



QUARTERLY NEWSLETTER **1Q 2020**

All in all, it's just another brick in the wall of worry


 Chart 1. Index Performance 2019



Source: 2020 Bloomberg Finance L.P.

Iran, trade wars, Brexit, Fed policy, impeachment, election, slowing growth, and a possible recession. All bricks that have built the wall of worry that the U.S. equity market has climbed. Any of these issues could have heavily weighed down market returns in 2019, but in fact, they had little effect outside of some short-term volatility. Instead, the market seemed to shrug it all off and did what the market does - focus on the road ahead. The markets tell a story. The story is in the data that all the participants are discounting in the future, and the current story seems to include more economic green shoots and a rebound in earnings. The question is if the market participants are too positive and have overshot on the positive side, or just right. We think that topline growth is the starting place to look for current and future earnings, cash flow growth, and therefore valuation expansion. That topline revenue growth comes from GDP growth, so if the economy is growing, then it is likely that the market will go up over time in our opinion.

With current valuations peaking at slightly over-valued levels, we need growth to show up this year or we should expect to see a revaluation in prices. The chart below (Chart 2) shows the S&P 500 Price-to-Earnings based on next year's Bloomberg consensus estimate. We reached a valuation level at the end of 2019 similar to 2018, but have come off that level somewhat, and with far different consequences. So far we have avoided the correction we experienced at the end of 2018 and we believe that is due to different expectations at each point in time. In addition, there are many ways to measure value. For example, if we looked at all the data points we follow, most would point to overvaluation, but there is also plenty on the positive side of the ledger. For example, the Fed model, the equity risk premium versus the 10-year treasury, money market balances (\$791 Billion 3Q 2019 according to St. Louis Fed - the highest since the financial crisis), and Fed policy are all arguments for the bulls. We can also see that in periods like 1999, the market expectation can get significantly more out of balance and although these extremes are a low probability, valuations can get much more extreme.

 **Chart 2.** S&P 500 Price-to-Earning



Source: 2020 Bloomberg Finance L.P.

We talk quite a bit about the mosaic theory of investing, which is the idea that many different variables drive returns. In our opinion, this is also affected by the time horizon. As the time horizon shortens, the number of variables become infinite, and as the time horizon lengthens, the variables become manageable. Maybe this is the reason long-term perspectives and forecasts usually win out. Sometimes, among these many variables we can see a few that are more heavily weighted in the short-term, but they are always changing. That is a big reason why economic and market forecasters have a horrible track record predicting what will happen in the next year. It is also why we believe our long-term investment process works over time.

What Are We Watching Closely?

 Fed Balance Sheet  Revenue and Earnings Growth  2020 Election

The Fed Balance Sheet

The graph to the right shows the S&P 500 Index in orange, along with the growth in the U.S. Fed Balance Sheet in yellow for the last six months. As you can see, the bottom of the market during August 2019 and the Fed Balance sheet have moved almost in lock-step. Currently, we are watching this key driver, and short-term it seems to be a significant factor driving the recent market exuberance. If this changes it could lead us to be more bearish, especially if growth does not continue to pick up, and therefore take up any slack that could be left by the U.S. Federal Reserve pulling in the reigns.

 Chart 3. S&P 500 Index and Fed Balance Sheet

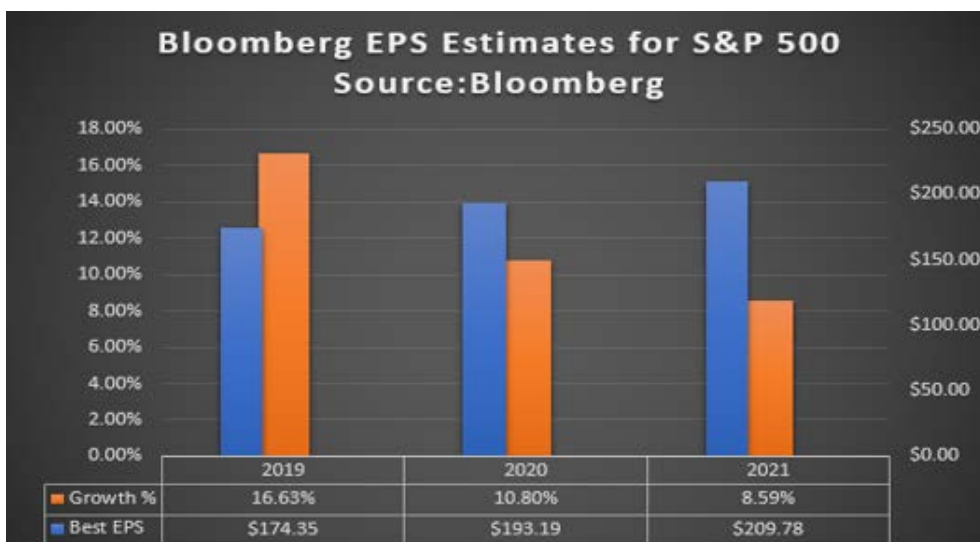


Source: 2020 Bloomberg Finance L.P.

Revenue and Earnings Growth

On the growth front we continue to look good. The Street is currently expecting robust growth with 16.63% to close out 2019 (to be reported in early 1Q2020), as well as solid growth for the next two years. Estimates have come down for the fourth quarter but this is somewhat typical for the final quarter of each year. As of 1/13/2020 we were trading at 18.79 times 2019 earnings, but only 15.62 times 2021 EPS. If the growth story remains the same and the U.S. Fed keeps adding liquidity, we should continue the current run, notwithstanding any normal intra-year correction.

 Chart 4. EPS Estimates for S&P 500

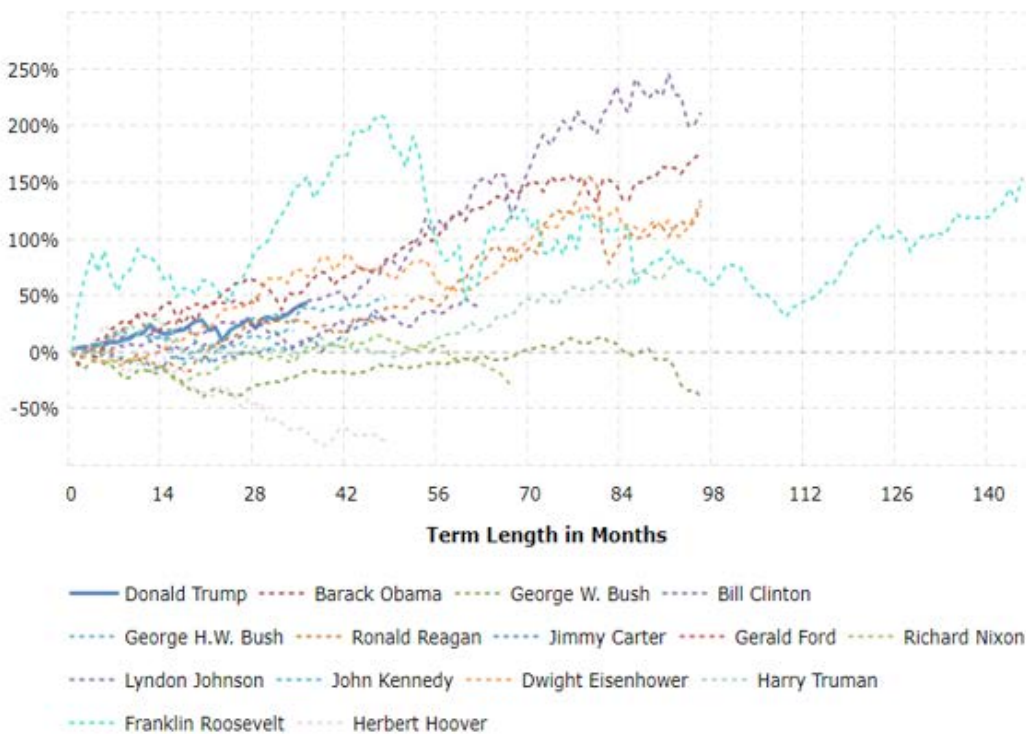


Source: 2020 Bloomberg Finance L.P.

2020 Election

The U.S. election could have the largest short-term impact due to extreme differences in each candidate's approach to the economy, but current probabilities are limiting our worry at the moment. The below (Chart 5) is from Macrotrends.net and illustrates in our opinion that, although there are plenty of emotions on both sides, the President does not matter as much as assumed by most to market performance. It is more about the economic and fundamental environment in which they exist. In fact, most performance of multi-term Presidents is pretty good, probably due to the longer time horizon "in the market", and the underperformers were usually dealing with wars or the Great Depression in President Hoover's case. Policies have led to volatility and underperformance in the past and could come into play again if some lower probability candidates win. In our opinion, the probable nominees and winner on either side of the aisle offer little to no risk with respect to performance of the market, but again we have our collective eyes on this and a plan if a change in strategy is needed.

 **Chart 5.** Dow Jones returns by Presidential term



Source: Macrotrends.net

INTERNATIONAL VIEW – “TIME”

They say time heals all things. The fourth quarter of 2019 painted a completely different picture than the year before for both U.S. and international markets, and what were once headwinds turned into tailwinds. Over the course of the year, these tailwinds propelled the MSCI EAFE to post its best 4Q return since 2006 of 8.22%, and an annual gain of 22.77% with every sector experiencing positive returns. Over the course of the year, and quarter, global equities were supported by:

- Improving U.S. China trade relations
- Brexit elections that seemingly cleared the path for a negotiated plan to withdraw from the EU
- The dampening of Geopolitical tensions
- The avoidance of a drastic “global slowdown” that many feared would come amid China’s slowing growth
- Dovish leaning Central Banks

The U.S./China trade truce was arguably the largest development as the world’s two largest economies avoided a full-blown trade war. Despite the robust returns, tensions in the region remained high as Hong Kong fell into a recession after months of political protests and unrest which effected both tourism and retail sales in the region. The Hang Seng Index, one of Hong Kong’s most widely followed indexes lagged other markets and finished 13.01% higher on the year, however gained over 8% in 4Q on the back of progress in U.S China trade relations.

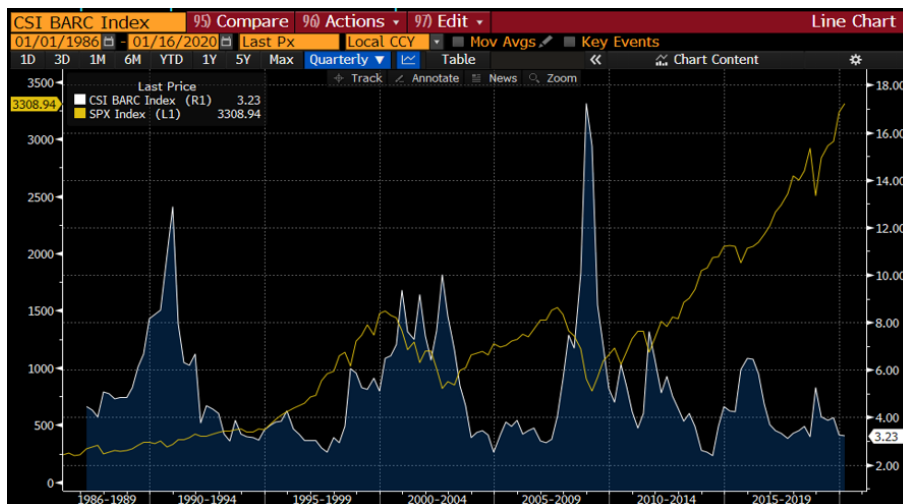
Elsewhere, European markets followed suit ending higher, however the Eurozone economy continued to falter with annual GDP that is expected to fall to its lowest levels since 2013. Germany, narrowly avoided a recession amid a slowdown in manufacturing and structural changes within the automotive industry. However, the export reliant economy was bailed out by positive consumer spending trends which continued to be a major global theme in 2019. Cyclical sectors in the region outpaced defensive equities led by Info Tech, Industrials, and Consumer Discretionary. Energy and Communication services both lagged broader European markets as oversupply and low prices plagued energy related names while continued weak economic growth was the cause for concern of communication companies. Additionally, government bonds in the region declined as demand for safe haven assets fell and negative interest rates caused investors to shy away, looking for yield elsewhere.

ASSET ALLOCATION VIEW – “COMFORTABLY NUMB”

Key to the Level Four asset allocation process is to first identify areas of potential alpha and risk the market provides, and second to employ the best investments to exploit the alpha opportunity while trying to minimize areas of risk. How the markets define these areas is an ever-changing dynamic over time. As we have stated earlier in the newsletter, today’s market seems to be climbing the “wall of worry” or to put it another way is “comfortably numb”. Issues such as Brexit, trade issues with China and elsewhere, impeachment, and the 2020

election just to name a few, have really not gotten the market's attention in a negative way. However, we all know that markets can turn to "uncomfortably painful" in a short period of time, so vigilance is always necessary. Paying close attention to bond spreads is one way to gauge the temperature of the market. Above is a long-term chart of high yield bond spreads compared to S&P 500 (Chart 6). Note that when spreads are tight (the blue area is low - meaning the bond markets are very comfortable with credit risk), the equity markets tend to rise. This is one of several indicators we regularly review as part of our mosaic approach to research to help understand what opportunities and risks the markets currently pose.

 Chart 6. High Yield Spreads



Source: 2020 Bloomberg Financial L.P.

Current global market conditions factor into, and have the following implications for asset allocation:

General Allocation – As equity markets remain in a “climbing the wall of worry” posture, we continue to recommend at the core, a mixture of passive and quality factored exposure surrounded by a “risk off” and “risk on” barbell approach to equity allocation. We believe the equity markets remain in a favorable status, though we do not anticipate 2019 level of returns. We also believe that the Fed will likely be “on hold” in the near-to-medium term. We remain vigilant regarding our indicators and will modify our overall allocation as these indicators and market environment dictates.

Equity Allocation - We continue to monitor financial conditions and market returns to determine our optimal asset allocation. Relative to benchmarks, we are neutral equities relative to fixed income, slightly overweight U.S. equities, and are neutral small/mid-cap equities. We are emphasizing a quality equity core, including barbells with lower volatility exposure coupled with some exposure, which is opportunistic to upward market movement. We will continue to evolve our factor exposure as markets dictate. We continue to monitor developed international markets, and find that valuations continue to be favorable, however earnings and returns benefited U.S. equities in 2019. If Dollar weakness manifests in 2020, this could lead to some additional opportunities internationally. We maintain a neutral weighting on emerging markets.

Fixed Income Allocation – We believe core fixed income returns in 2020 will be challenging. We recommend a slight underweight to neutral weighting in duration, and a modest exposure to credit spreads. Due to the lower rates seen in 2020, higher quality and higher duration fixed income have limited upside and provide lower yields. We believe the Fed has done a good job regarding the overnight liquidity issues in the REPO markets, as those spreads were very tame year-end. We believe that the interest rates may rise in 2020 and see a tail risk as a rapid rise in rates in 2020. Though the yield curve remains shallow, it has resumed a normal curvature (no longer inverted). In practice, this means exposure to areas such as short-to-intermediate term securities and floating rate securities are preferable. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

Liquid Alternatives – Liquid alternatives can help to lessen portfolio volatility and improve risk adjusted returns. We recommend considering adding these to portfolios when appropriate.

Outlook/Summary

An intra-year correction would not surprise us due to a number of factors such as the current valuation and lack of fear/excessive bullishness in the current market. Quite a few data points that we follow in order to gauge sentiment, such as the the Put/Call ratio, % above 200-day moving average, and low volatility as evidenced by the VIX, concern us in the short-term and may lead to some short-term correction at some point. However, we are not overly concerned as this would be a normal occurrence and do not think it will be a tradable event as most are not. According to First Trust, the average intra-year decline since 1980 is 14%, yet the average return of the S&P 500 since 1980 is 11.79% per year with dividends re-invested. Unless we are expecting a recession and a bear market, major changes are not warranted.

In our opinion, our fundamental process will allow us to choose companies with good growth potential at great prices, that is our focus. Here is to a great 2019, we are looking forward to working with you in the 2020 and building on our success.

THANK YOU,
Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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