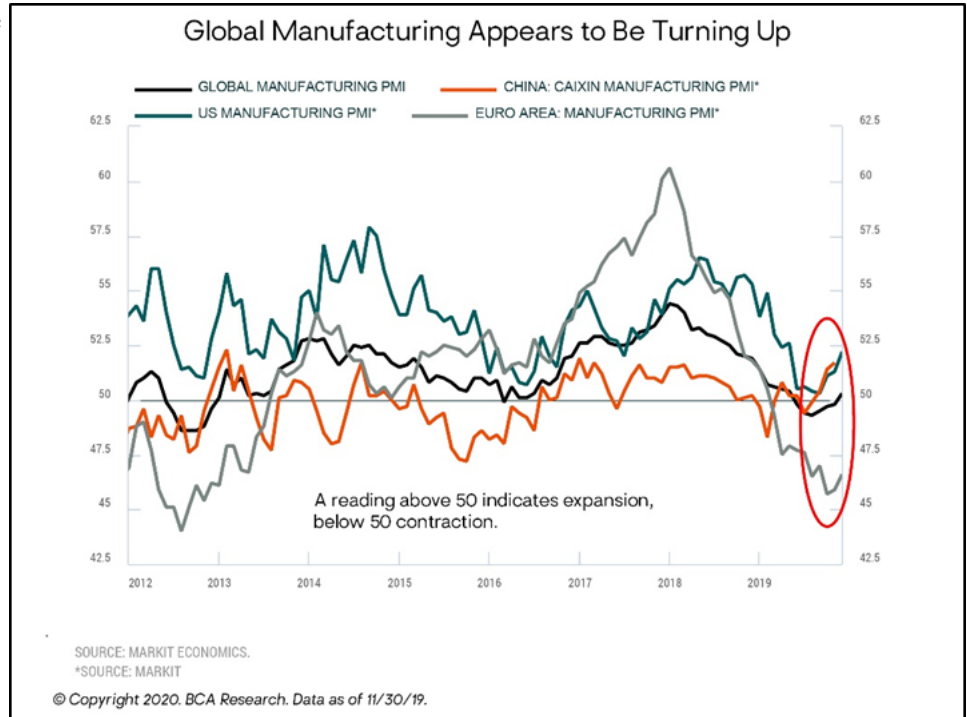
As we look ahead to financial markets in 2020, there are reasons to be cautiously optimistic for financial markets. Accommodative central bank monetary policy and easier financial conditions should continue to support at least a modest rebound in global economic growth. As just one point of reference, the Global Manufacturing Purchasing Managers' Index (PMI) has risen for four consecutive months and inched into expansion territory (above 50) in November. Along with reduced U.S.-China trade risk, this suggests the global economy may be on the rebound. The U.S. consumer also remains in good shape as ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

Investment Review and Outlook (Cont.)

However, this modestly positive outlook is consistent with the consensus view, meaning that financial markets have already responded positively to these developments. The risk of an unpleasant market surprise or deterioration in the macro environment in 2020 shouldn't be ignored.

A critical question for fundamental investors like us is always, "What's in the price?" In this regard, we note that it wasn't corporate profit growth that drove U.S. stocks higher in 2019. Reported earnings for the S&P 500 were actually flat over the first three quarters, and mid-single-digit percentage growth is projected for the fourth quarter. The lion's share (roughly two-thirds) of the S&P 500's 31% return came from a sharp expansion in valuations. We believe such stretched valuations leave U.S. stocks particularly vulnerable to disappointment or negative surprises in the macro environment.

Despite recent positive developments, the U.S.-China trade war could reignite or a different area of geo-economic conflict between the two countries could escalate. This would hurt a still-weak manufacturing sector and impact capital spending and business confidence (CEO confidence is already at recessionary levels).



U.S. election uncertainty, inflation surprises, and Brexit are also among the myriad risks that could impact markets over the coming months. Geopolitical risk is also, as always, a major unknown that we factor into our portfolio downside stress-testing. As of this writing in early January, global tensions are high following the unexpected killing of Iran's military commander by U.S. forces and now Iran's retaliatory missile strike. While it is far too early to know how this will play out on a broad scale, equity markets have largely taken this in stride.

Special report - Opportunities and Risks Over the Medium Term (continued from Page 1)

U.S. stocks sport the unappealing combination (from a forward-looking, return-on-investment perspective) of high valuations, in conjunction with high profit margins, and above-normal earnings. History, economic logic, and our scenario analysis strongly suggest this isn't a sustainable state of affairs. The business cycle and the market cycle haven't been repealed.

However, we also know momentum and sentiment (driven by central bank liquidity) can extend the current trend still further. Many investors seem to be of the mindset that, "as long as the music is playing, you've got to get up and dance," as Citigroup's ex-CEO infamously said in July 2007. (Presumably, they also believe they will be able to slip out the emergency exit ahead of the crowd just before the party gets shut down.)

Said differently, valuation is worthless as a short-term market-timing indicator. Overvalued markets can get even more overvalued in the short-term due to investor optimism, greed, and euphoria. The 1999–2000 tech stock bubble is an extreme example.

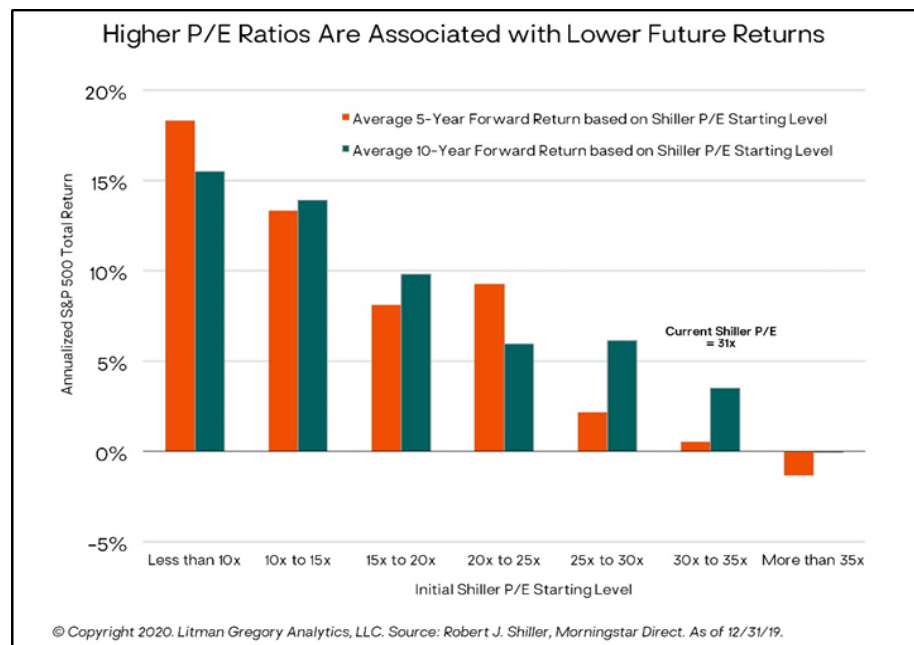
But valuation—the price you pay for an expected future stream of cash flows—is a hugely important driver of investment returns over the medium to longer term. For example, the Nasdaq index had an annualized loss of 6.3% in the 10 years following its March 2000 peak. And it didn't reclaim that peak level until mid-2015, more than 15 years later.

Valuation is not 100% determinative of future returns. Nothing is. But it's a very strong indicator, as shown in the chart below. (Note: The chart uses the Shiller price-to-earnings ratio, where earnings are a 10-year average adjusted for inflation. Our internal valuation analysis is not based on the Shiller P/E or any single valuation metric. But the Shiller P/E is well-known and captures the longer-term relationship between starting valuation and future return reasonably well.)

With U.S. stocks expensive and high risk, we continue to see better investment opportunities elsewhere: in foreign stocks, flexible bond funds, and selected alternative strategies.

European and EM stocks are a kind of mirror image of the U.S. market. They've been out of favor for several years and look relatively cheap on still-depressed (below normal)

earnings. Our base-case five-year return outlook for both markets is several percentage points higher than for U.S. stocks (see the five year, annualized Asset Class Return table on the next page).



Economic Scenario:	Bear	Base	Bull
<i>S&P 500 at 3231, Bloomberg Barclays U.S. Aggregate Bond Index yield at 2.32%, MSCI Europe Index at 1683, MSCI EM Index at 1115, ICE BofA ML High Yield Cash Pay Index at 5.3%</i>			
Stocks	Estimate	Estimate	Estimate
Larger-Cap U.S.	-10.0%	-0.9%	7.1%
Developed International—Europe	-10.0%	5.7%	13.7%
Emerging Markets	-2.0%	9.0%	16.5%
REITs	3.1%	4.7%	2.0%
Fixed-Income			
Investment-Grade Bonds	2.7%	2.2%	1.8%
High-Yield Bonds	1.7%	2.4%	3.0%
Floating-Rate Loans	5.2%	4.0%	6.6%
TIPS (in real terms)	1.1%	0.5%	-1.0%

In the shorter term, should the positive global growth outlook for 2020 play out, we'd expect international and EM stocks to outperform U.S. stocks, given their higher cyclical and sensitivity to overall GDP growth. To the extent the U.S. dollar weakens in this environment—due to it being a counter-cyclical currency—that will further help foreign stock returns (for dollar-based investors).

Core bonds' very low starting yield implies very low expected returns over the next five years. Nevertheless, in our conservative portfolios we still maintain meaningful exposure for risk management purposes.

Given this backdrop—weighing the shorter- and medium-term risks and return opportunities and considering the economic fundamentals against market valuations—we think the wisest course for balanced investors continues to be a broadly diversified, moderately defensive posture.

We appreciate your trust in us and welcome any questions you may have.

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