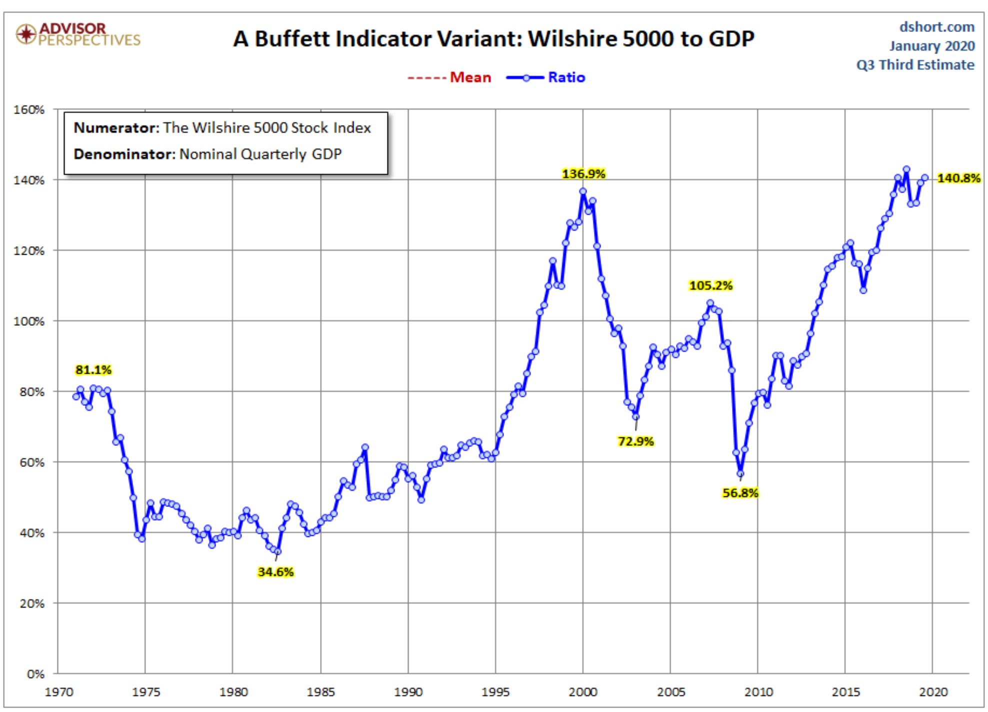
2020 - A BRAVE NEW WORLD

"Actual happiness always looks pretty squalid in comparison with the overcompensations for misery. And, of course, stability isn't nearly so spectacular as instability. And being contented has none of the glamour of a good fight against misfortune, none of the picturesqueness of a struggle with temptation, or a fatal overthrow by passion or doubt. Happiness is never grand."

– ***Aldous Huxley, Brave New World***

2019 will likely go down in the annals of investment history as the triumph of hope over experience. Although not entirely uncommon, late cycle rallies of the magnitude witnessed last year often embolden investors at just the wrong time. While Nottingham's hope is that 2020 brings us similarly good fortune, our 30+ years of experience suggests investors might now better favor caution over valor.

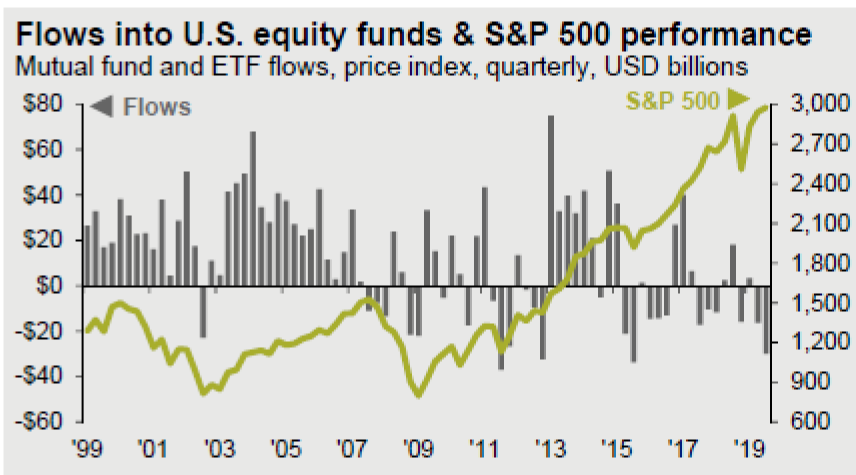
Aided no doubt by a remarkable about-face from the Federal Reserve, which moved from four interest rate hikes in 2018 to three cuts in 2019, risk assets soared to historically high levels. Regardless of temperament, one likely made some money over the past twelve months. Risk-oriented investors favoring domestic tech and growth stocks witnessed extraordinary returns of over 30%, while more conservative portfolios favoring US Treasury securities still managed gains of nearly 10%. Even doomsayers favoring gold and precious metals saw double-digit returns. In sum, it was hard not to make money in 2019.



Alas, we fear we may not be so fortunate in 2020 (you heard it here first). Not to rain on anyone's parade, and admittedly hoping we're wrong, but asset prices have generally disconnected from historical valuation patterns, in some case to the extreme. The chart on page one, a favorite of Warren Buffett, would suggest that US equity valuations are at an extreme last seen in 1999. While the near-term predictive power of this chart isn't strong, it has a solid track record of handicapping longer-term returns. And right now it's flashing red!

The good news from our viewpoint is that the inevitable day of reckoning may be some time off. With a Federal Reserve committed to low interest rates for the foreseeable future, risk asset prices may stay elevated a while longer. The US economy continues to hum along steadily, while global economies appear to be wakening from their most recent period of hibernation.

And if it's true, as legendary investor Sir John Templeton once remarked, that "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria", we're some ways away from the top. As the chart below shows, courtesy of our friends at JP Morgan, US equities have actually experienced outflows over the past few years, even considering strong performance in 2017 and 2019. Indeed, despite historically low interest rates, money continues to flow into bonds rather than stocks. Having experienced two generational drawdowns in the decade of the oughts', many investors, especially those just starting out following the '90's tech boom, have chosen to sit this bull market out.



Source: JP Morgan, Guide to the Markets Q4 2019

So, with the gloom and doom out of the way, here's our wish list as the new decade begins. Included are some hopeful and reasonable requests, as well as some reaches and downright fantasy. Nevertheless, here goes:

1. **US economic growth trends upwards towards more historical norms.** From 1950 until 1999, US Real GDP grew at a 3.7% annual rate. From 2000 through 2018, our economy only grew by 2.0% per annum. Given a $21.5 trillion economy, a reversion to the historical pace of growth would translate into over $300 billion of additional GDP annually.

2. **Less drama from the political arena.** If we needed another reminder that political noise often doesn't matter when it comes to investing, 2019 was a case in point. Despite all the wrangling over trade, impeachment and the 2020 presidential election, the cascade of steady negative news (and hats off to today's news media which only seems to present negative news) couldn't derail the power of 75 basis points in interest rate cuts. Moral of the story, the Fed matters more than politicians.

3. **Higher domestic interest rates.** This is like hoping the tooth fairy leaves you a crisp $20 under your pillow – pure fiction! At this point, the Fed seems committed to lower for longer when it comes to short-term US rates. While good for some – borrowers primarily – the penalty exacted on savers can't be understated. Even though the transition to higher rates would likely take a short-term toll on equity prices, in the long run, we believe 4% to 5% US Treasury yields would offer retirees a much better investment option than the 5% available in today's high yield debt market.

4. **An end to the negative interest rate experiment.** We were heartened somewhat in December when reading that Sweden's central bank, the Riksbank, decided to raise short term interest rates – to 0.0% from -0.25%! As the first, and hopefully not the last, central bank to abandon negative short-term interest rates, Sweden will hopefully set a precedent for the Eurozone, as well as Japan, Denmark and Switzerland. While one could argue negative rates kept things from getting worse, they sure didn't seem to fix structurally moribund economies and they enacted a brutal toll on banks and investment returns alike.

5. **The US and China establish a new trading framework.** Note to China, you are no longer an "emerging market" and cannot hide behind developing nation status when it comes to global trade. With a "phase 1" deal waiting to be signed as we go to press, we're hopeful that a comprehensive overhaul of our trading relationship is ironed out in the coming months. Although markets are currently pricing a favorable outcome into stock prices, less uncertainty is always preferable to more when it comes to equity markets.

6. **The Eurozone leads an international recovery.** 2017 aside, international investment returns have trailed domestic results by a wide margin. The Brexit fiasco, along with the negative interest rate experiment, has weighed on European growth prospects. It appears, however, that the German economy, long the driver of Eurozone growth, is finally awakening from its most recent slumber. Any signs of life from this region would be most welcome by global investors.

7. **US political leadership based on unity rather than populism.** I told you there would be a stretch ask in here! But honestly, enough already with the polarizing rhetoric from both political parties. As we near the 2020 election, our hope is the electorate demands an end to class warfare, fear-mongering and impossible promises (what else might today's politicians run on?). Instead we would hope to see political leaders thoughtfully address income inequality, our exploding deficit and national debt, and our role in the seemingly endless and intractable violence plaguing the Middle East.

8. **One more year of decent US equity returns (yes, I know, we're pushing it).** We're reminded of Saint Augustine's plea, "Please God, make me chaste, but not yet." We know stocks are overvalued, but a gradual mean reversion wouldn't be the worst thing. A scenario of modest stock price increases accompanied by positive EPS growth is far preferred over a swift -25% pullback.

9. **The Bills win a playoff game.** So close in 2019!

10. **The Sabres actually make the playoffs.** (Sadly I think one has a better chance of getting that $20 from the Tooth Fairy.)

Summary

2020 will no doubt bring a host of surprises to investors, much as 2019 did. The question one should ask is, *Am I Ready?* The answer will likely be different for each individual. Are you defensive enough? Or, too defensive? Do you have enough beta in your portfolio? Or potential alpha? How about volatility? These are the conversations we're having with our clients and the questions we're asking. After last year, rebalancing is a must. Always remember, trees don't grow to the sky. That which can't keep going up won't (Tesla at $537 per share?? It is currently worth more than Ford and GM combined). But, markets can stay irrational longer than you may remain solvent (thank you Mr. Keynes).

One thing is for sure, regardless of which direction the market moves: <u>Nottingham Advisors will remain committed to helping our clients achieve their goals and objectives.</u> Our service to you will remain steadfast. Our value proposition continues to be one of thoughtful and time tested investment strategies, exceptional personal service, and honest and ethical behavior. If we can be of any help as you go about planning for the New Year, please don't hesitate to reach out. We thank you for your continued trust in Nottingham Advisors and from all of us we want to wish you a happy, healthy and peaceful New Year.

Happy New Year,

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President/Chief Investment Officer
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