The Cobblestone Advisor
Investment Brief
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COBBLESTONE
CAPITAL ADVISORS

Distinction With a Difference

Equities ended 2019 on a high note, with the S&P 500 closing fractionally below the all-time high it had reached just two trading days prior to the end of the year. This capped what was an exceptionally strong year for domestic equity markets, with the S&P 500 returning +31.5%. Outside of 2013, when the index delivered a +32.4% return, this was the strongest year for domestic stocks since 1997. The noteworthy performance of equity markets largely resulted from strength at the beginning and end of the year, with performance in the first and fourth quarter accounting for approximately three-fourths of the calendar year's total return.

It was not only stocks that performed remarkably well in 2019. Bonds also generated strong performance and delivered equity-like returns for the year. The Bloomberg Barclays US Aggregate Bond Index, measuring broad US fixed income markets, rose +8.7%, its best annual performance since 2002. Notably, more than half of the returns from bonds in 2019 came from the two periods when equities came under pressure amid US-China trade tensions—the month of May and again during the first two weeks of August—suggesting that bonds continue to act as an important diversifier during risk-off periods when capital preservation is needed most. Taken together, the strong returns of both stocks and bonds translated to a balanced 60/40 equity-fixed income portfolio delivering its strongest annual performance since 1997. Other asset classes such as REITs and commodities were also up double digits. Broadly, the markedly positive performance in 2019 across virtually all asset classes stood in stark distinction from 2018 when nearly all asset classes experienced negative returns.

In recent Advisor newsletters, we have written extensively about how sentiment appeared to be the likely catalyst underpinning movements in asset prices against a backdrop of mixed signals showing up in US and global economic data. Specifically, certain areas of the economy such as manufacturing were showing signs of deterioration, whereas other areas such as services were performing well. These categorical distinctions generally remain in place today, and we believe that we are at the proverbial "fork in the road" for the economy and markets. We are monitoring for the catalysts—both positive and negative—shown in the below exhibit, as they are likely to determine the trajectory of economic growth and financial markets from here.

For now, the backdrop remains challenging for overall company earnings. Although only a small percentage of S&P 500 companies have reported fourth

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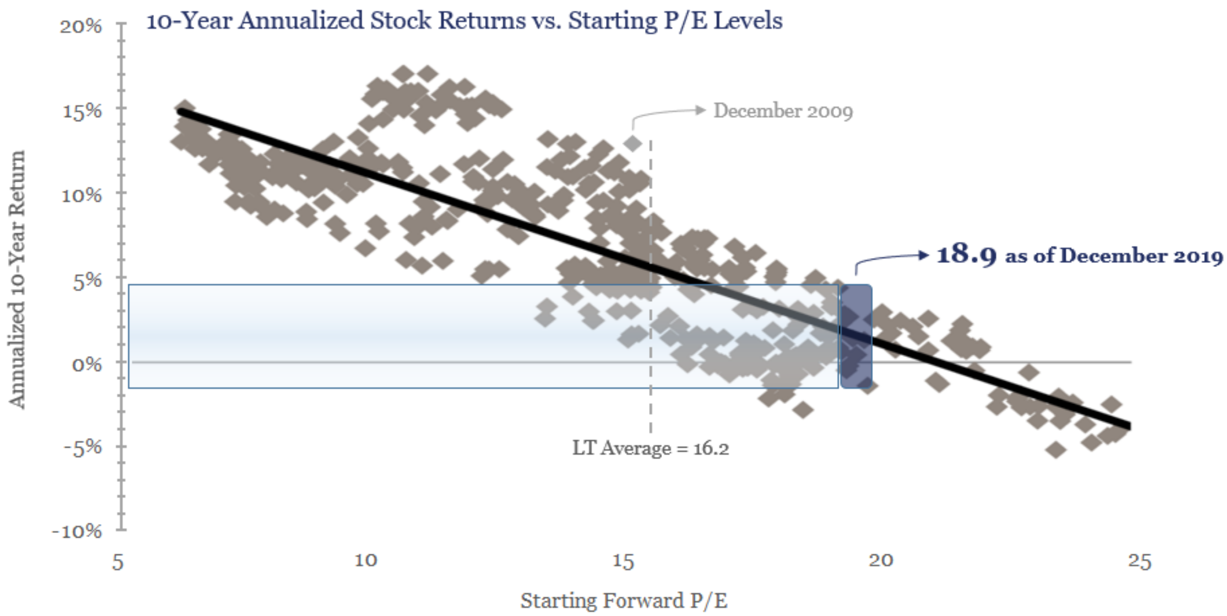
POSITIVE CATALYSTS	NEGATIVE CATALYSTS
Positive Resolution to Trade Tensions	Escalation in US-China Trade Tensions
Recovery in International Economies	2020 US Election Jitters
Positive Earnings Surprises	Business/Consumer Confidence Deteriorates

quarter 2019 earnings thus far, those results combined with the estimated earnings of companies that have not yet reported show a year-over-year decline in earnings for calendar year 2019. Absent an earnings-driven move in equity prices, the 2019 return generated by the S&P 500 was predominantly sustained by rising valuations. In fact, 92% of the S&P 500 rally was powered by valuation expansion, with the forward price-to-earnings (P/E) ratio beginning the year at 14.9 and ending it at 18.9.



Source: Credit Suisse; Data 1964 - 2019

While not out of the realm of possibilities, counting on equities to continue moving meaningfully higher from here amid further valuation expansion is a tall order in our view. Given current valuations, our suggestion is for clients to have more moderate expectations for returns going forward. As shown in the above exhibit, starting equity valuations are strong determinants of long-term forward stock returns (e.g., returns over the next 10 years). In other words, starting at relatively low valuations has historically led to higher stock returns over the subsequent 10-year period, whereas starting at relatively high valuations has historically led to lower stock returns over the subsequent 10-year period. Ten years ago, the P/E ratio—at 15.4—was relatively attractive. The S&P 500 went on to deliver a +13.5% annualized return over the following 10-year period. With the P/E now at 18.9, a lower range of potential outcomes is expected, with stocks now unlikely to generate returns above the low-single digits.

A similar case can be made for fixed income, where the starting yield on bonds is a significant determinant of the return that investors can expect to earn on bonds going forward. With interest rates just slightly above historical lows, long-term forward bond returns are unlikely to mirror the elevated returns generated by bonds of late.

Our message is not intended to sound dire. Rather, our goal is to communicate the importance of maintaining a realistic perspective on what the likely range of outcomes may be for future asset class returns, as realistic return expectations are a crucial input when establishing a viable long-term financial plan.

Total Return (%), Ending 12/31/2019				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	9.06	31.48	31.48	15.26	11.68	13.54
Russell 2000 (Small Cap Stocks)	9.94	25.52	25.52	8.59	8.22	11.82
MSCI EAFE (International Stocks)	8.17	22.01	22.01	9.56	5.67	5.50
MSCI EM (Emerging Markets)	11.84	18.42	18.42	11.57	5.61	3.68
Bloomberg Barclays US Aggregate Index	0.18	8.72	8.72	4.03	3.05	3.74
Dow Jones US Select REIT	-1.23	23.10	23.10	6.95	6.40	11.56
Consumer Price Index (% Chg over Period)	0.84	2.29	2.29	2.11	1.82	1.75