Video Transcript
Economic Review & Outlook

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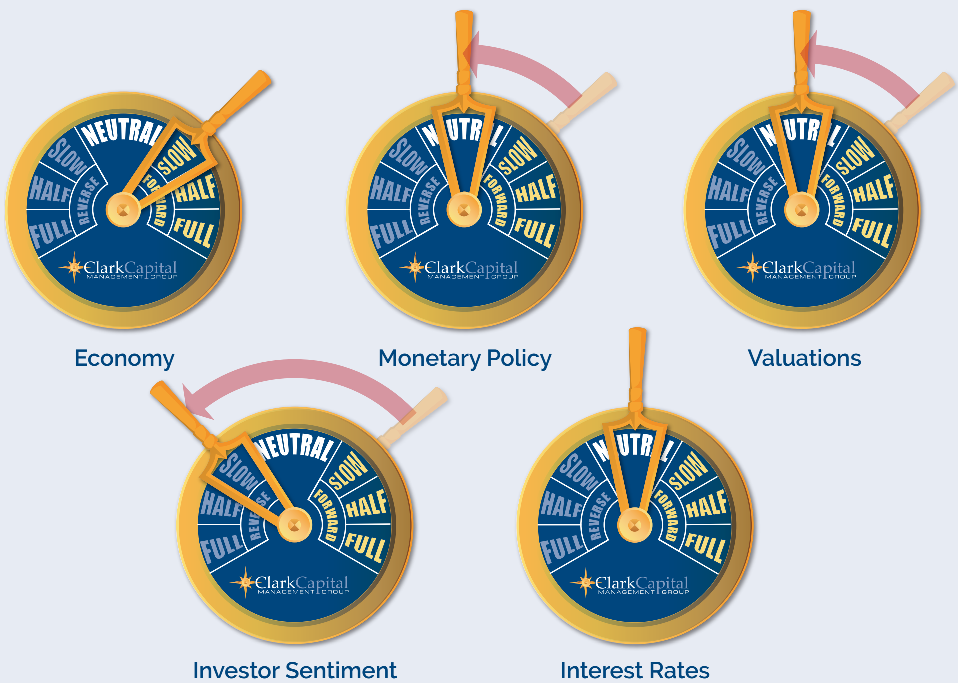
Fourth Quarter 2019

Thanks for joining me for a recap of the latest economic and capital market developments from the fourth quarter of 2019. So let's begin.

As a reminder, these gauges represent the 5 major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative. We made adjustments to three gauges this quarter and we will discuss those shortly.



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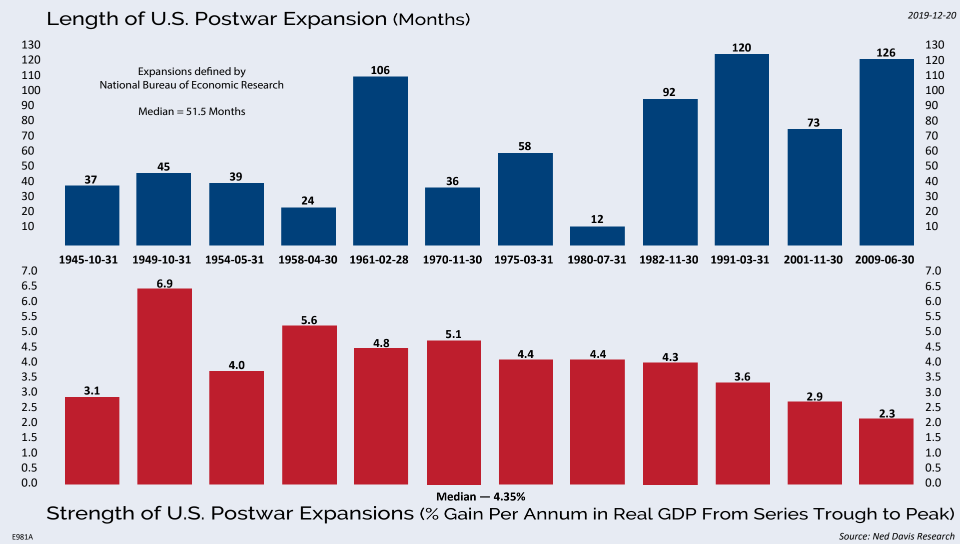
Economy



U.S. Economy

Our first gauge is the U.S. economy, which we leave in a slow forward position.

The first half of 2019 grew around 2.6% and the final reading of 3rd quarter GDP came in at 2.1% with 4th quarter growth estimates trending at a similar pace. Economic growth in 2019 was not as strong as 2018, but back to trend growth in the low 2% range, which we have experienced for most of the post-credit crisis period.

As we move into 2020, we expect economic growth to continue at a similar pace well into the New Year. While a few warnings signs of slower growth developed in 2019, we believe most indicators we monitor show little threat of a slowdown occurring in the near-term.

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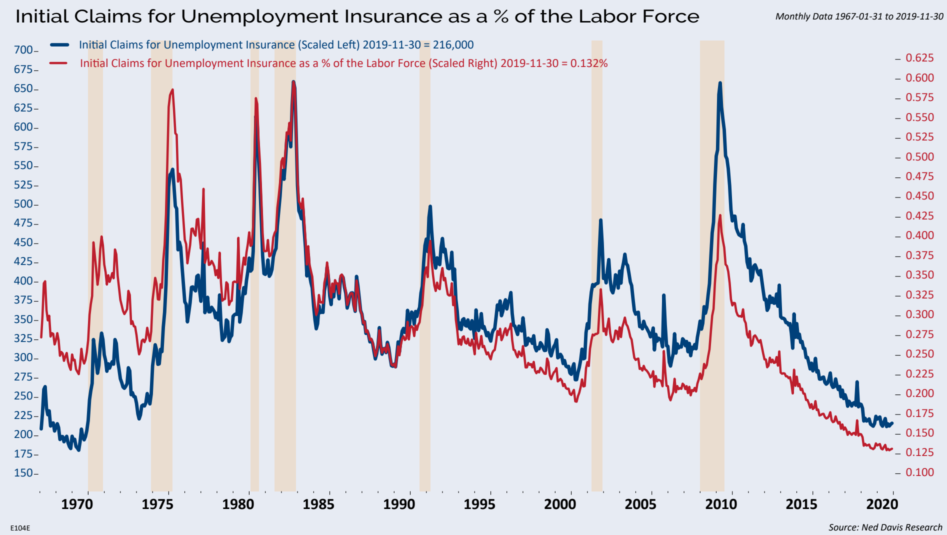
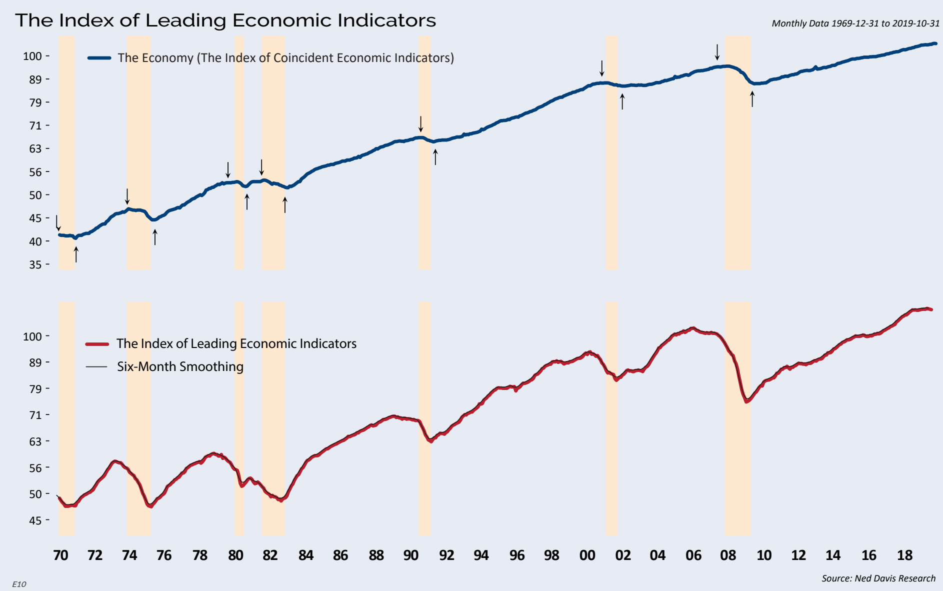


In particular, job market data remained strong throughout 2019. Almost 70% of our economy is driven by consumer spending, so an employed and financially healthy consumer is a key driver of economic growth. The unemployment rate and jobless claims hover near 50-year lows and job additions have been positive throughout the year. We believe the job market remains healthy as we move into 2020.



The Conference Board's Leading Economic Indicators Index (the red line on the bottom of this chart), was a bit mixed later in the year after putting in record highs multiple times in 2019. Historically, this indicator peaks about 11 months prior to a recession and in the last 3 recessions, that lead time has been longer at 16 months. It is too early to determine if this index has hit a cycle high, but regardless, we believe it is not indicating any sort of imminent recession as we move into the New Year.

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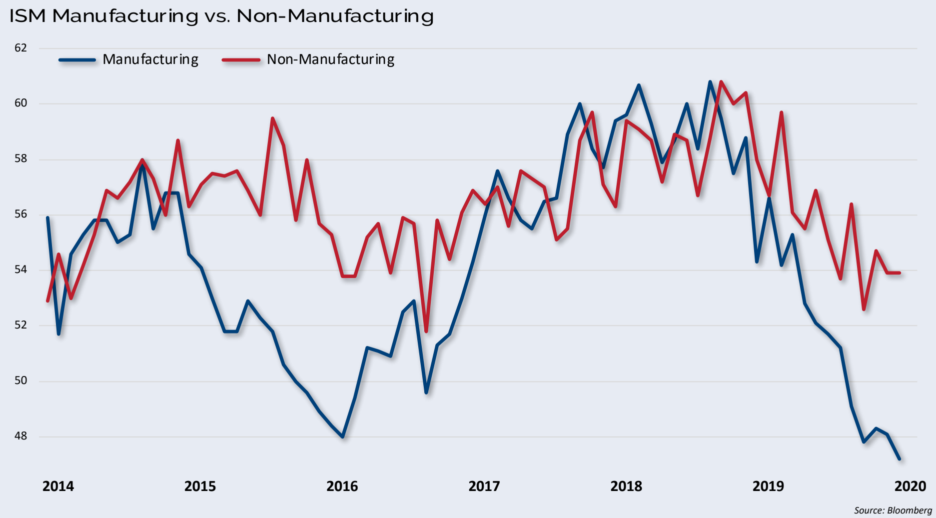
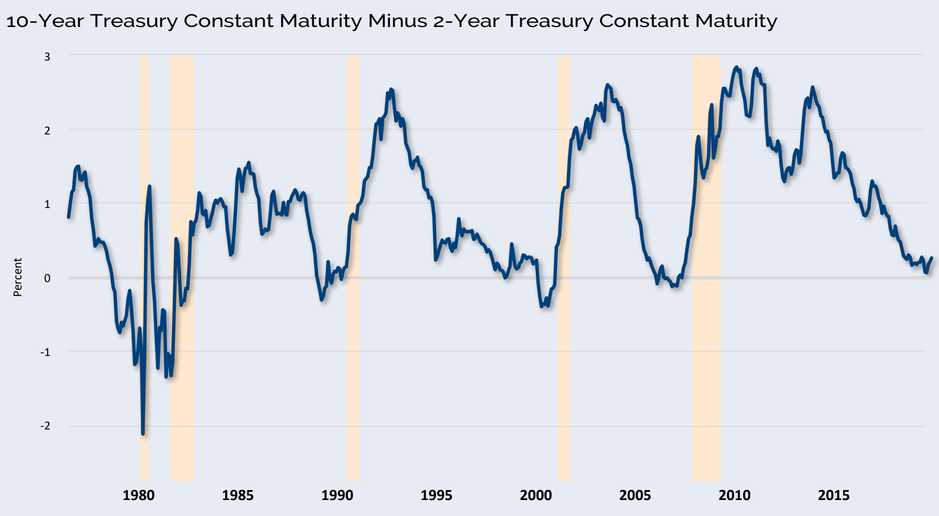


Manufacturing has been a point of weakness in the U.S. for the last few months. The ISM Manufacturing Index recorded a reading in August below 50, the demarcation line between expansion and contraction and it has stayed below 50 for four consecutive months. Manufacturing is directly impacted by the headwinds of higher tariffs and the uncertainty of U.S. and China trade negotiations. On a positive note, a phase one trade deal with China appeared to be reached late in the year and this could provide some near-term relief to the manufacturing sector. Furthermore, the ISM Non-Manufacturing Index, which covers the much larger service industries in the U.S. economy, has remained comfortably above the 50 level in recent years.



Finally, the yield curve inverted in 2019, historically a sign of upcoming economic headwinds. As a reminder, the prior seven recessions dating back to 1962, have all been preceded by an inverted yield curve, but we have had two instances of an inverted yield curve without a subsequent recession. The inversion is often induced by a Fed that tightens rates too much.

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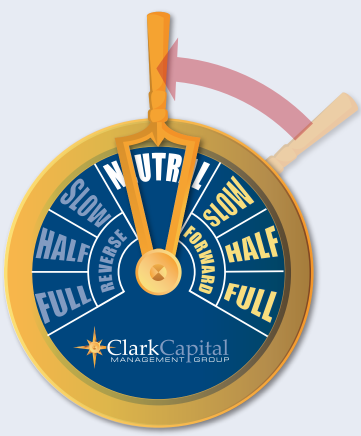


Monetary Policy

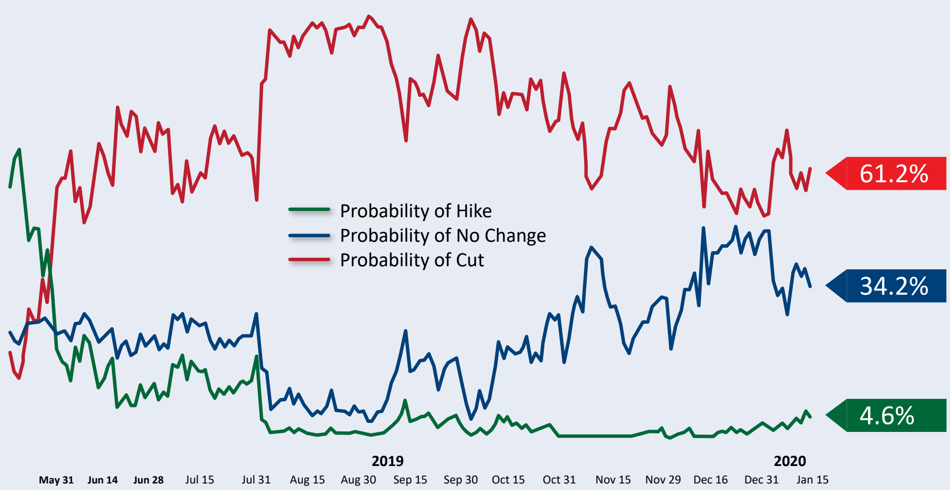
An important question we ponder as we move into 2020 is whether the Fed's quick and rather dramatic reversal of policy from 2018 to 2019 was enough to curtail the potential damage done by higher front-end rates. Were the three rate cuts in 2019 enough to rekindle growth and avert a near-term recession? While history does not favor the Fed's ability to engineer this type of soft landing and recovery, it is yet to be seen whether they pulled it off this time. Initially, the economy has continued to grow and some better momentum surfaced in the latter part of the year, so that is an encouraging sign.

All in all, we believe the fundamental backdrop for the economy continues to look solid and we expect growth to continue well into 2020. In other words, we do not see a recession on the horizon through at least 2020. The Federal Reserve does not have a recession in its forecast through 2022.

Monetary Policy

This leads us to Monetary Policy, which we bring back to a Neutral position moving into 2020. The Fed went from four rate hikes in 2018 to dovish comments in early 2019, which ultimately led to three rate cuts in the second half of last year. The Fed indicated it would likely be on hold from some time after that third cut and the bar appears to be very high for any Fed action in 2020, so we therefore move this gauge back to Neutral.

Fed Rate Cut Probabilities



We have been in a period in recent years where actions by the Fed were often pivotal for economic and capital market expectations. We might be entering a period when the Fed could largely be on the sidelines and issues like the robustness of economic growth, ongoing trade negotiations with China, company earnings and, yes, a presidential election might be more front and center. Never count out the Fed and the impact it might have on the economy and markets, but 2020 might be a year when the Fed moves back to its historical role of operating monetary policy in the background of the economy – a respite I'm sure Fed Chairman Powell would welcome.

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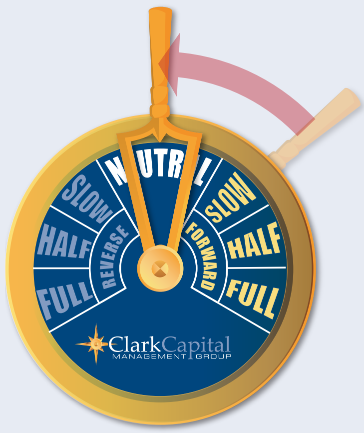
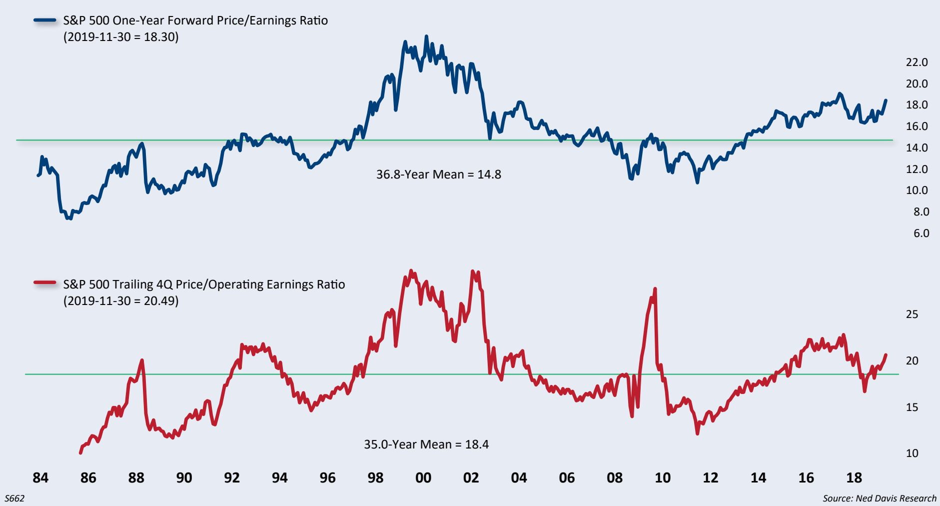


Valuations

Valuations

Next are Valuations, which we move back one notch to a Neutral position.

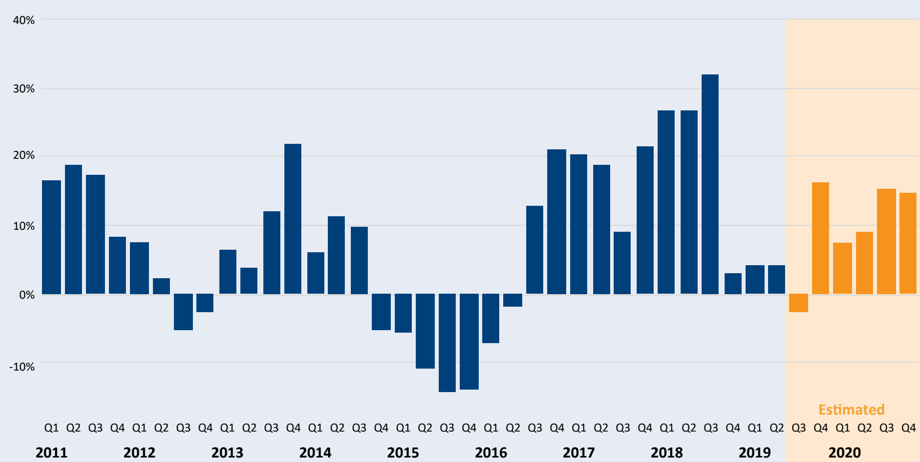
S&P 500 Forward vs. Trailing Price/Earnings Ratios



Stocks rose to record highs last year. From a market valuation perspective, the P/E ratio for the S&P 500 moved to around 18x forward operating earnings. Clearly, this was a year when the "P" or prices rose much more rapidly than the "E" or earnings.

This valuation expansion has meant that stocks have become more expensive. While expensive on a historical basis, interest rates remain low from a historical perspective as well, and this combination makes us move the valuation gauge back only one notch to Neutral.

S&P 500 Operating Earnings Year-Over-Year Change



Economic and market forecasts presented herein reflect a series of assumptions and judgments as of the date of this presentation and are subject to change without notice. Forward-looking statements cannot be guaranteed.

Source: S&P Dow Jones Indices. For illustrative purposes only.

Earnings have been on quite a ride over the last two years. Earnings growth was dramatic in 2018 driven in large part by the tax cuts. Those earnings gains created a very tough comparison year in 2019 and earnings were muted. Now the tables have

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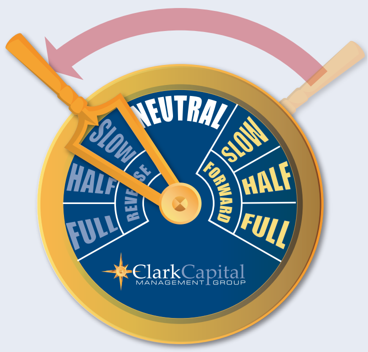

Investor Sentiment

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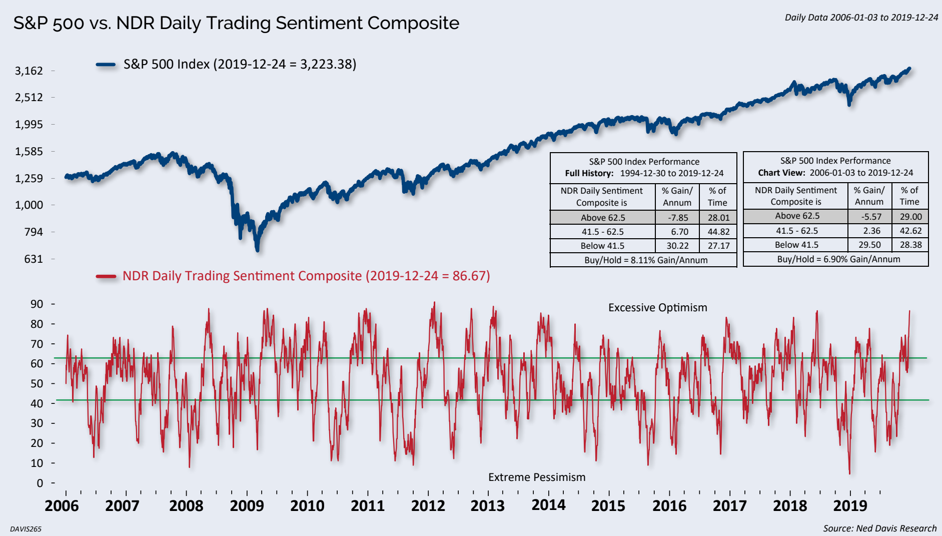
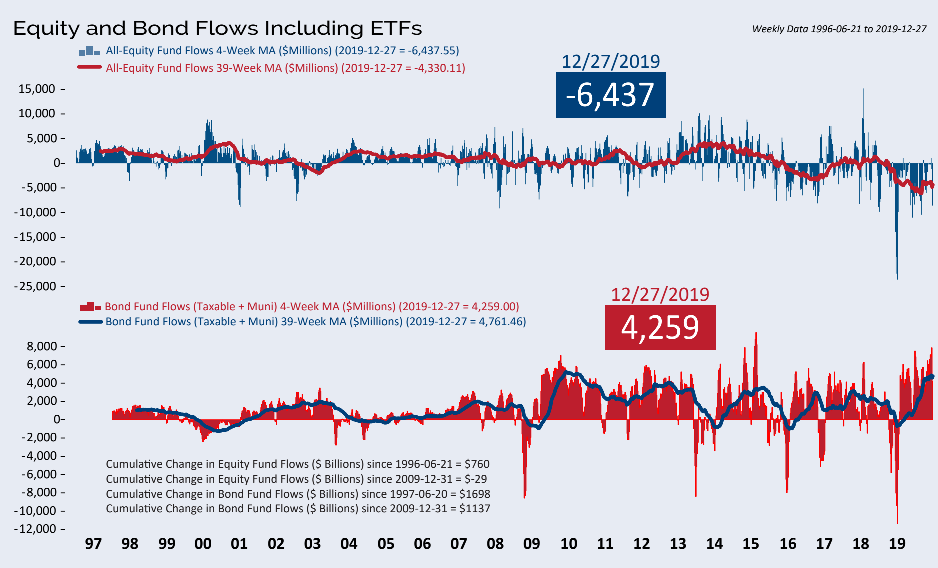
turned once again and comps become easier in 2020 for corporate America. We do not expect further valuation expansion in 2020, so earnings growth will be an important driver of potential stock market gains this year.

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation. Recall this gauge is a contrarian indicator based on the behavior of investors and moving into 2020, we drop this gauge two spots from Slow Forward to Slow Reverse.



As the stock market continued to hit new highs throughout December, investor sentiment grew to a point that now looks a bit optimistic, which can be a contrarian signal.



Interest Rates

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Fund flow data drove our decision to change this indicator to a Slow Forward last quarter and while the one-way fund flow out of stock and into bond mutual funds and ETFs continued late last year, the pace of outflows has slowed. Volatility, which we will discuss shortly, was also largely absent late in the year and this can be a contrarian sign as well.

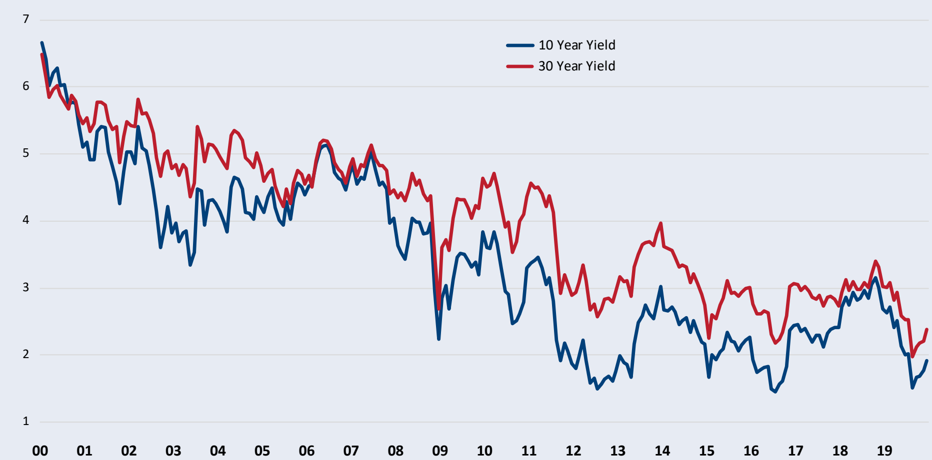
After reviewing both sentiment and fund flow data, along with suppressed volatility, we are compelled to move the Investor Sentiment indicator back to a Slow Reverse position.

Interest Rates

Our final gauge is Interest Rates, which we leave in a Neutral position.

10 Year and 30 Year U.S. Treasury Yields

1/31/2000 – 12/31/2019



Source: Bloomberg

As the Fed became dovish and ended up cutting rates in 2019, interest rates dropped rather dramatically with multi-year and even historic low interest rates put in during August. Lower rates, which lower the cost of capital, are a net positive for an economy generally speaking. However, the inversion of the yield curve in 2019 is a historically negative warning sign. And although the yield curve is now positively sloped, it is also quite flat, which has typically been a more challenging environment for stocks. With these two countervailing signs present, we keep the Interest Rate gauge in a Neutral position.

Moving to capital markets, what a difference a year can make! After suffering through a fourth quarter in 2018 when the S&P 500 fell about -13.5% with over -9% of that decline coming in December alone, the fourth quarter of last year ended with stocks hitting new all-time highs. The S&P gained 3.02% in December and 9.07% in the fourth quarter to cap off a year when this index rose 31.49%.

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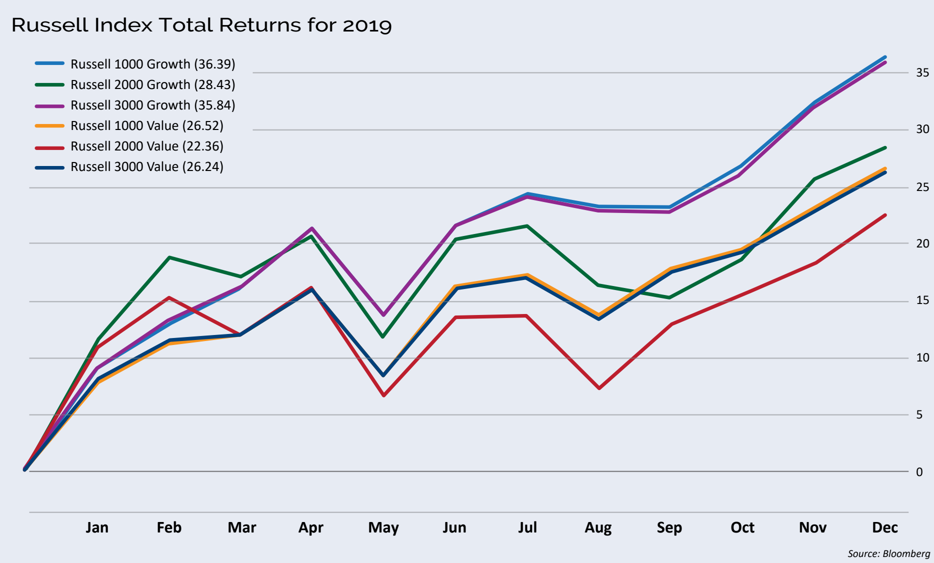
The VIX Index, a measure of equity market volatility, hit its lowest level of the year in the latter part of the 4th quarter after starting October above 20. We move into 2020 with very low levels of volatility, which can sometimes be a sign of market complacency and a more turbulent ride could be ahead.



In recent months, we have been discussing the nature of the stock market rally and we think those points are worth revisiting. Overall, large-cap U.S. growth stocks have dominated market performance during the last couple of years.

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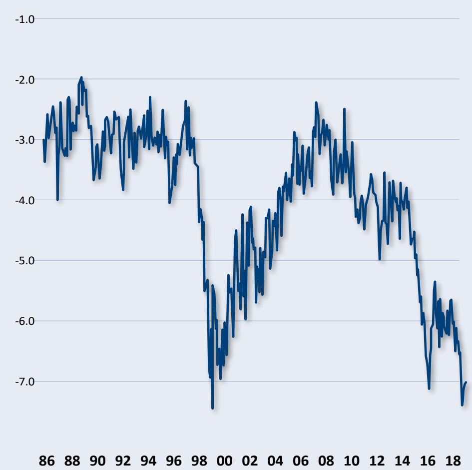
Foward P/E Spread, S&P 500, Value vs. Market



P/B Spread, S&P 500, Value vs. Market

This had led to a valuation disparity between growth and value stocks that we had not seen since the late 1990s during the tech bubble. We believed that at some point during this market cycle, this trend would reverse and value factors would be rewarded. While too early to declare a decisive reversal to this long-running trend, at times over the last few months of 2019, we saw value outperform growth, and small and mid-cap stocks outperformed large cap stocks. International equities even showed periods of better relative performance.

We believe we might be entering a time late in this bull market run when fundamentals and valuations matter more and active management could add value for investors. Different pockets of the market might be treated differently moving forward and having an active and purposeful approach to investing could be valuable in this maturing market cycle. We at Clark Capital believe we are well positioned for this type of market environment.

10 Year U.S. Treasury Yields

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Turning to bonds, the overriding factor for fixed income returns in 2019 was falling interest rates and most bond sectors showed solid gains for the year. However, as risk assets rallied late in the year, yields rose. High-yield bonds performed better under those conditions than more interest-rate sensitive bonds, validating our long-standing position favoring credit over pure interest rate exposure in the current market environment.

As we move into 2020, several long-standing concerns persist. Trade negotiations with China are still ongoing, the ramifications of the long-awaited Brexit are not fully known, global economic growth concerns linger, and the mood in Washington DC seems at its lowest point in years. In 2019, the market was resilient and climbed this wall of worry. With such a powerful year of gains and stocks markets near record highs, volatility will likely resurface as the market continues to deal with those issues and faces a new one – a presidential election – in 2020. However, if the Fed rate cuts help stabilize growth, consumers stay strong, emerging signs of better global growth blossom, and corporate America delivers earnings, stocks could continue to progress.

We maintain our stance that fundamentals are what matter in the long run and we believe the current fundamentals remain positive for the U.S. Volatility will likely elevate, but we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives.

Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients.

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Disclosures

The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months.

The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI). Based on a survey of purchasing managers at more than 300 manufacturing firms by the Institute for Supply Management (ISM), the index monitors changes in production levels from month to month. The index is the core of the ISM Manufacturing Report.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The 10 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10 year treasury yield is included on the longer end of the yield curve.

The 30 Year Treasury Rate is the yield received for investing in a US government issued treasury security that

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has a maturity of 30 years. The 30 year treasury yield is included on the longer end of the yield curve and is important when looking at the overall US economy.

Created by the Chicago Board Options Exchange (CBOE), the Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower expected growth values.

The Russell 2000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 3000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower expected growth values.

The Russell 3000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The forward P/E ratio is a current stock's price over its "predicted" earnings per share. If the forward P/E ratio is higher than the current P/E ratio, it indicates decreased expected earnings. Keep in mind, analyst estimates are not set in stone, and can often be wrong.

The price-to-book ratio compares a company's market value to its book value. The market value of a company is its share price multiplied by the number of outstanding shares. Traditionally, any value under 1.0 is considered a good P/B for value investors, indicating a potentially undervalued stock.

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