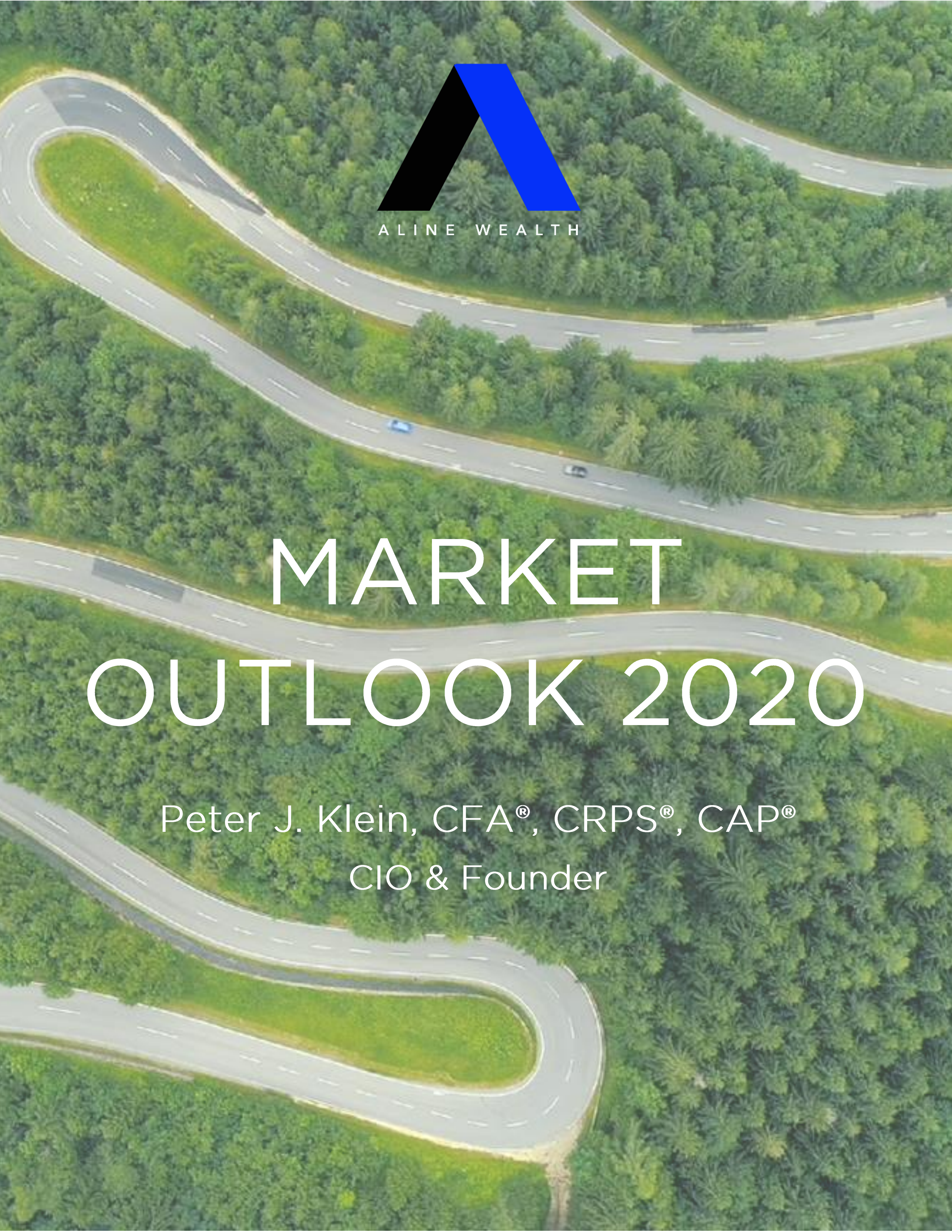

ALINE WEALTH

MARKET OUTLOOK 2020

Peter J. Klein, CFA®, CRPS®, CAP®

CIO & Founder

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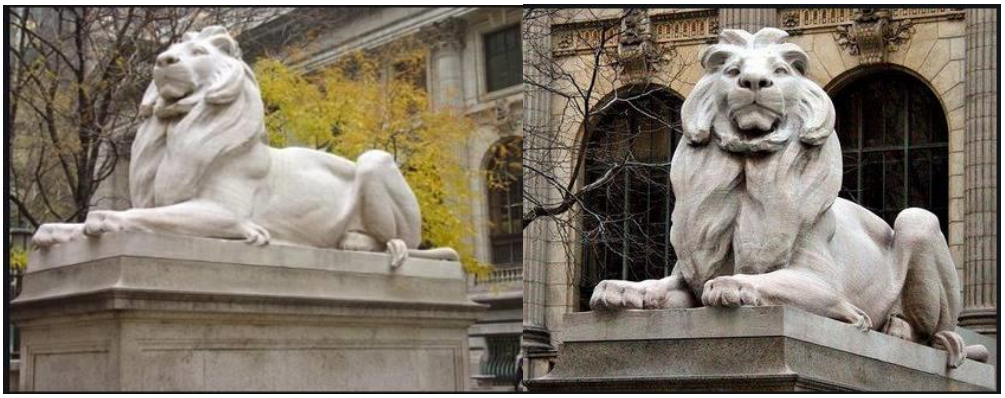
I. FORTITUDE AND PATIENCE



As a kid at Bronx HS of Science I "treated" myself to studying (yes, I was a geek—briefcase and all) on occasion at the NY Public Library. Specifically, the Dewitt Wallace room. Those who haven't enjoyed its quiet, yet engaging atmosphere should do so immediately. Whenever I entered this emporium of learning I would marvel at the two lion statues out front (on 5th Ave entrance). They have names—Fortitude & Patience.

I thought of these lions as I was reflecting on markets and portfolio exposures—in Wall Street parlance these might be called "fear & greed". The thinking is similar: sometimes you need to "pile in—or load the bus" and other times it might be best to accumulate "dry powder", that is, maintaining a cautionary stance. On the following pages, I provide some "food for thought" as it relates to risk and return.

It seems that just until recently, a couple of days ago, in fact, no one gave a care about risk—complete complacency. It reminds me of what economists call a **"Minsky Moment"**. Minsky stated that complacency towards risk and the resulting sense of stability very well may cause increased instability in the future. Most folks have been turning a blind eye to Minsky as of late uttering "Minsky—SchMinsky" rather than focusing on the notion that low awareness begets increased potential instability. Or, as we learned 11 years ago, "Black Swans".

On the following pages allow me to provide some observations and insights as to conditions as they currently exist in the global macro-economy and financial markets.

Chinese Debt & A Possible Minsky Moment

Turning an eye to China, the concerns of a pandemic Flu may pale in comparison (with all due respect to lives lost) to the contagion of debt. China's debt has ballooned over the last decade. The possibility of a "Minsky Moment" has stood at the top of the risks that worry macro investors. There's an argument that China's system is so divorced from the capitalism that Minsky was covering that such an implosion is impossible there. According to Robert Barbera, the Johns Hopkins University economist who was a friend of Minsky, the dynamic that Minsky was worried about saw financial institutions marking their exposures to market until their exposures ended in bankruptcy. This can bring a cascade of bankruptcies in its wake.

In China, where there is far less fealty to free-market ideology, there is no compunction in averting bankruptcies. Authorities have been bent on doing this for years now and have great power to do it. Can this continue? As Barbera puts it: "*It's not nearly as easy to identify a Minsky Moment in China, but if and when it goes bust, God help us all.*"

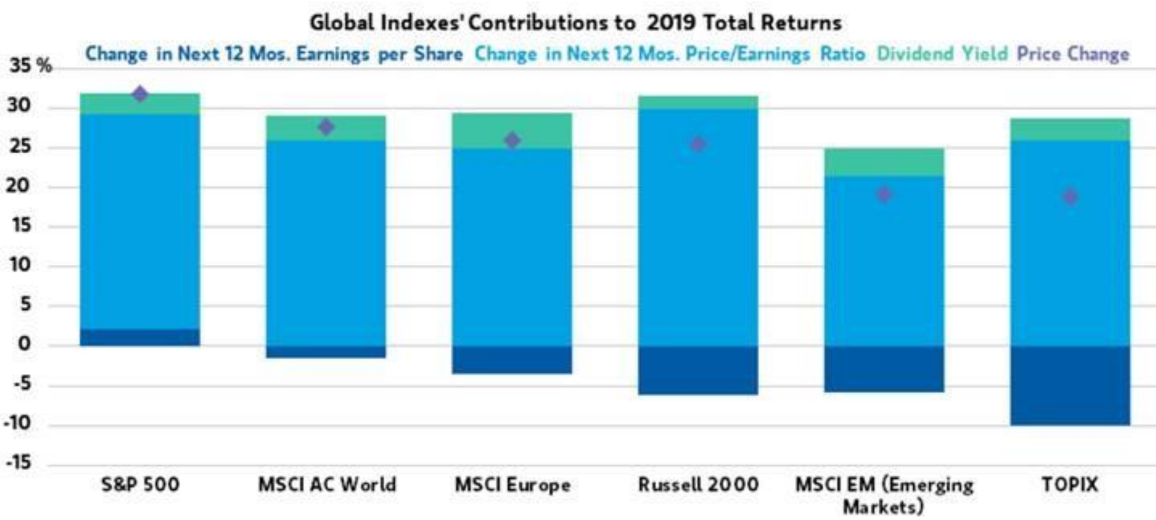
2019 Market Recap

Recapping 2019 let's look at what happened in 2019 (take a look at the chart below). Stocks went up—30% up—despite:

- CEO optimism retracted
- IMF reduced its assessment for global economic growth
- Earnings in the US contracted—no growth
- Yield curves globally are either inverted or nearly so

How did stocks go up as much given the above? Multiples expanded—but 30%!? And they were already high. This is a function of what investors are willing to pay for earnings (and as we will see in a bit revenues or sales as well)—animal spirits and exuberance (dare I utter that Greenspanian phrase) move multiples, not facts or data. This move is all sentiment-based, and friends that worries me.

Exhibit 3: Equity Returns in 2019 Were Driven by Expanding Valuation, Not Profit Growth



Note: Return attribution above is an approximation. The explicit value of a fourth return factor, the product of the percent change in earnings and the percent change in the multiple, has been allocated into returns attributed to the earnings and multiple, respectively. Attribution was made using a weighting of the absolute value of the percent change in that source of return over the sum of the absolute values of the percent changes of both sources of return.
Source: FactSet, Morgan Stanley Research as of Dec. 27, 2019

II. 2020 ECONOMIC TEA LEAVES

Look at the charts below (thanks to our friends at Rosenberg Research) and ask yourself: Why are economic conditions so slow?

In fact, consider these recent data points:

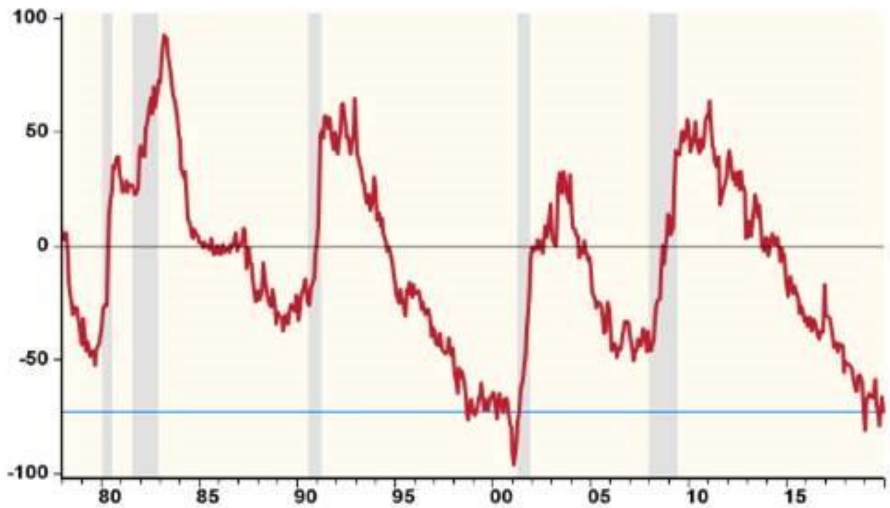
- The conference board's LEI in December declined 0.3%—and has been DOWN in 4 of the last 5 months. Bet you are shocked by that in light of recent market action. Recall Buffet's famous quip: in the short-term, the market is like a voting machine—a popularity contest, but in the longer term it is a weighing machine—dependent on actual data. The current level is back where we were in October 2018.

- PwC annual survey of CEOs (1600 spanning 83 countries) showed them more concerned about economic outlook than any other time in the past 11 years!!! More than 50% expect slower growth the year ahead.

- The IMF economists trimmed their global growth forecast for 2020 to 3.3% from 3.4% and to 3.4% from 3.6% next year. The IMF estimates that 2019 real GDP for the US would have been lower than the expected 2% if it wasn't for the accommodation by the Fed—will we ever get off the Fed dole? Will they ever normalize rates? Just the whisper of doing so in late 2018 led to a market rout —and to the new Fed chief to backtrack those comments a few weeks later. Where have all the heroes gone (homage to the late, great Paul Volker)?

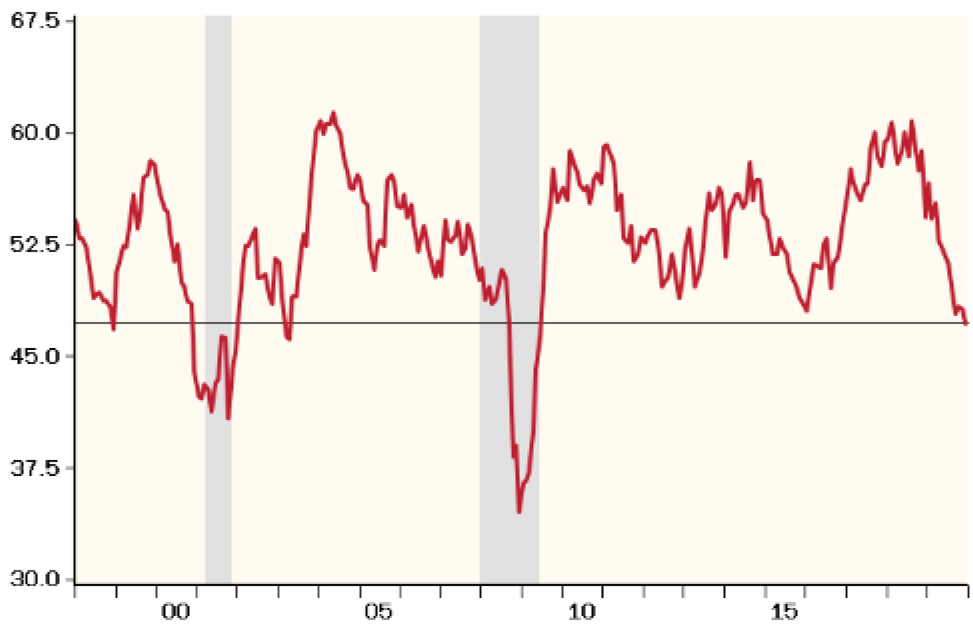
- The world economy is in such a fragile state that it took these lower rates to avoid a recession. IMF Managing Director Kristalina Georgieva stated that we would have been in a recession if it was not for the synchronized monetary easing. And yet markets climb higher on the shoulders of Herculean monetary accommodation and financial engineering.

CHART 1: Consumer Confidence: Expectations minus Current Conditions
United States
(index)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 2: ISM Manufacturing PMI Index
United States
(index; >50 denotes expansion)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

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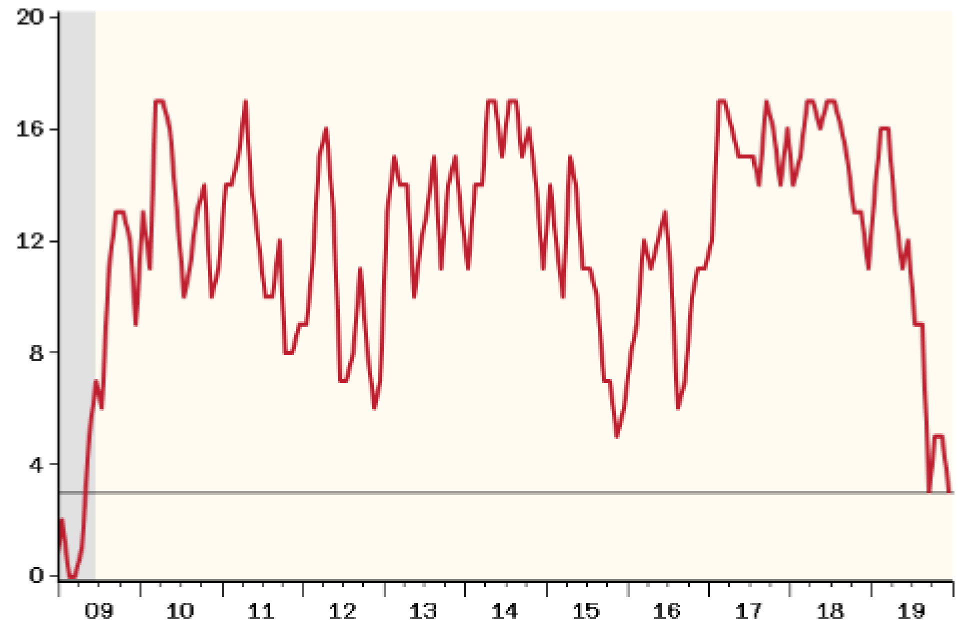
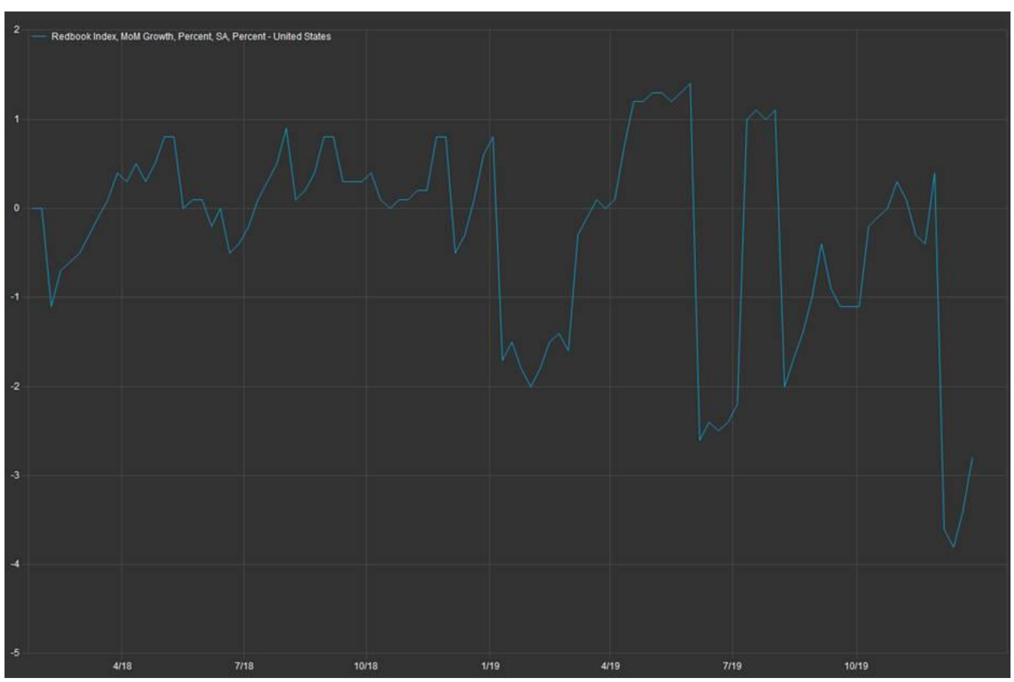
CHART 3: Number of Industries Reporting Growth
United States: *ISM Manufacturing PMI Survey*
(count)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Rosenberg Research

Retail Sales—Redbook Survey



III. Trade Deal Skepticism

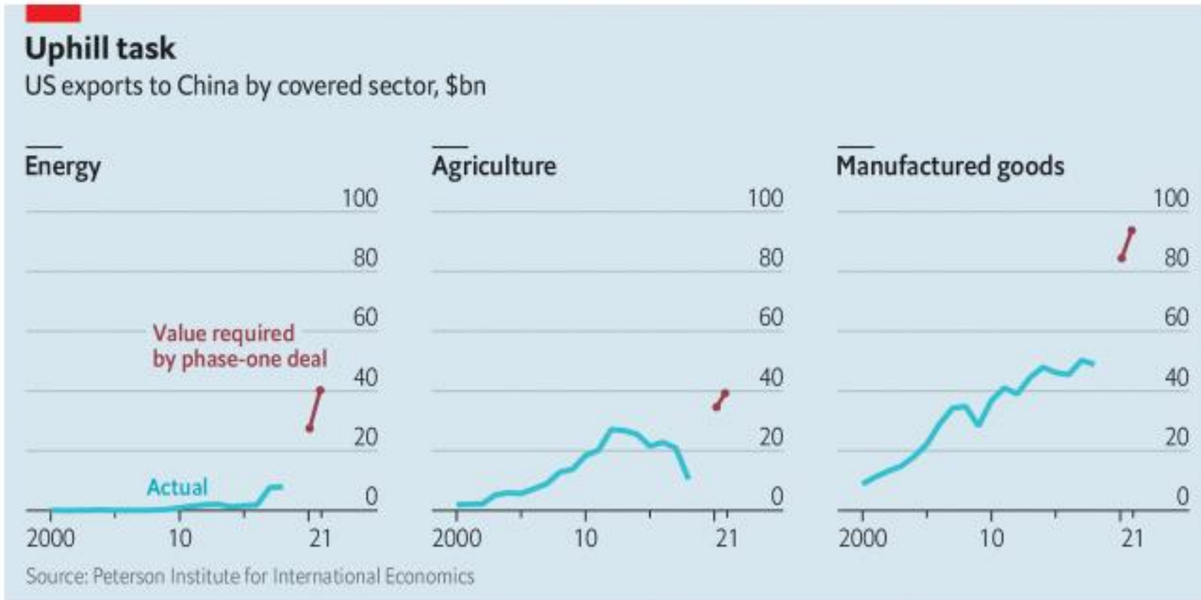
Perhaps another Minsky Moment that is brewing is with global trade. As the thinking goes, everything is now OK—China and the US have signed the "Phase 1" deal and it calls for a lot of good things for the US (more exports that China has agreed to buy). So, all good, right? Well not so fast. As the following article from The Economist points out, what the Chinese government has committed to is an increase in bilateral trade that has not been seen in 20 years. A healthy amount of skepticism on implementation and market distortions is warranted.

As you can see from the chart below, these are some Herculean efforts that China will have to go through to meet these goals. As stated in the Economist article:

Dig into the details of Mr Trump's new deal, though, and the risks of waste and distortion become clear. The agreed increase in sales to China is large and rapid. According to an analysis by Chad Bown of the Peterson Institute for International Economics (with whom your columnist hosts a podcast), China has, in effect, pledged to increase its purchases of certain American agricultural products by 60%, and manufactured products by 65%, by the end of this year compared with levels in 2017 (see chart). This must happen regardless of economic conditions in China.

The risk is that China has promised to buy products that it either will not need or would rather get from elsewhere. State-owned enterprises could suck up American commodities and leave them to rot. American exporters, lured by higher prices to Chinese buyers, could switch from more sustainable relationships to ones that fizzle once their artificial advantage ends. Or China could resort to logistical gymnastics to make it appear that it is buying American, such as by transporting goods from third countries through America.

Another danger is that China simply diverts trade from its other trading partners, prompting complaints that the biggest actors are carving up markets between themselves—and carving others out. Admittedly, members of the World Trade Organisation (WTO) are already allowed to agree on broad tariff cuts among themselves, which could lead to similar diversionary effects. But trade deals are permitted, whereas discriminatory managed-trade arrangements are not. And if, as Mr Bown warns, Brazilian and Argentine sellers of soyabeans or Russian and Canadian lobster-traders find themselves pushed out of China's market, they are unlikely to react well.



The Economist

Furthering this point please find: https://www.bloomberg.com/news/articles/2020-02-03/it-ll-be-a-while-before-china-spends-billions-on-u-s-farm-goods

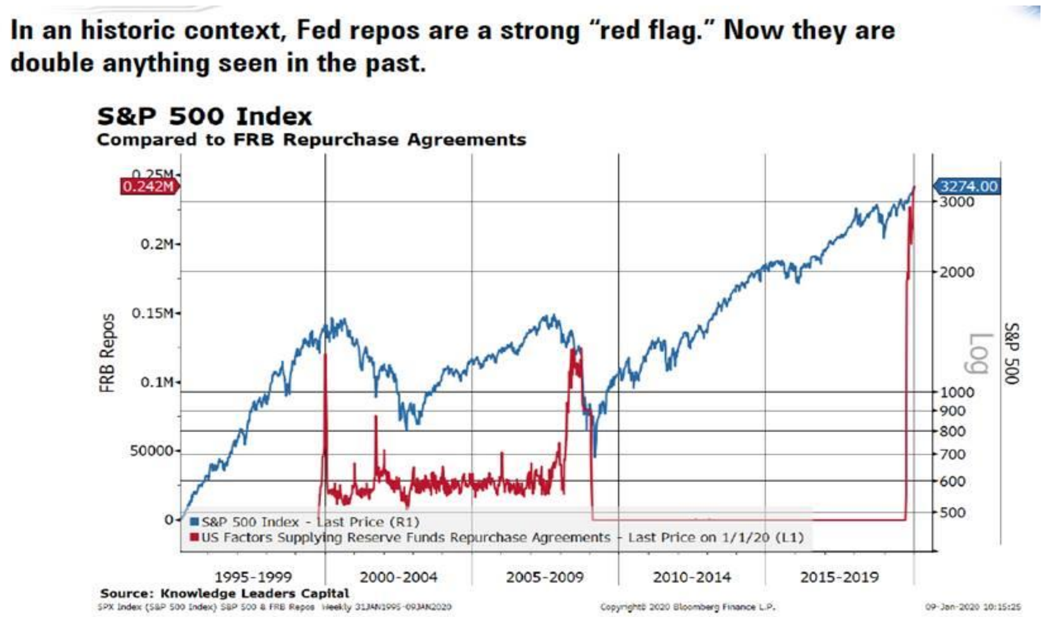
IV. REPO MARKET ACCOMMODATION

No, this is not a reference to the cult film of circa 1985, this REPO stands for "repurchase agreements" or overnight loans between institutions. Think of this as a major dose of lubrication into the gears of the economy. The Repo markets keep the banks and other institutions running. It all has to do with liquidity.

Look at the chart below (thanks to our friends at Knowledge Leaders Capital). Talk about a canary in the coal mine!

The Fed pushed more than half a trillion dollars (that's trillion with a "t") into the system in the last three months of 2019. This intervention is truly uncharted territory. When the liquidity scare arose in early September, the Fed came to the rescue, pumping money into the system. But it wasn't enough, and the Fed had to push even more liquidity into the system in December. What did the Feds see that caused them to react so dramatically? And, what unintended consequences did those actions create?

The Fed did similar emergency action in the Repo market in Y2K and 2008 crises. So, are we in a crisis? Hmm, someone should tell the stock market—they think it's party time where the music never stops. But guess what? It always does. This time the accommodation was 2x the prior levels—a **massive liquidity injection**. Looked what happened to the S&P in the prior two occasions post Repo injection.



Source: Bloomberg

V. Sentiment

The following charts speak to the aforementioned Minsky Moment—expect the unexpected when everything has been stable for a while and no one is paying attention to risk.

As of late January 2020:

- VIX was as low as 12 in recent days
- Fear and Greed index touched 90
- AAII sentiment poll bull share climbing to 45.6%—highest since October 2018—and the bear camp fell to 24.8%.
- Investor's Intelligence poll—bull share rose to 57% (highest since Oct. 2018) and Bears below 18% resulting in a 41.5-point spread—a level that has demonstrated danger ahead in past cycles.

Can this time be different? Sure, but I wouldn't bet on it—and certainly not with client's capital—that is not what a steward should do.

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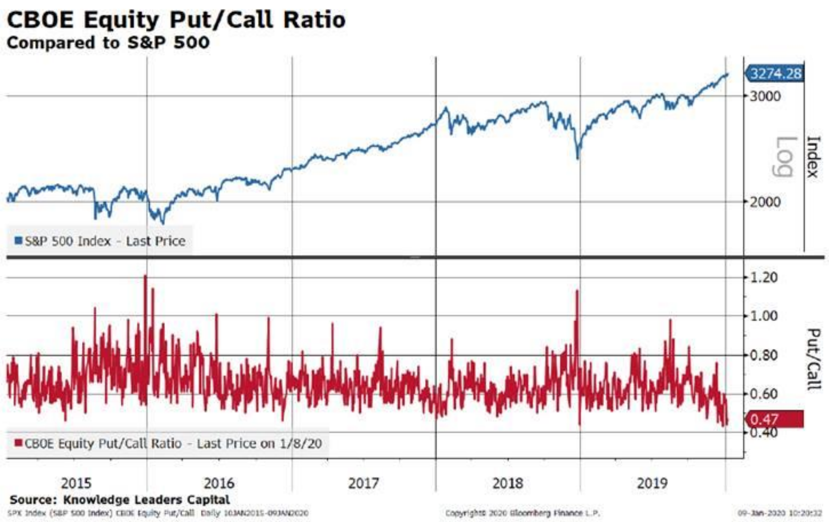
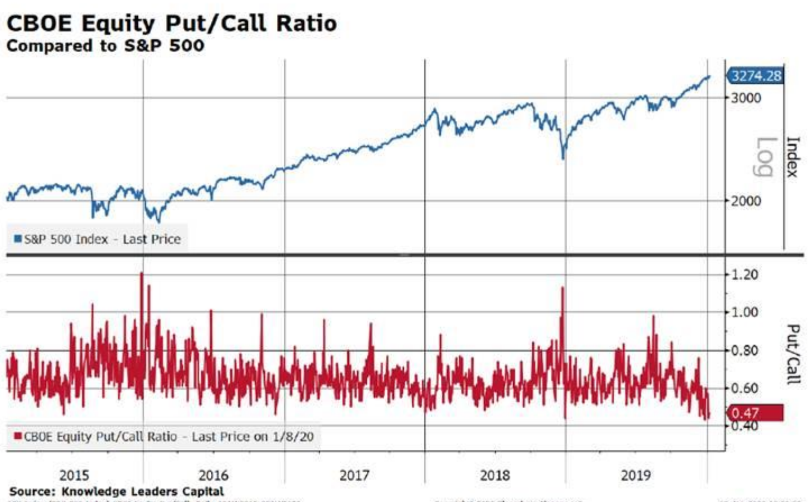
No investor seems to want to hedge equity exposure, sending the CBOE Equity put/call ratio to record lows.



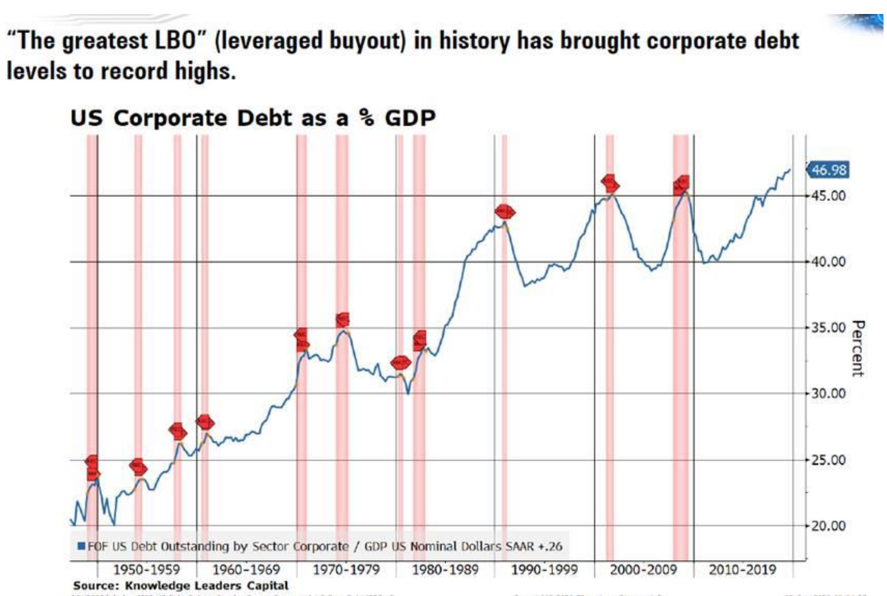
Source: Bloomberg

No investor seems to want to hedge equity exposure, sending the CBOE Equity put/call ratio to record lows.



Source: Bloomberg

VI. DEBT LEVELS



Source: Bloomberg

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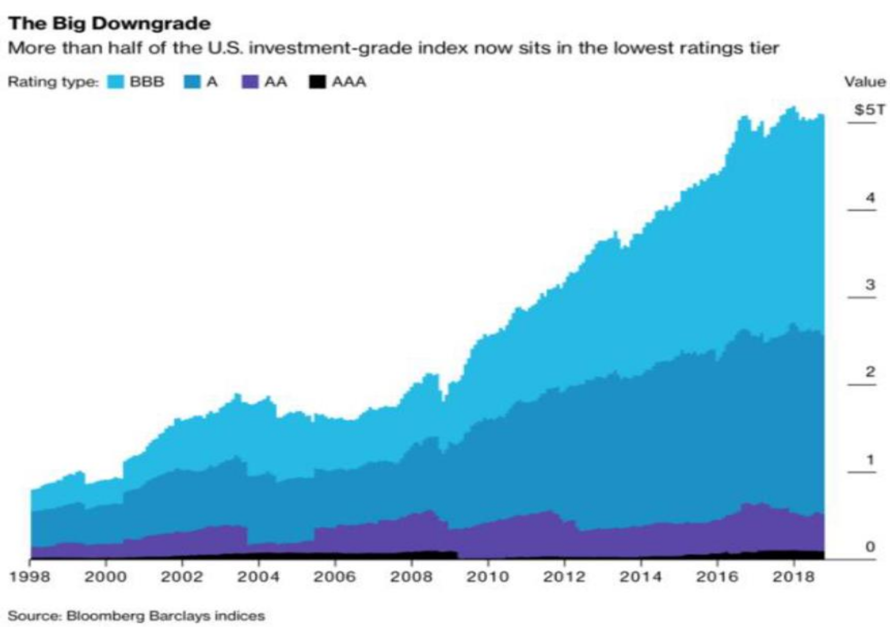
Corporations around the globe have increased their own liabilities as they take advantage of low interest rates and respond to the investor demand for fixed income. The amount of investment-grade debt (i.e., typically, the debt from healthy, large, profitable companies) has doubled since 2007 in the U.S. It is also larger, as a percentage of GDP, than it has ever been. And, the type of this debt that has grown the most is the lowest quality debt, meaning that a weak economy could cause it to drop in status from investment-grade to junk, which would dramatically increase those companies' borrowing costs—a fresh misery.

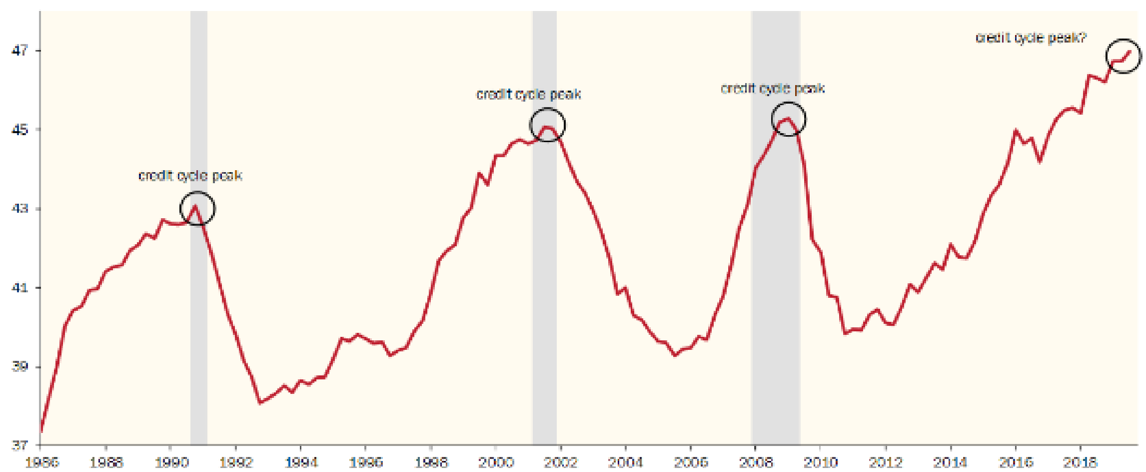
Debt is not inherently bad. If used for productive purposes, it is a logical means of funding. Is Main Street using debt logically? Are U.S. companies using it to invest in new machinery and ideas that will produce greater future profits? Not by the looks of it. Instead, they are buying back stock—financial engineering. Though we are all for stock buybacks—they are a great way to return an investment back to its owners—they should generally be funded with excess corporate profits. Today, we are seeing a transfer of capital from one hand (debt investors) to the other (equity investors). Put simply, U.S. companies are using debt to buy back their own shares.

From our friends at Guggenheim: Down grade risks to BBBs which is 50% of the Investment Grade (IG) market now but in 2017 it was 35%. More telling is that 8% of the IG market was BBB- in 2017 and today it is 15%. And the size is HUGE—as it quintupled in outstanding bonds from \$800 billion to \$3.3 trillion. As a portion (some pundits say as much as 20%) of these BBB rated bonds get downgraded to high yield in the next cycle (timing is never easy) it will swamp the high yield market. Another Minsky moment perhaps? Periods of relative stability in risk assets lead investors into complacency and, hence increasing their risk. A sort of a FOMO situation (investors add to risk because they fear prices will increase).



The ratio of corporate debt-to-GDP is at all-time highs. In addition to the unprecedented fiscal stimulus at this late stage of the economic cycle, and accompanying trillion-dollar deficits, we also have corporate leverage ratios at record levels. An enormous volume of corporate debt has been issued exclusively for the purpose of buying and retiring shares. This includes both buybacks and acquisitions of other companies. And, in classic mature-cycle fashion, we are seeing some cracks emerge in the junkiest parts of the U.S. credit market. This is an area to be focused on as leveraged credits are in an eerily similar situation to what was surfacing out of the subprime mortgage market back in 2007.

CHART 11: Corporate Balance Sheets are not in Good Shape!
United States: *Corporate Debt-to-GDP*
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

VII. MARKET BREADTH

This could also be couched in the Sentiment section, but I found it so interesting that I wanted to make sure no one missed it. Consider the following (again thanks to Rosenberg Research):

Google, Microsoft, Apple, Amazon, Facebook—together let's call them FAAMG (Netflix given its decline in market no longer makes the cut).

These 5 companies account for 20% of the market cap in the S&P 500 —1% of the companies accounting for 1/5th of the market cap. In mid-2016 before their near uninterrupted rise these 5 accounted for 12% of the S&Ps then market cap. **Today these 5 trade at a trailing P/E of between 27x to as much as 83x.**

To further identify the weak breadth in this market—consider that 50 companies in the S&P 500– **10% of the index— accounts for 53% of the market cap**. Part of this is sentiment and the near cult like status these stocks and sectors (mainly Technology) have among the investing public. Another part of it has to do with passive/index fund flows. Index funds must own the most liquid stocks so the largest companies with the highest liquidity receive the lion share of the flows of capital. This is creating a self-fulfilling feedback loop: the more capital that flows in, the more of these largest stocks must be purchased which leads to higher prices (supply and demand) and more investor demand.

VIII. EARNINGS AND THE MULTIPLE

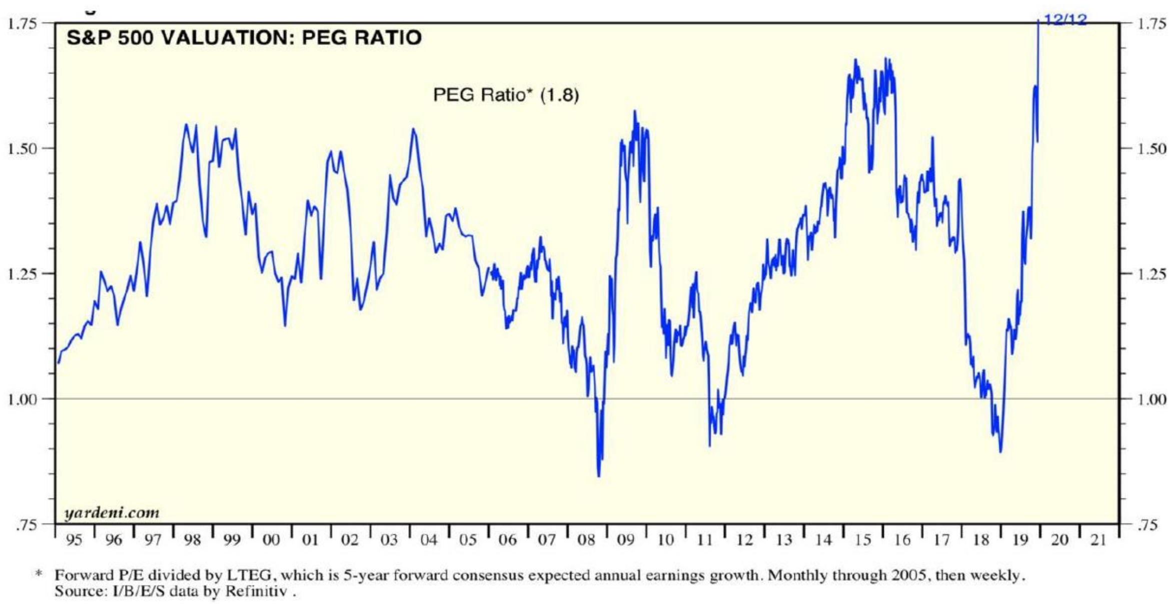
The following is a chart of the S&P Price to Earnings (PE) multiple (in white) vs the S&P earnings throughout 2019. Clearly, something must give as this just does not make sense. Why would the multiple on earnings increase 30% last year if earnings were down?

IX. PRICE TO EARNINGS GROWTH

Price Earnings to Growth or the PEG multiple is a way to look at the PE ratio and ask yourself—"Does the growth of earnings rationalize this PE multiple?" As Peter Lynch suggested, a PEG should be equal to 1. In other words, the PE and the earnings growth being equal means you have a fairly valued equity. But when the PEG is above 1 that would suggest that the multiple is too high given the growth expectations. And if the PEG is below 1, then you have an equity that might be undervalued.

To wit: a PE multiple of say 20x (that means investors are willing to pay 20 times earnings for each share , or said another way, they are paying 20 years' worth of earnings for each share they buy) with a growth rate of earnings of say 30% would equal a PEG ratio of .67 (20/30). So, given that the PEG ratio is below 1 that would mean that investors who are "paying up" of for earnings are doing so because the expected (a key consideration for the PE multiple is certain, but the growth rate is an expectation) growth is high. How about the PE that is 40x and the growth rate of earnings is expected to only be say 20%—a PEG ratio of 2? Well one would wonder why an investor would "pay up" for earnings that are not expected to grow as much as the premium they are willing to pay up for. Hmm...

Let's look at where we are today on the PEG Ratio:



X. VALUATIONS

When have you ever read a piece from me that didn't include something to do with valuations? Why? Because it has been shown in study after study that the price you pay for an asset—be it a stock, bond, fund, house, or artwork—determines the long-term success of that investment. Price matters!

The Price to Sales multiple matters a lot. In fact, it is in one of the most mean reverting of all the stats and has the highest correlation with investment success over the long term (that is, lower multiples mean increased success, higher multiples not so much).

As you can see below the PS multiple of the S&P is back to 2000 dot com bubble peak levels.

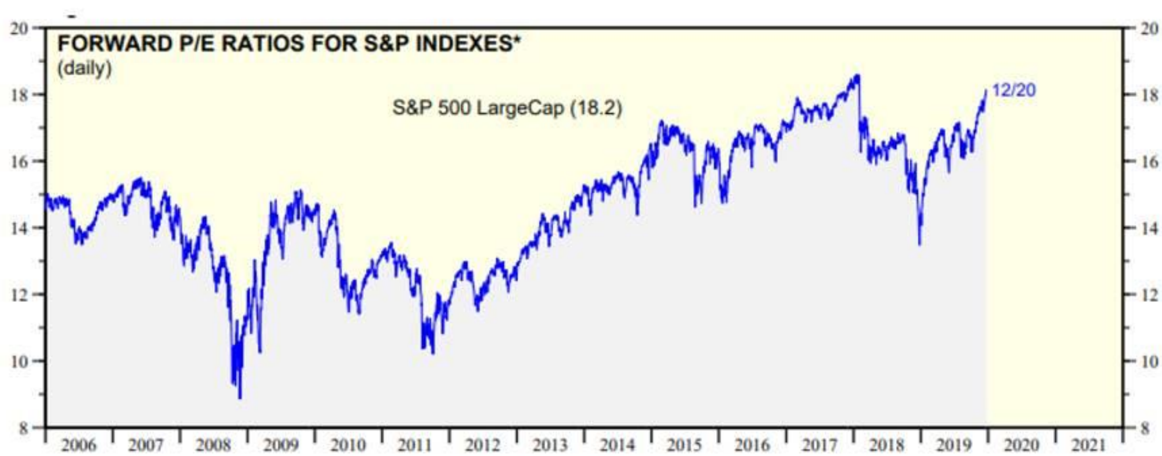
CHART 10: Most Expensive Stock Market Since the Dotcom Boom

United States: *S&P 500 Price-to-Sales Ratio*

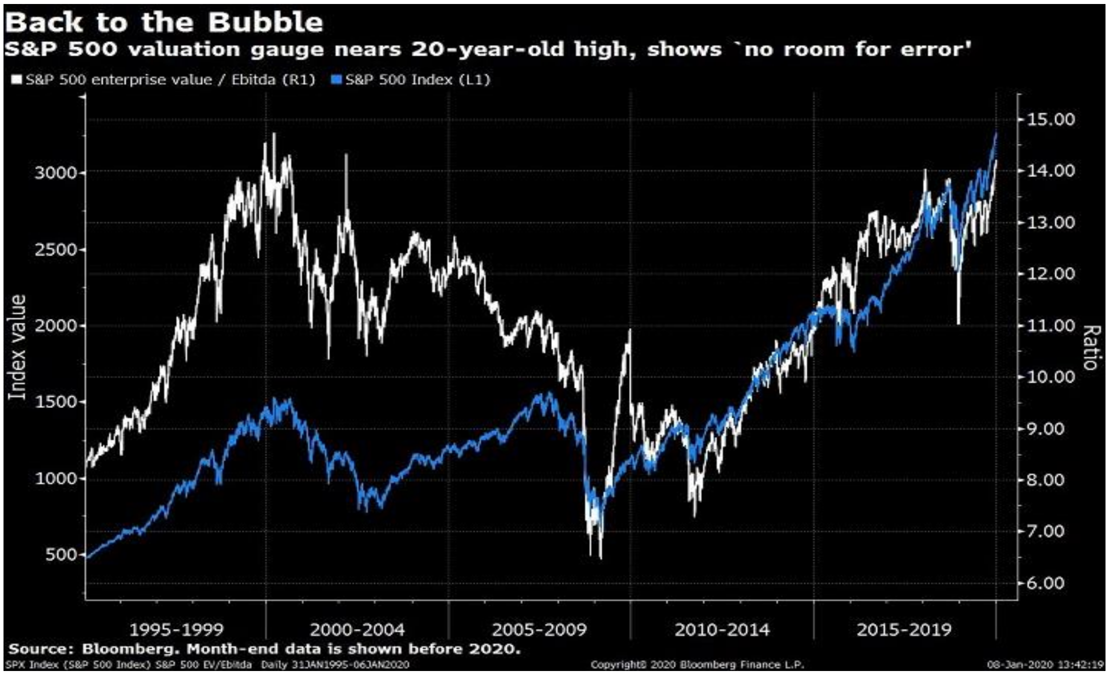
(ratio)

Source: Bloomberg, Rosenberg Research

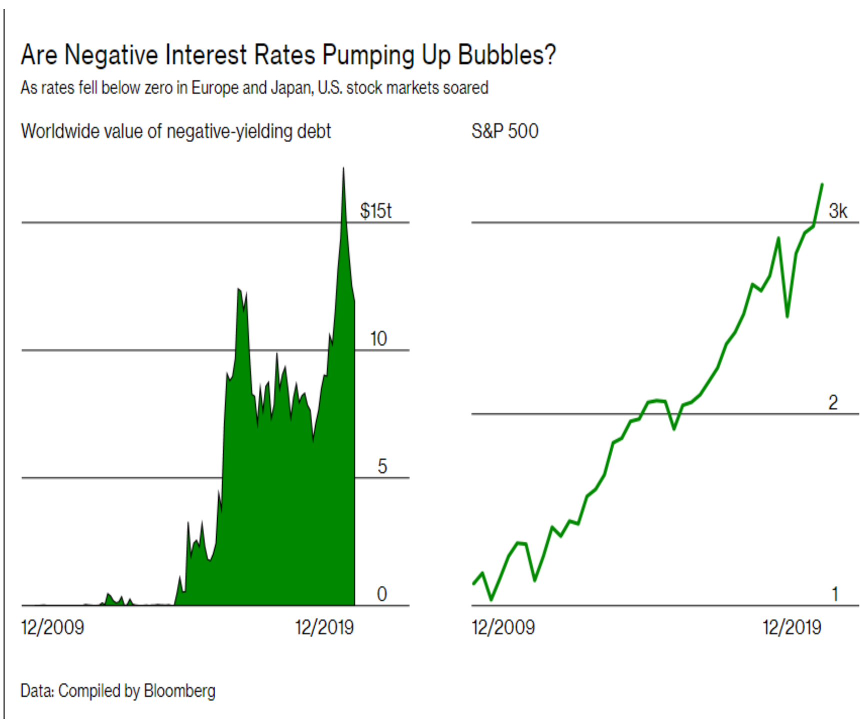
Price to Earnings multiples are not cheap either—not by a long shot.



As shown in the chart below U.S. stocks have "no room for error" after rising for more than a decade, according to Peter Boockvar, chief investment officer at Bleakley Advisory Group LLC. Boockvar cited the ratio between the S&P 500 Index's enterprise value, reflecting debt and cash levels along with market value and EBITDA (earnings before interest, taxes, depreciation and amortization). The ratio spent multiple days above 14 last month for the first time since 2000, when an Internet-driven bubble in stocks burst, according to data compiled by Bloomberg. A recent reading was 14.1.



And speaking of bubbles, maybe we will come to learn that negative interest rates have fueled this market's run. Perhaps the term will go down in the lexicon of Wall Street like CMOs, NINJA loans, portfolio insurance and eyeballs and clicks did in prior bubbling periods.



XI. . WHAT TO BUY?

Overweight International Markets and Value Style

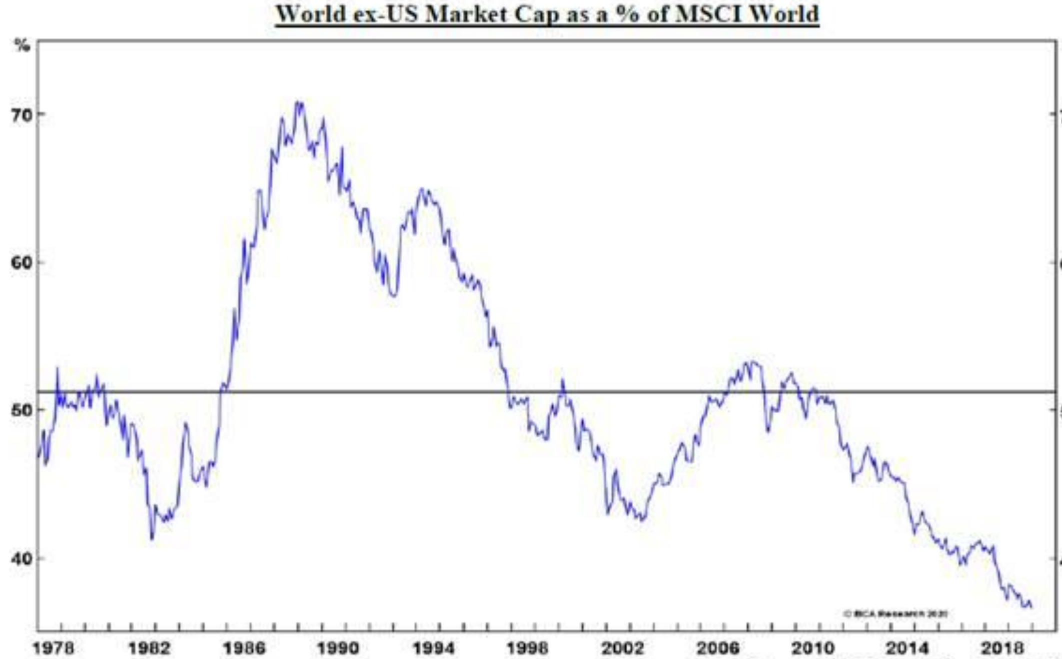
Please find the following observations and data (thanks to our friends at Schafer-Cullen):

Given the strong outperformance potential from **a reversal (aka Alligator Jaws or reversion to the mean) of the historically extreme multi-year underperformance of 1) international versus US equities and 2) value versus growth equities.**

In this regard, as seen below, **international or ex-US equities currently have the lowest weight in the MSCI World Index in 40 years (!!),** at 36.6% versus their long-term average weight of 51.2%, as the performance of world equities is being dominated by a narrow group of US-domiciled large capitalization growth stocks. On the previous two occasions when the weight of ex-US equities fell below 45%, this was followed by a period of strong outperformance by international equities:

- After being out of favor in the early 1980s, international equities represented by MSCI EAFE rebounded sharply and provided an annualized return of 31.4% from June 1983 to December 1988 versus only 9.5% for the S&P 500.
- In the second such incident, after lagging behind US equities in the dot-com mania of the late 1990s, international equities came back to favor and returned an annualized 12.1% from March 2002 to June 2008 versus only 3.7% for the S&P 500.

Further, **international value equities** are currently more favorably valued versus both international growth equities and international sovereign bonds than they have been during 95% of periods over the last 20 years. International growth equities, while having somewhat higher earnings growth, appear to be fully valued at over 20 times forward earnings.

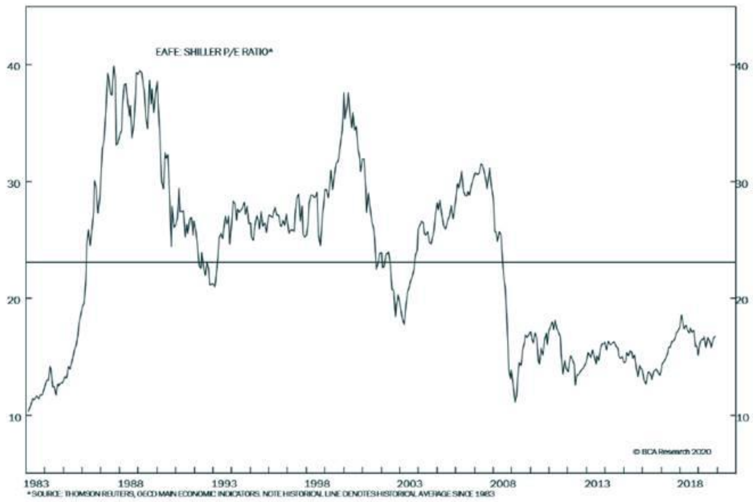


Source: BCA Research, December 31, 2019

Value As A Style Class Is Deeply Out Of Favor

Within global equities, value as a style class has currently underperformed growth on a trailing ten year basis by the second largest margin in nearly 30 years, translating into a negative two standard deviation event. Historically, such extreme underperformance of value equities relative to growth equities has been followed by strong outperformance of the former, as was the case in the nearly decade-long period following the NASDAQ crash in March 2000.

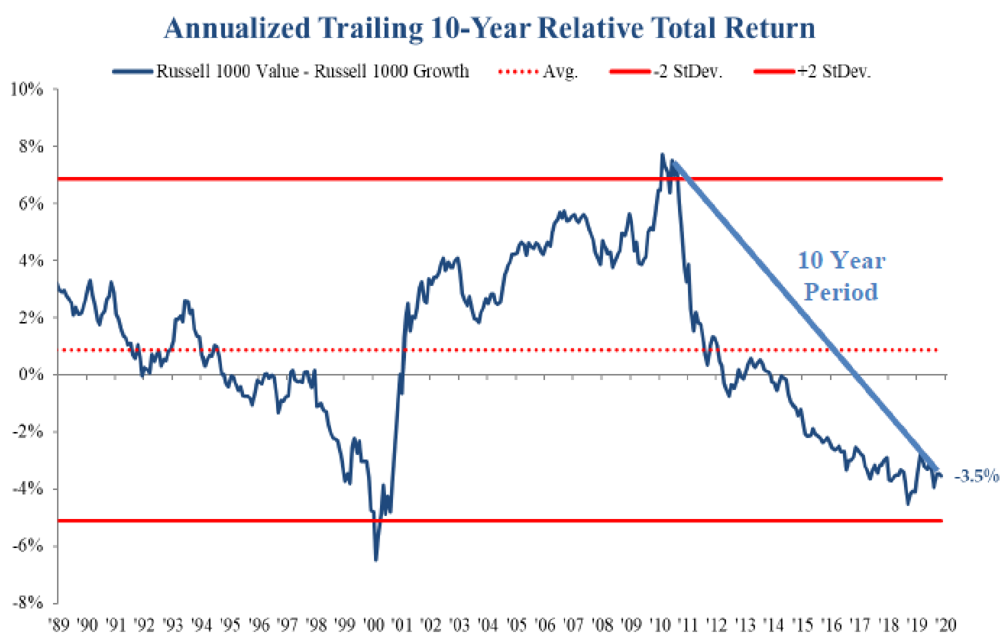
Source: Strategas Research, 12/31/2019. Past performance is no guarantee of future results.



MSCI EAFE's Shiller P/E Ratio is at approximately a 25% discount compared to its past 10-year average and near the same level as three decades ago.

Note: Historical line denotes historical average since 1983.
*Source: Thomson Reuters, OECD Main Economic Indicators. BCA Research, 12/31/2019.

By the way, the US CAPE index is at near highest levels ever but U.S. Value is cheap:



Source: Bloomberg & Strategas Research, 11/30/2019

We live in a world where many major buyers of assets have increasingly **become price and valuation insensitive** and this has contributed to value as a style remaining out of favor for an extended period. **Michael Burry** of Scion Asset Management (aka "The Man"), chief protagonist of the award-winning book and movie, **The Big Short**, compares current flawed pricing of indexed assets to that seen in the run-up to the subprime crises with CDOs (Collateralized Debt Obligations). While some value-insensitive buyers have always existed, such as banks and insurance companies looking to match assets to liabilities, the scale and scope of what we are seeing presently is unprecedented.

Within equities, **price discovery is also gradually being chipped away** at by the increasing popularity of **indexed products such as ETFs** (Exchange Traded Funds). Such **valuation-agnostic products** are often bought either passively/programmatically or for an actively sought-out exposure to a particular region, country, sector, industry or style class. This trend has likely begun to influence equity markets in the United States and Japan the most. In the United States, by some measures, over 50% of all equity investors now use indexed products, while **in Japan, the Central Bank has widened its mandate to include the direct purchase of domestic equities to support economic growth** (*if that's not a sign of froth what is?*). It is thus no coincidence that these two equity markets have been among the strongest performers over the last five years and each now provides less attractive valuations including sub-2.5% dividend yields.

Looking just at the ten largest holdings in the MSCI World index, the **current market cap weighted forward 12-month price/earnings ratio is currently 26.8x versus 15.9x five years ago**, for a much larger 63% valuation increase. Thus, the largest and most overrepresented companies in indices and ETFs which are passively being bought and bid up appear to be among the most richly valued areas of the market presently. For now, these index funds and companies most represented in them have **enjoyed a self-fulfilling positive momentum-led feedback loop**, which is a version of the **greater fool's theory**—the reason why people buy them is that this strategy has recently worked and the hope is that the trend continues irrespective of valuation considerations. When and if this trend reverses, meaningful losses of a more permanent nature could occur, as such **momentum led investments offer no real valuation support or margin of safety.** Given our disciplined value approach to investing, we have avoided such hotspots of momentum-filled overvaluation and euphoria.

On the Fixed Income side some real wacky things are brewing. **Negative interest rates**, which were once thought of as a temporary phenomenon, have now been with us for an extended multi-year period. This has **led to a loss of true price discovery** in the fixed income space and in some cases to **absurd outcomes**. Take for instance **Greece, which is a country with a high debt load, history of past defaults and non-investment grade sovereign credit rating of BB-. The current 1.4% yield on its 10-year government bonds is considerably lower than the 1.9% yield available on AAA-rated US treasuries of the same maturity** and appears staggeringly low versus the +35% peak yield on these same Greek bonds before the ECB (European Central Bank) stepping in to purchase them from 2012 onwards.

Also consider the following observations:

- Overbought scenario: The Nasdaq 100 is now **about 6% above its 50 day Moving Average**—same gap we saw in May of 2019 and in July—both right before a sizeable pullback.
- The S&P 500 is now trading **around 18.5x forward PE multiple**—practically the highest valuation levels in more than 20 years. No matter which metric you look at – Price to Book, Price to Sales, EV to EBITDA, Market Cap to GDP, CAPE—this is the most expensive market since the dot com bubble 2 decades ago. And why is this important? **Because it has been shown in study after study going back 50+ years that the most important determinant of investment success is what you pay of the investments when you buy it. Valuation matters.**
- This article by Nobel Laurette Robert Shiller tells it all.
- The S&P 500 now trades at a 2.4x price to sales multiple. That's higher than the metric during the dotcom bubble
- SOX index (semis) was up 60% in 2019 despite semi chip stocks had posting a 10% chip sales growth
- Investors have become very excited about an economic recovery in 2020 and are willing to ignore any data that doesn't support their thesis. The **Deloitte CFO survey of 147 CFO's** with companies with at least $3 billion in annual sales in Canada, Mexico, and the United States **was particularly downbeat**. In aggregate they see consumer and business spending slowing, and **82% anticipate taking more defensive actions**, like reducing discretionary spending and staff. This outlook doesn't jive with investor expectations that the weakest sectors in 2019—business investment and manufacturing—are getting ready to strengthen (Source: MacroTides).

FINAL WORD

Finally, not that I am a big believer of calendar related metrics, but this one struck the historical chord in me—check it out:

New Decade Big Changes in Store

The coming decade is the culmination of the 80-year cycle that has marked significant turning points in our nation's history i.e. 1781, 1861, 1941, and potentially 2021. Each of the prior turning point decades included major changes and upheaval, so we should be prepared.