First Republic
Private Wealth Management

2019 RECAP | 2020 OUTLOOK

A Look Back to 2019: Markets Climb a Wall of Worry

HIGHLIGHTS

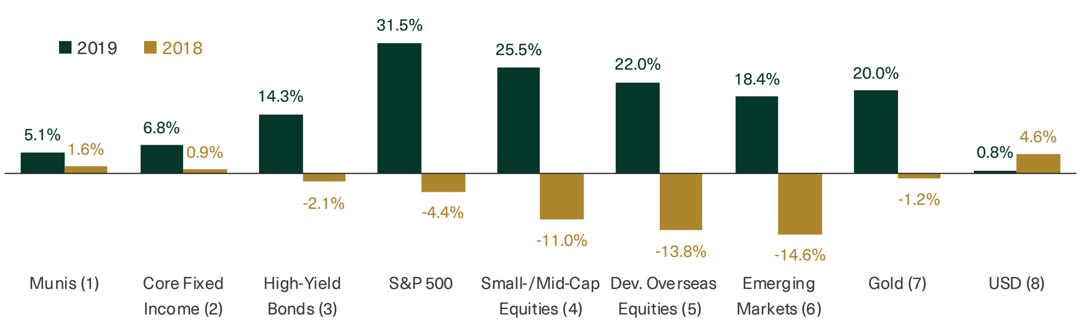
- **U.S. equities mark best annual performance in half a decade as U.S. economy avoids a recession for the longest period ever.**
- **Easing trade tensions with China, a shift in monetary policy at the Fed and improving economic outlook renewed investors' risk appetite.**
- **A bond market indicator that once warned of recession is now at its steepest in more than a year.**

OUR VIEWS IN SUMMARY

Looking back a year ago, investor sentiment was in the doldrums as 2018 closed with all three major U.S. indexes in the red. The retreat — stoked by concerns about a slowing global economy, intensifying trade tensions and tighter central bank monetary policy — sent global stock markets on their worst year since the financial crisis. While the mood at the end of 2018 was one filled with uncertainty, 2019 witnessed a series of catalysts that triggered inflection points across financial markets.

2019 was a year of strong returns for both equity and bond markets, with alternating periods of "risk-on" and "risk-off" sentiment among investors. A "phase one" U.S. trade deal with China helped avert an additional steep and threatening round of tariffs, while global monetary policy shifted firmly into easing territory, as the Federal Reserve (the Fed), along with other central banks, lowered interest rates. Across the globe, the U.K.'s general election yielded a new Conservative majority, offering new clarity around the future of Brexit and boosting international equities. As some uncertainties cleared, U.S. equities continued to power forward, with the three major U.S. indexes ending the year on a high note (see Figure 1).

Figure 1: Market performance



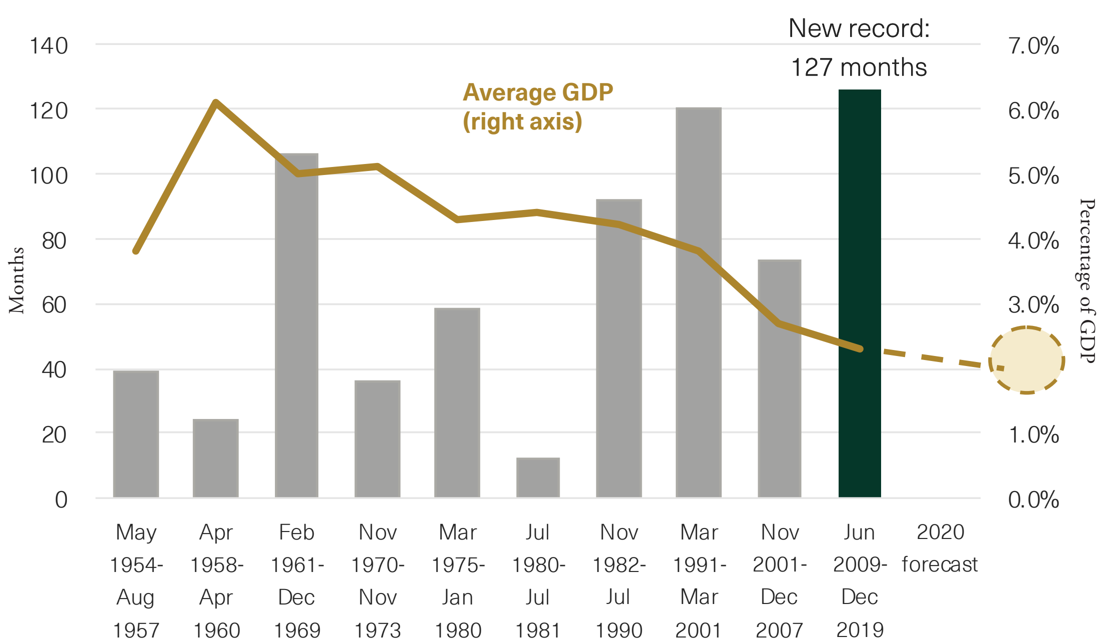
Source: Morningstar. Indexes: (1) ICE BofA Merrill Lynch Municipals 1-10 Year AAA-A, (2) Bloomberg Barclays Intermediate Government Credit, (3) Bloomberg Barclays High Yield, (4) Russell 2000 Index, (5) MSCI EAFE, (6) MSCI EM, (7) KITCO Gold Index, (8) Dollar Index Spot. As of 12/31/2019.

With central banks globally providing more accommodation, bonds made strong progress in 2019 with spreads over sovereign debt continuing to tighten. Yields on government bonds made fresh record lows (pushing up their prices), especially during the "risk-off" periods seen in May and August. In 2019, negatively yielding sovereign debt reached $17 trillion.

STRONG LABOR MARKET UNDERPINS U.S. GROWTH NARRATIVE

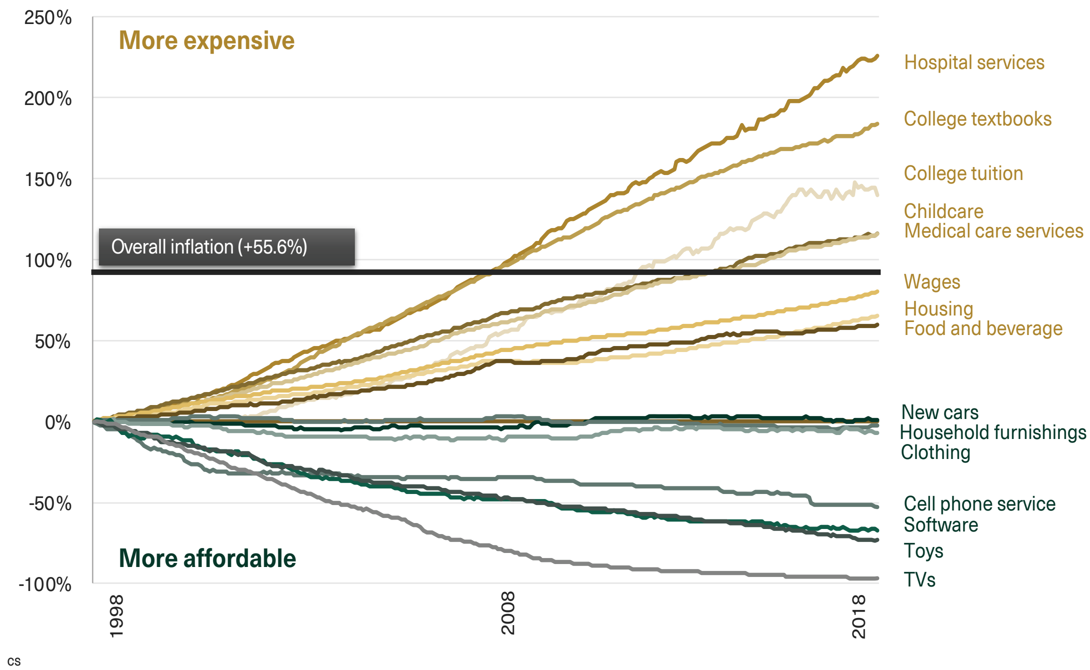
With lower interest rates and de-escalating trade tensions, some economic indicators improved while others remained strong throughout 2019. This can be attributed mostly to the resilience of the U.S. consumer. Robust consumer spending, sustained by a tight labor market and steady wage gains, is driving a healthy service sector and broader economy. However, the U.S. manufacturing industry deteriorated, as factories continue to struggle with trade frictions and feeble global growth. Nevertheless, as of last December, the U.S. economy had expanded for a record 127 straight months, the longest period in the country's history (see Figure 2). Put another way, the United States has avoided a recession for an entire calendar decade for the first time ever.

Figure 2: U.S. economic expansion



On the macroeconomic front, the U.S. unemployment rate fell last year to a 50-year low of 3.5%, a remarkably low number that underscores continued strong labor demand. The low unemployment rate has lifted the growth in wages to around 3% per year, almost the largest annual increase since the 2008 recession. And while the most recent Conference Board might report another slight dip in consumer confidence, this remains close to an 18-year high. A robust labor market explains why Americans feel secure in their jobs and confident enough in the economy to keep spending. However, such low unemployment is not stoking up wage inflation. The primary reason: technology (see Figure 3).

Figure 3: A closer look at inflation



Source: Bureau of Labor Statistics

Many economists have added that there are other forces at work as well, which are not technological in nature. One major force is demographics; as consumers age, they consume different goods and generally consume less (particularly consumer goods). The aging of the population and the slowing of population growth are common themes even in most developing countries. Lower prices among technological devices such as cellphones, TVs and software are offsetting higher costs on items that have become more expensive over recent years, including hospital services, education and childcare.

BONDS: LOWER FOR LONGER

U.S. interest rates started 2019 in a downward spiral as investors fled risk assets and flocked to safety amid an escalated U.S.-China trade war and deteriorating economic data. Adding to the downward pressure was the anticipation that the Fed would lower borrowing costs to combat recessionary concerns. Next, the Fed embarked on what it characterized as a "mid-cycle adjustment," cutting borrowing costs three straight times. However, U.S. Treasury yields started to rise across the board in September after the U.S. and China agreed on a truce in their tit-for-tat tariff war and started to negotiate a deal. December's announcement of a so-called "phase one" trade deal sent the 10-year U.S. Treasury yield on its biggest monthly climb after President Trump stated he would sign the deal on January 15.

AMERICA FIRST: U.S. EQUITIES POWERED FORWARD IN 2019

Compared to 2018, the S&P 500 climbed 31.5% higher in 2019, its best performance since 2013. Meanwhile, the NASDAQ Composite and the Dow Jones Industrial Average also posted healthy returns in 2019. The tech-heavy NASDAQ Composite jumped 36.7% to notch its best gain since 2013. The 30-stock Dow index soared 25.3%, its strongest yearly performance since 2017. In turn, the House of Representatives' decision to refer President Trump to the Senate for impeachment had no adverse impact on the equity market. This points to how quickly the outlook, and sentiment, can change.

Entering 2019, skeptics believed that economic growth had peaked, but the cycle actually extended throughout the year. However, some pockets of soft economic data also emerged. Business confidence has faltered, as measured by the recent drop in chief executive confidence. And it is likely to continue to be muted in the run-up to the 2020 presidential election. Looking forward, we expect U.S. economic growth to be moderate but remain positive. Accordingly, we see U.S. returns in single-digit territory.

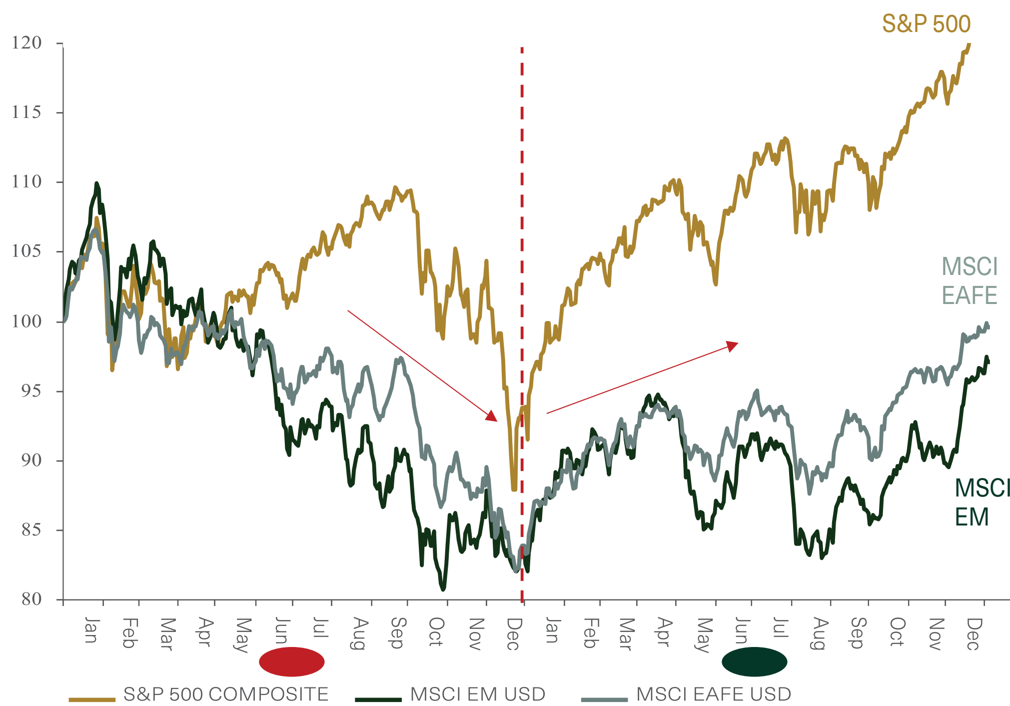
YIELD CURVE (UN)-INVERTED: DODGING THE RECESSION BULLET

Back in May, the 10-year U.S. Treasury yield fell below the Federal Reserve funds rate, causing a so called "inverted yield curve." Such a phenomenon, which has preceded every recession since 1950, fueled concern that the bull market was on its last legs. Thanks to the Fed's recent cuts, however, the curve is sloping upward again. Because of this, the Fed now estimates that the chance of a recession next year is only around 25%, compared with almost 40% a few months ago.

ELSEWHERE AROUND THE WORLD

The global bull run also saw international indexes rally, although most markets lagged behind the U.S. (see Figure 4). The Stoxx Europe 600 jumped 23% during the year. China's Shanghai Composite rose 22%, and Japan's Nikkei 225 gained 18%. After a turbulent year for the pound sterling, the pound rose to its strongest level against the dollar since May 2017, following the Conservative victory in the U.K.'s general election. Ultimately, the pound's rally reflects investors' relief over the prospect of a relatively smooth withdrawal (Brexit) from the European Union.

Figure 4: U.S. vs. international markets
Rebased to 1/1/2018, as of 12/31/2019



Meanwhile, China's manufacturing sector continued to expand output in December, adding to evidence that the world's second-largest economy is stabilizing as the signing of a "phase one" trade deal with the U.S. nears. In addition, the People's Bank of China cut interest rates three times during 2019 as Beijing tried to protect companies from the damage caused by the trade war. Despite these efforts, growth hit a 30-year low in 2019. This slowdown has adverse implications for countries such as Germany, which exports capital goods worth billions of dollars to China.

Commodities and safe-haven assets also gained value throughout the year. Gold posted its biggest jump since 2010 after soaring 19%. Oil finished at 35% — its best performance since 2016. The Brent crude oil price rose by almost $12 to near $72 a barrel following an attack on Saudi Arabia's oil production facilities in September. The U.S. blamed Iran for the attack on a key crude processing complex. The incident highlighted the geopolitical vulnerability surrounding oil production and prices.

Unless otherwise noted, chart sources are Reuters Thomson, Bloomberg as of 12/31/2019.

FINANCIAL MARKET RETURNS

U.S. Equity	Q4 2019	1-Year*	3-Year* (Annualized)	5-Year* (Annualized)	10-Year* (Annualized)
DJ Industrial Average	6.7%	25.3%	15.7%	12.6%	13.4%
NASDAQ Composite	12.5%	36.7%	19.9%	14.9%	16.1%
S&P 500 TR Index	9.1%	31.5%	15.3%	11.7%	13.6%
Russell 1000 Index	9.0%	31.4%	15.0%	11.5%	13.5%
Russell 1000 Growth Index	10.6%	36.4%	20.5%	14.6%	15.2%
Russell 1000 Value Index	7.4%	26.5%	9.7%	8.3%	11.8%
Russell Mid Cap Index	7.1%	30.5%	12.1%	9.3%	13.2%
Russell Mid Cap Growth Index	8.2%	35.5%	17.4%	11.6%	14.2%
Russell Mid Cap Value Index	6.4%	27.1%	8.1%	7.6%	12.4%
Russell 2000 Index	9.9%	25.5%	8.6%	8.2%	11.8%
Russell 2000 Growth Index	11.4%	28.5%	12.5%	9.3%	13.0%
Russell 2000 Value Index	8.5%	22.4%	4.8%	7.0%	10.6%

International Equity	Q4 2019	1-Year*	3-Year* (Annualized)	5-Year* (Annualized)	10-Year* (Annualized)
MSCI EAFE Index (USD, net)	8.2%	22.0%	9.6%	5.7%	5.5%
MSCI AC World Index (USD, net)	9.0%	26.6%	12.4%	8.4%	8.8%
MSCI AC World Ex US Index (USD, net)	8.9%	21.5%	9.9%	5.5%	5.0%
MSCI Emerging Markets Index (USD, net)	11.8%	18.4%	11.6%	5.6%	3.7%
MSCI BRIC Index (USD, net)	13.1%	22.8%	14.7%	7.9%	2.9%

Fixed Income	Q4 2019	1-Year*	3-Year* (Annualized)	5-Year* (Annualized)	10-Year* (Annualized)
Bloomberg Barclays US Treasury 1-3 Year Index	0.5%	3.6%	1.9%	1.4%	1.2%
Bloomberg Barclays US Treasury 5-10 Year Index	-0.8%	7.5%	3.6%	2.7%	4.0%
Bloomberg Barclays US Long Treasury Index	-4.1%	14.8%	6.9%	4.1%	7.0%
Bloomberg Barclays US Treasury US TIPS Index	0.8%	8.4%	3.3%	2.6%	3.4%
Bloomberg Barclays US Govt/Credit Intermediate Index	0.4%	6.8%	3.2%	2.6%	3.1%
ICE BofAML Municipals 1-10 Year A-AAA Index	0.7%	5.1%	3.1%	2.2%	2.7%
Bloomberg Barclays US Corporate High Yield Index	2.6%	14.3%	6.4%	6.1%	7.6%
ICE BofAML Preferred Stock Fixed Rate Index	2.0%	17.7%	7.6%	6.5%	7.4%
JPMorgan GBI EM Global Diversified Index	5.2%	13.5%	7.0%	2.8%	2.7%

** All returns for the period ending on December 31, 2019.*
Source: Bloomberg, Morgan Stanley Capital International, Russell®, Standard and Poor's and Barclays.

A Look Forward to 2020: A Year of Two Halves

HIGHLIGHTS

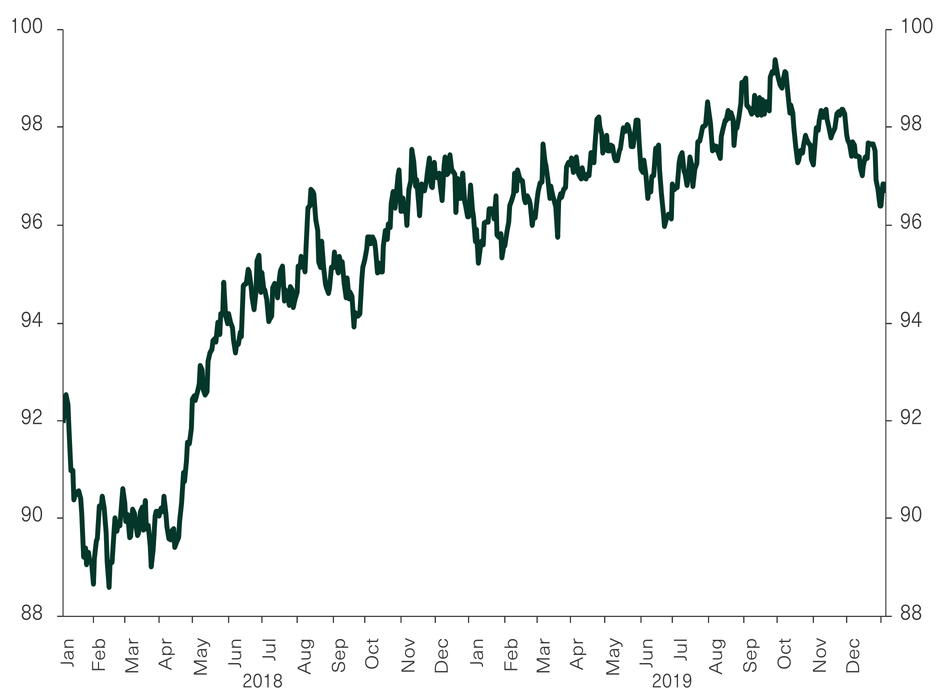
- **We expect resilient U.S. equities as the 10-year U.S. bull market is likely to remain intact but with more moderate gains in 2020.**
- **Interest rates are likely to remain near historically low levels. While we do not anticipate negatively yielding debt in the U.S., we expect negatively yielding debt levels globally to remain elevated.**
- **Geopolitical uncertainties are expected to linger; investors should prepare for heightened volatility.**

OUR VIEWS IN SUMMARY

Looking forward, we believe that many of the conditions that supported the gains witnessed last year — including the de-escalation of trade tensions, an accommodative Fed and signs that economic growth remains stable — are still in place to potentially nudge U.S. stocks higher in 2020, at least for the first half. However, we are also likely to see episodic bouts of heightened volatility due to the geopolitical risk in the Middle East, Brexit, trade relations and the U.S. presidential election.

Some of these headwinds could start surfacing later in the year. Given the sharp differences between Trump and his Democratic challengers, the 2020 presidential election is expected to raise business anxiety around the course of government policies. Political uncertainty is bad for the economy as it can cause some companies to delay capital spending until the fog lifts. The election year is likely to be a period when the dollar weakens, possibly weakening further should candidates whose policies are unfriendly to business rise (see Figure 1).

Figure 1: U.S. dollar index

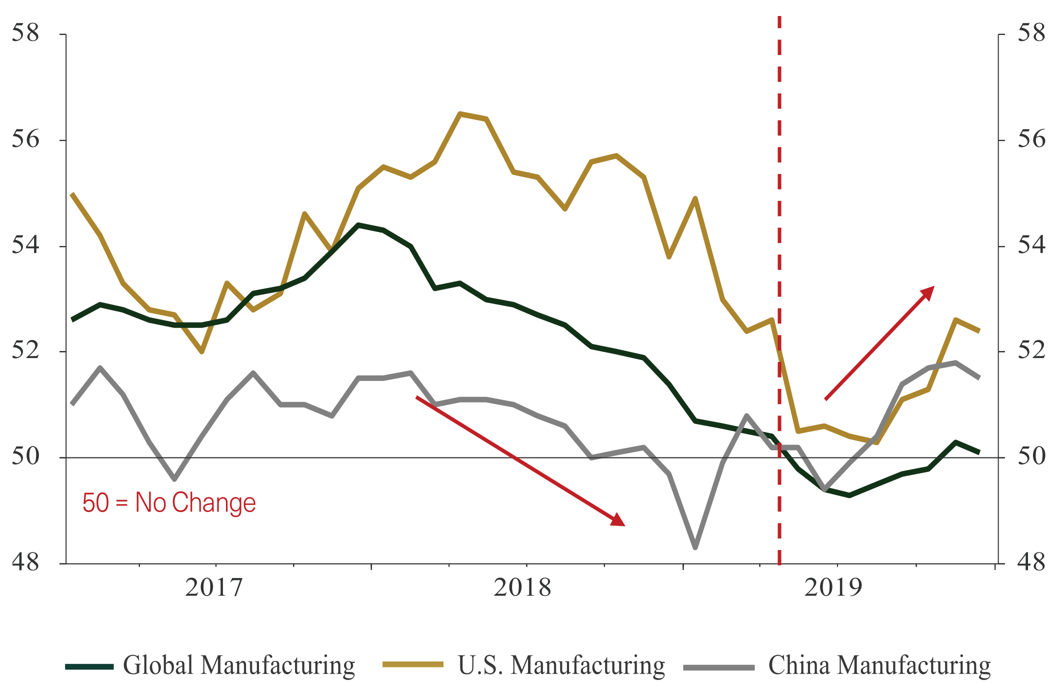


NO RECESSION, STEADY ECONOMY AND LOW INFLATION FAVOR STOCKS IN 2020

Within equities, we see the U.S. market outperforming its peers again in 2020. After all, that's where most of the growth is and U.S. companies are growing profits faster than the rest of the developed world. The trade war would appear to be the biggest headline risk, but we believe interests are aligned for a de-escalation on both sides. President Trump wants to claim a victory going into the election, and the Chinese will also want a victory approaching the centenary of the Communist Party.

A U.S. recession is unlikely in 2020 — it was the most overdone story of 2019 — and it's been taken off the table by an accommodative Fed and Chinese stimulus, both of which are tailwinds for global economic growth. Geopolitical and macro noise surrounding the Chinese stock market in 2019 is likely to persist in 2020 as these headwinds continue. Looking forward to 2020, however, we can already see some signs of the economy bottoming out (see Figure 2). Manufacturing data, for example, incrementally improved in the last few months of 2019. Investors can also feel some reassurance that globally central banks are easing.

Figure 2: Global manufacturing indexes



GEOPOLITICS: UNCERTAINTY CLOUDS 2020 VISION

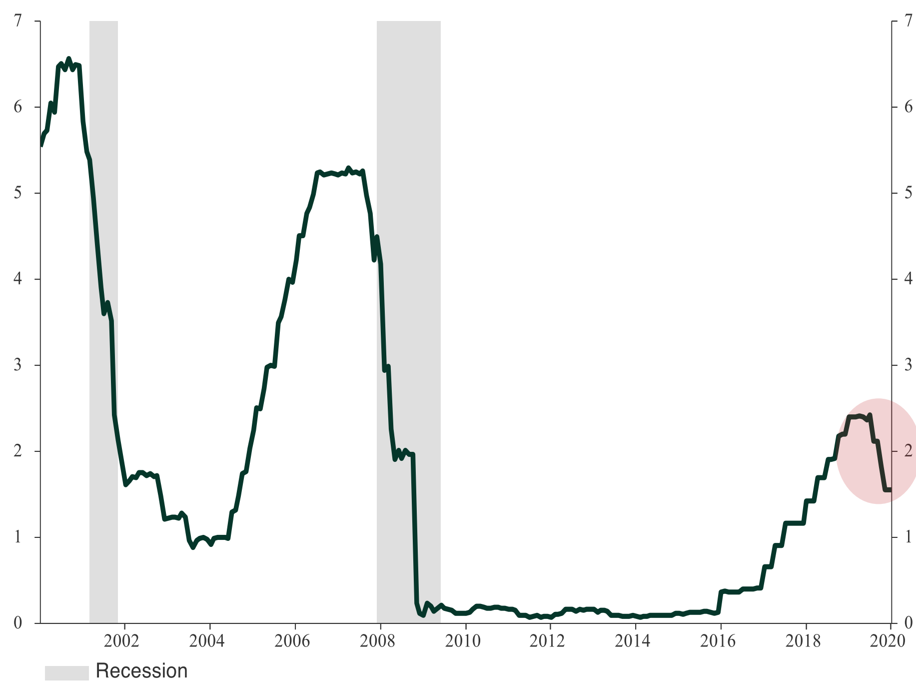
One feature of the equity markets recently has been sensitivity to prospects for the U.S.-Chinese trade war: Hopes of a de-escalation have driven prices up, while fears of an escalation have forced them down. Uncertainty about the trade war doesn't just hurt equities, though. It also damages the real economy, not least because it curtails business investment. Any decline in uncertainty would, therefore, be good for both equities and economic activity.

We expect market attention to geopolitical risks to remain elevated in 2020, even as we see U.S.-China trade tensions likely extending beyond their temporary pause. Furthermore, many of the complex negotiations required to get Brexit done have yet to begin and will last for several years. Nonetheless, a reduction in political uncertainty may provide some relief to international investors.

FED TO REMAIN ON PAUSE

Having peaked at 2.25%-2.5% in December last year, the target Federal Funds rate is now 1.5%-1.75% (see Figure 3). The Fed is loath to promise further cuts, so investors cannot bank on a repeat of the late-cycle stimulus to markets that occurred in 2019. There were central bank rate cuts around the world in 2019 and a handful, including the European Central Bank, pushed their benchmark interest rate below zero. In our view, while President Trump repeatedly urged Fed Chairman Powell to push rates lower, the Fed is likely to remain on hold through this year's presidential and congressional elections. The Fed has shown a willingness to act when the financial system has needed lubricating, however. When the overnight bond repurchase or "repo" rate spiked in September, the Fed acted quickly to diffuse worries of a crisis.

Figure 3: Fed funds rate



ON INTERNATIONAL MARKETS

Geopolitical and macro noise surrounding the Chinese stock market in 2019 is likely to persist in 2020 as these headwinds continue. Chinese manufacturing data, for example, incrementally improved in the last months of 2019. Investors can also feel some reassurance that globally central banks are easing. China's purchasing managers' index — an indicator highly correlated with global manufacturing growth — recently rose to its highest level since January 2017 thanks to rising output and export orders. Recent tensions elsewhere in the region, including riots in Hong Kong and a growing trade rift between Korea and Japan, have put further downside pressure on market sentiment while the growth outlook remains uncertain.

Being caught in the crossfire remains a major concern. As one of the largest players in world trade, the European Union's export-oriented economy is highly sensitive to rising tensions — most notably between the U.S. and China, but also with the U.S. directly. The eurozone's internal problems include France's battle with social unrest, Germany's gigantic manufacturing sector still in recession territory, and Italian lawmakers' confrontation with Brussels.

CLOSING REMARKS

CLOSING REMARKS: POLITICS ARE A DISTRACTION, POLICY IS NOT

While we recommend investors to stay fully invested, we anticipate more modest stock returns with higher volatility in the future. Further, we expect corporate earnings to grow at mid-single digits, lower than in 2019, but still at levels strong enough to support equities. Additionally, our baseline scenario does not foresee a recession in the next 12 months, but rather anticipates slow and steady growth, low inflation, accommodative policy and single-digit profit growth. Given the low interest rate environment, we do see a broader opportunity for investors to raise their exposure to private markets.

In our view, we expect some of the same factors of 2019 to remain heading into 2020. Slower economic global growth, ever-loosening monetary policy and heightened political risk continue, while the powerful deflationary drivers of an overly indebted world, aging demographics and technological disruption remain in the background. With this backdrop, we continue to see the U.S. market outperforming its peers again in 2020. The trade war would appear to be the biggest headline risk, but we believe interests are aligned for a de-escalation on both sides. In addition, we expect the rate cuts from July to October of last year to begin to stimulate the economy over the first half of 2020. Lastly, policy actions will remain a key topic as we approach the elections, given the new sweeping policies that would replace those of the current administration if President Trump were to lose the White House to a Democratic candidate.

Chart sources: Reuters, Bloomberg as of 12/31/2019.