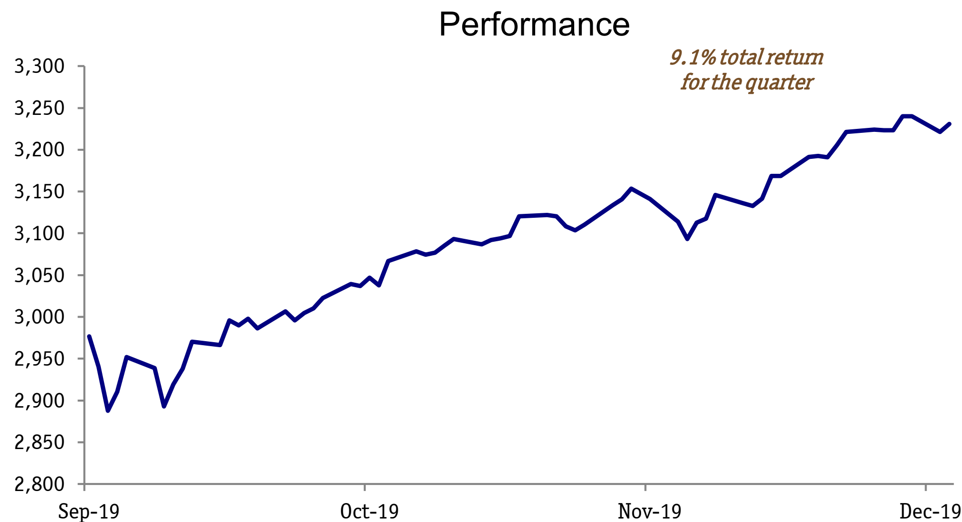
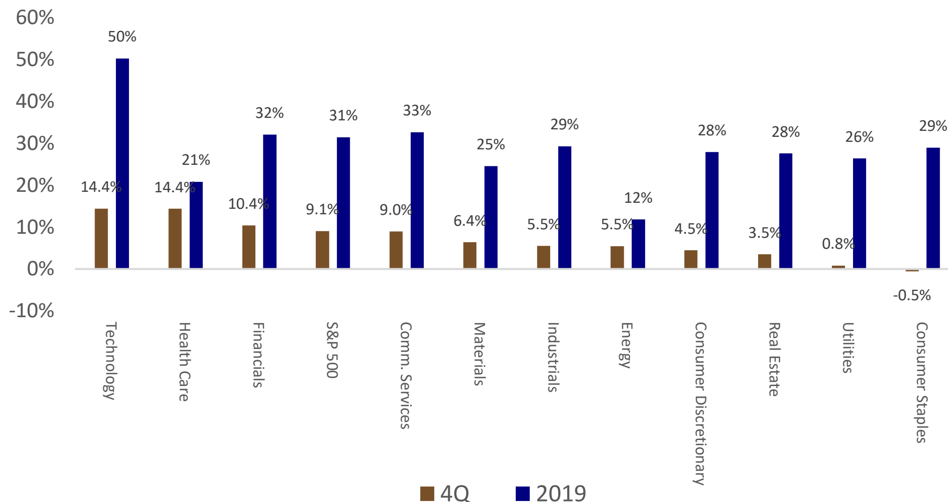
S&P 500® - Fourth Quarter



Quarter Highlights

- Equity markets continued to march higher in the fourth quarter as the S&P 500 returned 9.1%, the Russell Midcap gained +7.0% while small caps (Russell 2000) were up 9.9%. Better economic growth and subsiding trade tensions combined with monetary stimulus were positive for equities.
- The Federal Reserve (Fed) cut the Fed Funds rate for a third time in October, bringing the range to 1.50% to 1.75%.
- The U.S. and China have reached an initial agreement on trade. The Phase One deal eliminates certain tariffs on Chinese goods, it will reduce the rate on earlier imposed tariffs, and China committed to increase purchases of US agricultural products.
- Fourth quarter U.S. GDP is expected to increase at a 1.6% annual rate with consumer spending up 2.1%.

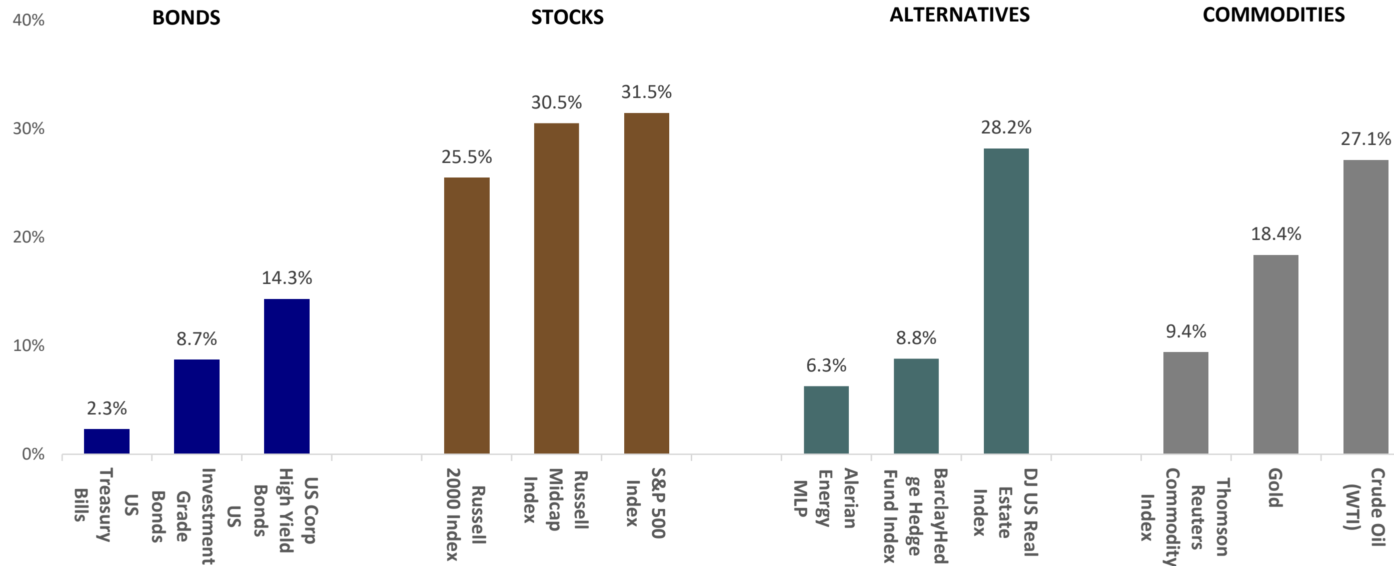


Sector Snapshot

- As trade tensions and fears of a recession waned, along with better than expected economic data, the fourth quarter was led by strong performance in Healthcare, Technology, and Financials.
- Interest rates moved higher as the Fed signaled it would hold rates steady resulting in interest rate sensitive sectors such as Real Estate and Utilities underperforming in the fourth quarter.
- Consumer Staples also underperformed as investor sentiment improved and moved into more cylclical sectors.
- For the year, the market was led by the Technology and Financials sectors. Semi-conductor companies and Apple pushed the technology sector higher as economic growth stabilized and the US and China agreed to the first part of a trade deal. Financials performed well as economic growth and interest rates normalized.

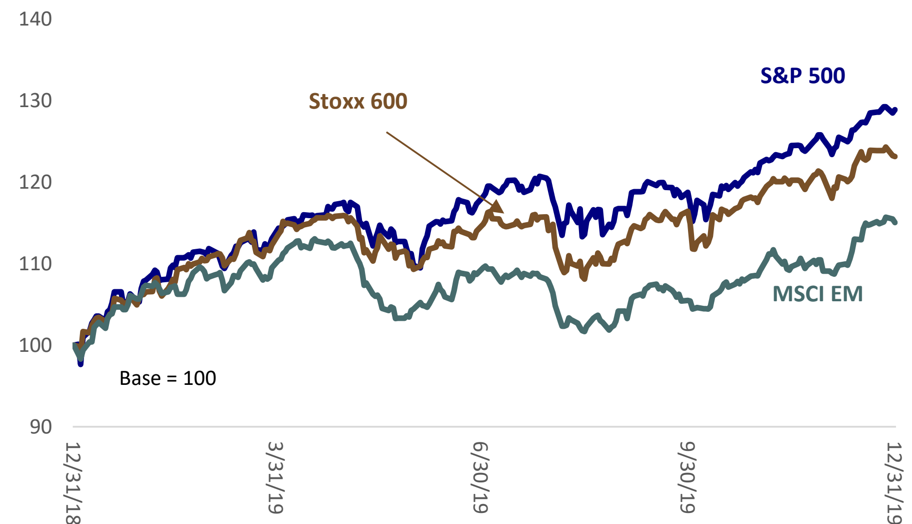
Sources: FactSet

What a Difference a Year Makes: All asset classes moved higher



All Asset Classes Positive (top chart). In stark contrast to 2018 where only cash and short-term bonds outperformed, 2019 returns were positive across all asset classes led by equity markets. As the Federal Reserve pivoted from increasing interest rates to cutting rates in early January, the equity markets started moving higher. Global central banks increased monetary stimulus throughout the year with the goal of sustaining global economic growth. The benefit of lower rates combined with strong consumer spending in the US drove most asset classes beyond the October of 2018 highs.

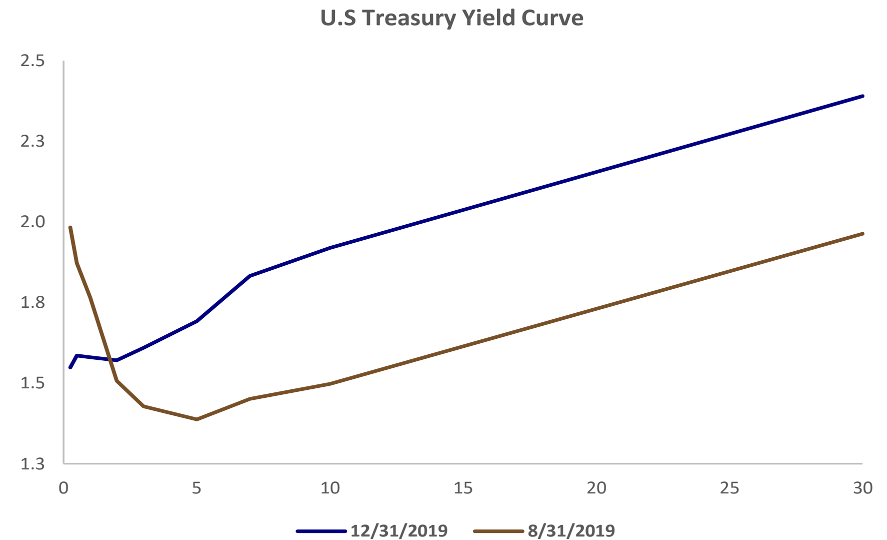
Equity Markets Led the Way (bottom chart): Equity markets were strong in 2019 with double digit gains across all markets and sectors. US stocks outperformed International markets with the Stoxx 600 (Europe) gaining 27.7% and MSCI Emerging Markets up 18.6%. Growth continued to outperform Value.



Sources: Bloomberg. Morgan Stanley.

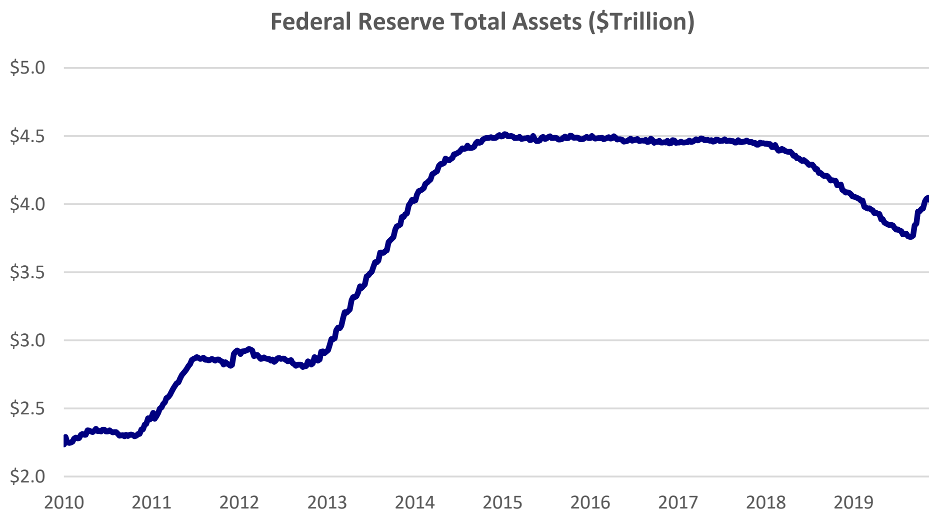
Fed Cuts Rates Third Time, Expands Balance Sheet Supporting Markets

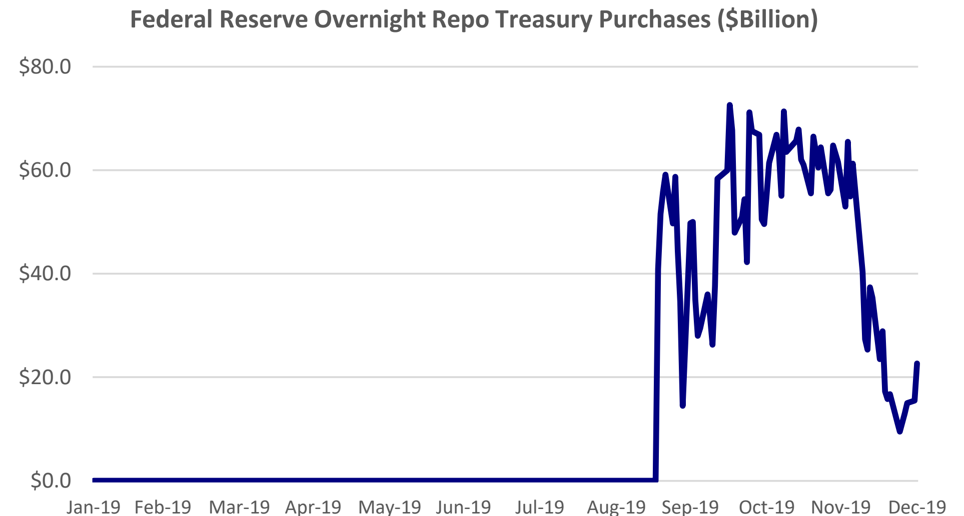
The U.S. Treasury yield curve has resteepened (top right). Recession fears percolated in August after the yield curve (10-year minus 2-year) went negative or inverted, a condition that has occured in close proximity to the start of past U.S. recessions. After three Fed Funds interest rate cuts and an improvement in investor sentiment, the curve has regained a positive slope.



Federal Reserve balance sheet expands again (bottom left). The Fed spent two years proactively shrinking its balance sheet via "quantitative tightening". This October the Fed changed course, indicating it would begin purchasing $60 billion of short-term T-bills per month in order to replenish the amount of reserves available to the market. The degree of change has been remarkable. From the middle of 2017 the Fed's outstanding assets shrank from a peak of $4.48 trillion to $3.76 trillion, a reduction of roughly $720 billion. Since September, the Fed has added approximately $410 billion, unwinding 57% of its 2-year tightening program in a mere 3.5 months.

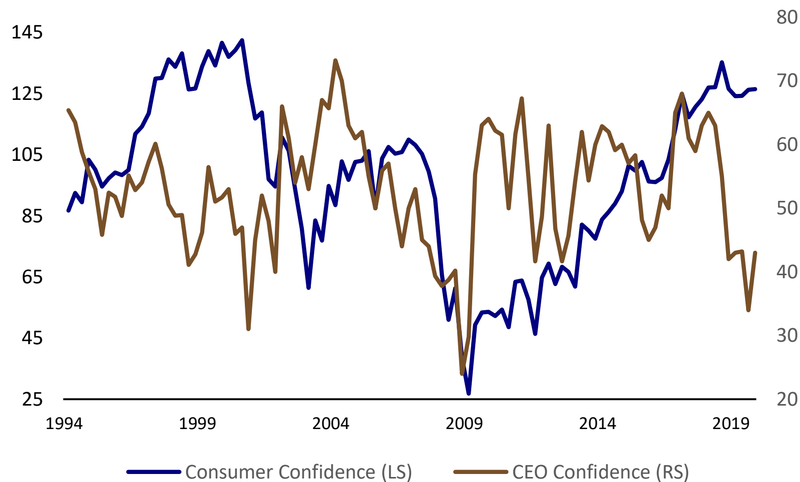
Repo market madness (bottom right). Part of the sudden spike in the Fed's balance sheet can be attributed to the acute shortage of funds in the overnight repurchase market. A lack of available reserves sent the overnight repo rate soaring until the Fed jumped in with more liquidity.

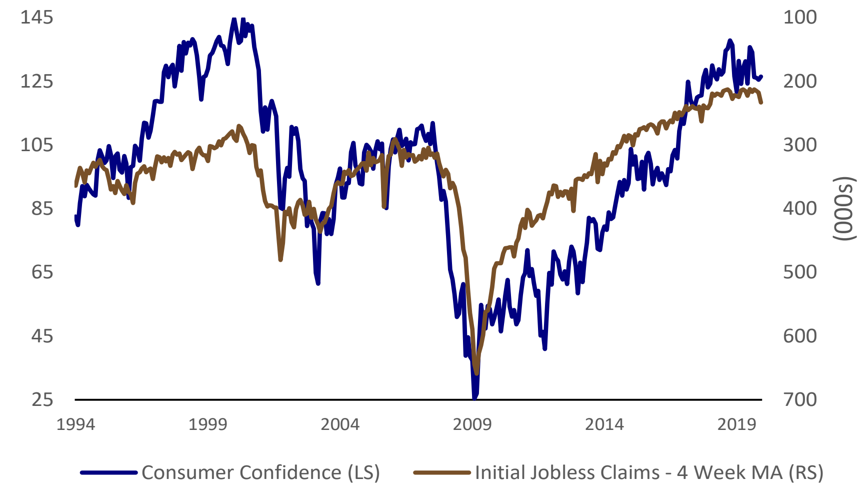


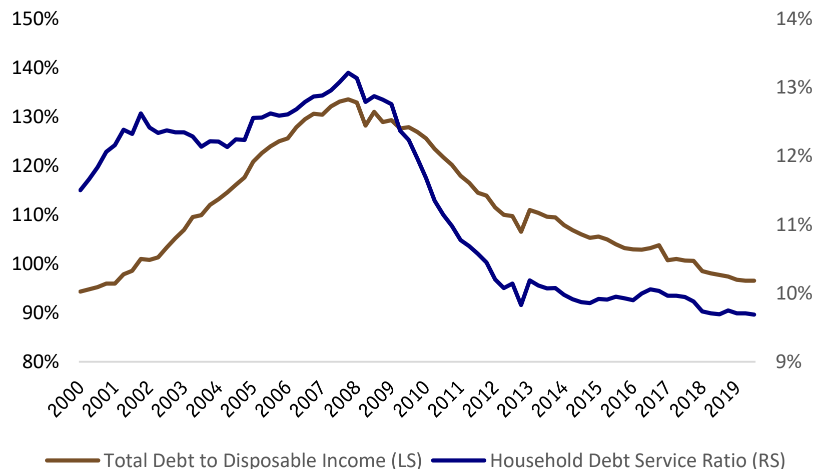


Sources: FactSet, Bloomberg, Federal Reserve FRED.

U.S. Consumer: Confident and Able to Spend







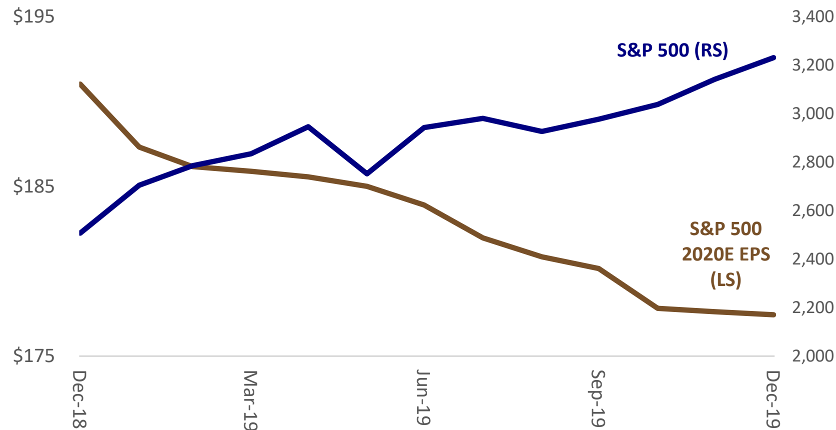
U.S. consumer confidence is elevated and at odds with CEOs (top left). A large divergence has developed between the confidence of consumers and those running U.S. corporations. The U.S.-China trade dispute and associated global manufacturing malaise has cleary hurt the corporate spirit (and spending). Which way this divergence closes is shaping up to be the story of 2020.

Initial jobless claims are key to confidence (top right). Jobs and confidence go hand-in-hand. Once consumers sense their job (income) is in peril, confidence and spending can rapidly decline. If CEO confidence remains weak, layoffs could be on the horizon.

Consumer finances appear to be in good shape (bottom left). Consumer debt metrics have improved dramatically over the past decade. If desired, the capacity to increase debt is there for consumers. A solid job market and low interest rates offer support for continued spending and possible debt expansion.

Source: FactSet

S&P 500 Valuation and 2020 Earnings



2020 Earnings Estimates More Reasonable (top left). 2020 estimated earnings for the S&P 500 have come down from $191 to $177 over the last year. The reason for this decline can be attributed to slower GDP growth post the stimulus from US tax cuts, the impact of the trade war on global industrial manufacturing, and muted economic conditions abroad. We believe 2020 earnings estimates are more reasonable as companies have adjusted expectations for this year and we are likely to see a more balanced economy between the consumer and industrial activity.

The Market Is More Dependent on Earnings Growth in 2020 (bottom left). The Fed's monetary stimulus in 2019 had a positive impact on the equity markets with valuations moving higher despite earnings moving lower. With the Fed on hold for the foreseeable future, the equity markets will more likely depend on earnings growth. As such, we highlight that the range of earnings growth for the market could be between 5% and 10% with valuation multiples staying within the current range of 17x to 19x. This would generate lower returns compared to the strong gains we experienced in 2019.

Projected S&P 500 Level based on 2020 EPS Estimate

2020 EPS Y/Y Growth	14x	15x	16x	17x	18x	19x	20x
	P/E Multiple						
15.0%	2,611	2,797	2,984	3,170	3,357	3,543	3,730
10.0%	2,497	2,676	2,854	3,032	3,211	3,389	3,567
5.0%	2,384	2,554	2,724	2,894	3,065	3,235	3,405
0.0%	2,270	2,432	2,595	2,757	2,919	3,081	3,243
-5.0%	2,157	2,311	2,465	2,619	2,773	2,927	3,081
-10.0%	2,043	2,189	2,335	2,481	2,627	2,773	2,919
-15.0%	1,930	2,067	2,205	2,343	2,481	2,619	2,757

S&P 500 Consensus Earnings:

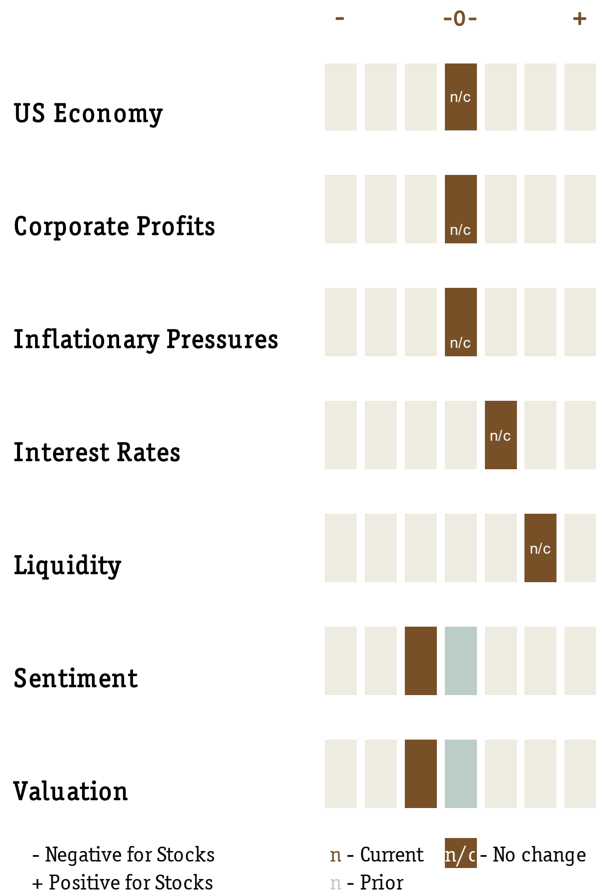
2018 Actual	$160
2019Estimated	$162
2020Estimated	$177

Sources: FactSet, Bloomberg

Macro Economic Scorecard

December 31, 2019

The US economy remains resilient, while global economies are stabilizing. Valuation is a headwind, but persistently low interest rates provide stocks a pathway to move higher. The Presidential election is approaching and could spark volatility. Financial markets are uncomfortably reliant on global central bank accommodation; higher inflation would threaten this heretofore beneficial equilibrium



US Economy: The US economy continues to expand at near 2% (real) growth. Manufacturing continues to lag the broader economy; a near-term manufacturing rebound is key to sustaining growth.

Corporate Profits: Corporate profits have been flattish in 2019. Profit growth could prove challenging in 2020 as margins are pressured by rising costs. This is often the case in maturing economic cycles.

Inflationary Pressures: Overall Inflationary pressures remain well-contained for now. The price of oil remains an outsized influence on inflation; supply side issues with oil could present an upside surprise.

Interest Rates: The Fed is on hold. The fed funds rate is currently at 1.50% - 1.75%. Interest rates are historically low and likely to remain low due to increasingly elevated global debt levels.

Liquidity: Illiquidity in the overnight repo market was a catalyst for the Fed to again expand its balance sheet. Since September, the Fed has unwound 57% of its earlier 2-year tightening program.

Sentiment: Volatilty remains historically low as central banks continue their ongoing efforts to appease recognizable threats via unprecendented monetary accomodation. Complacency is elevated.

Valuation: Valuation levels are stretched. However, strong free cash flow yields are selectively available, oftentimes due to a lessening of capital-intensity in our increasingly "digital" economy.

Madison Macro View - Fourth Quarter 2019

Summary

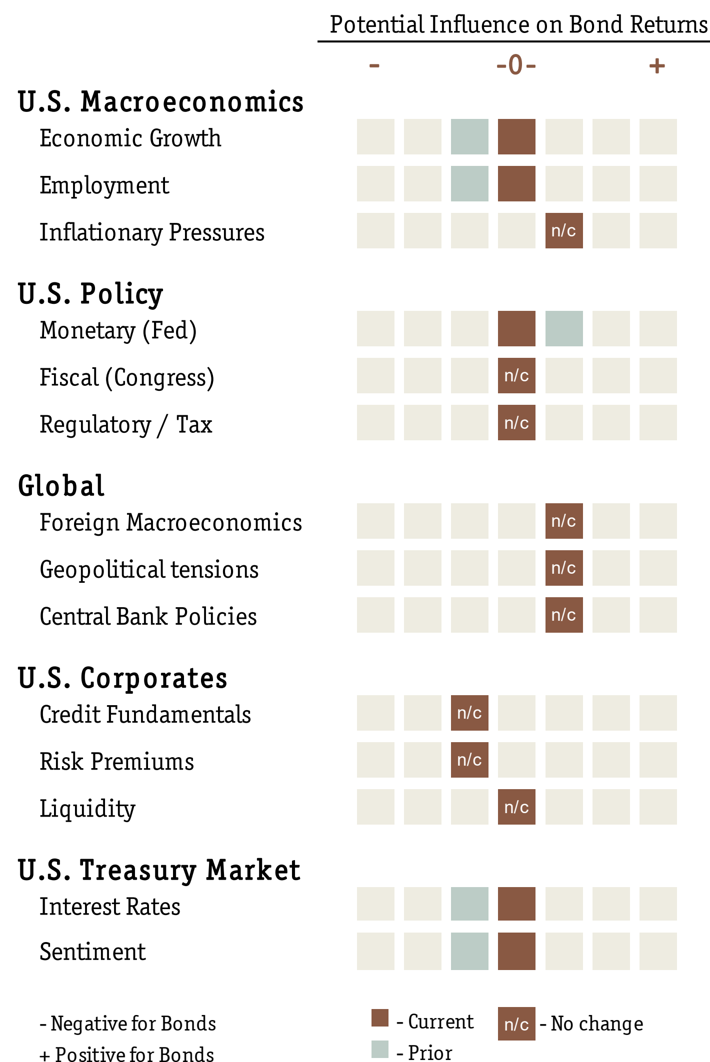
We anticipate the U.S. economy will grow at a moderate pace during 2020 as steady consumer and business confidence offset possible downside risks associated with global uncertainties. The Federal Reserve Bank has signaled its intention to hold rates steady for the foreseeable future as long as financial conditions support their policy mandates. The upcoming presidential balloting should have no bearing on the central bank's actions as the Fed has historically done what they think is right during election years. Consumer strength continues to drive economic growth, supported by the lowest unemployment rate since 1969 along with relatively low levels of financial obligations including household debt. Currently, broader-based GDP growth seems hindered by businesses maintaining a cautious stance due to on-going trade and tariff concerns. We believe a more permanent trade resolution would bolster confidence in global manufacturing and agricultural output. In this regard, we're monitoring purchasing manager surveys and key commodity prices for signs of improving conditions. Although rates could persist near current levels given inflation remains near the Fed's 2% target and global rates remain low, we foresee U.S. interest rates shifting higher in coming quarters in response to consistent economic growth, wage gains and increased U.S. Treasury issuance. Within the corporate sector, investor complacency appears prevalent. Risk premiums seem limited given deteriorating credit metrics and therefore, we plan to sustain our up-in-quality bias.

Catalysts for lower u.s. rates (+ for bond returns)

- Unresolved trade negotiations weigh heavily on business confidence and investment.
- U.S. consumer strength diminishes should employment gains weaken.
- Slower global growth negatively impacts prospects for U.S. exports.
- Volatility within risk markets (including corporate credit) increases Treasury demand.

Catalysts for higher u.s. rates (- for bond returns)

- Global growth rebounds should trade issues be resolved and confidence improve.
- The Fed tightens policy in response to wage gains and/or a major rise in commodity prices.
- Stronger global economic growth decreases foreign flows into U.S. assets.
- Increasing U.S. deficits results in substantial U.S. Treasury issuance.



Sources: Madison

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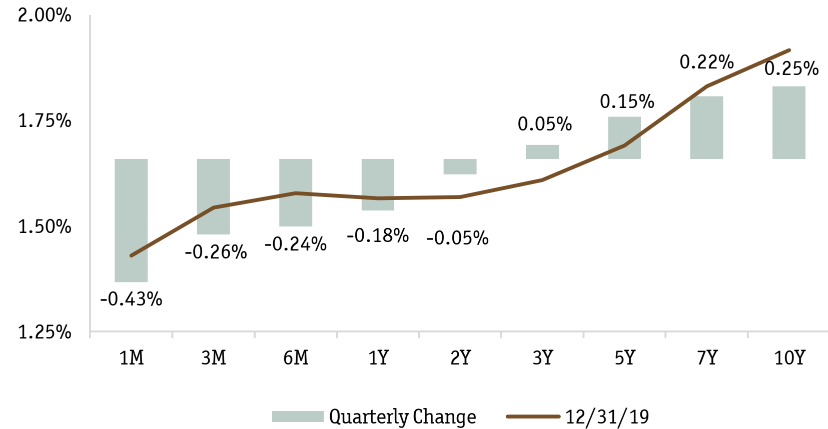
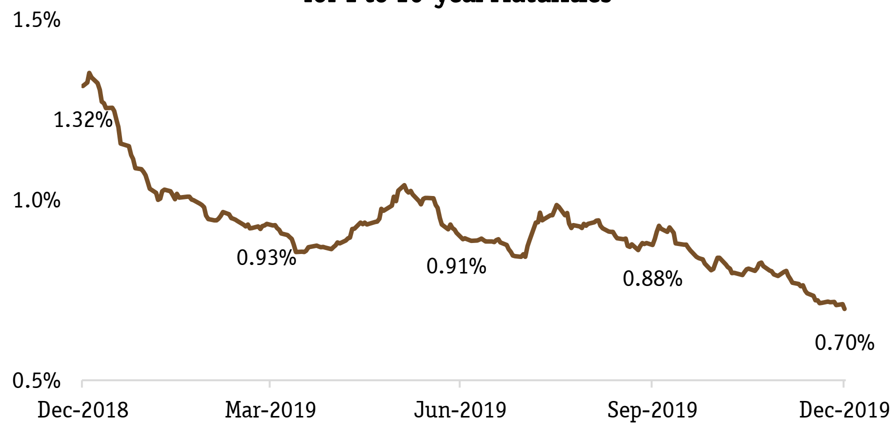
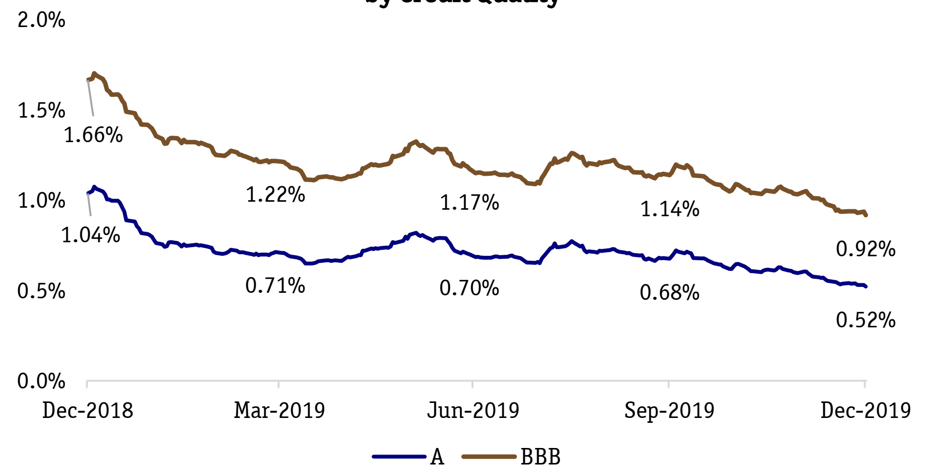
Rate and Spread Snapshot - Fourth Quarter 2019





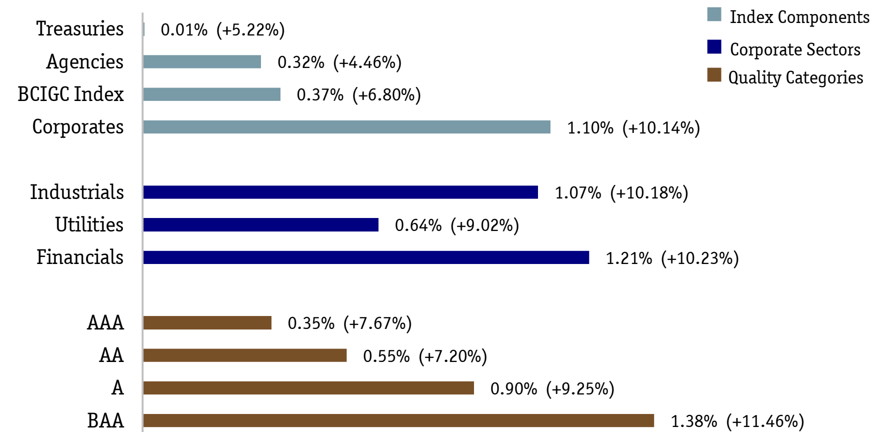


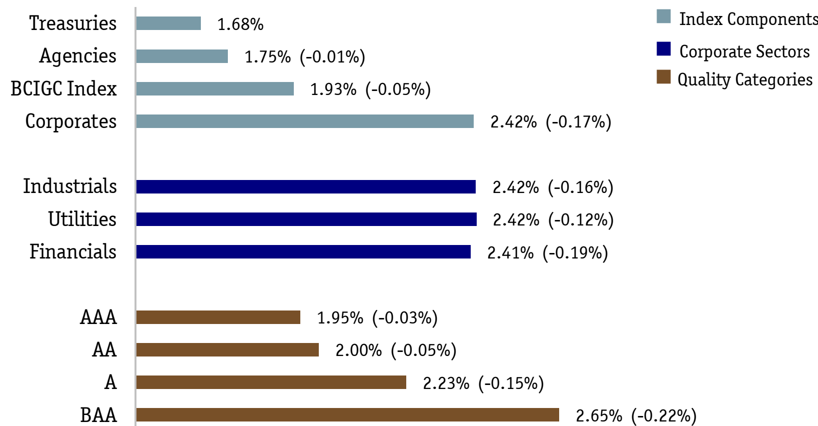
Sources: Madison, Bloomberg, Bloomberg Barclays

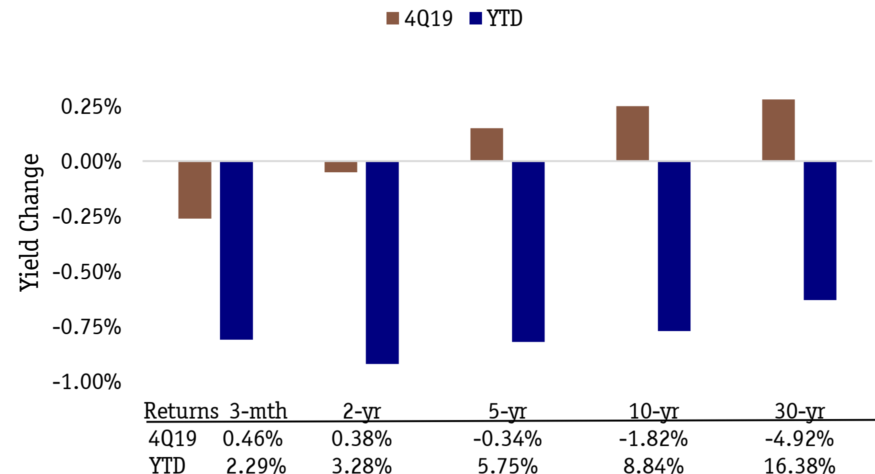
Performance Update for the Fourth Quarter 2019

Asset Class Returns

Asset Class	Market Sector	4Q19	YTD (12/31/19)
Money Market	3-month Tbill	0.5%	2.3%
Fixed Income	US Aggregate (1-30 yr)	0.2%	8.7%
	Intermediate Gov/Credit	0.4%	6.8%
	Municipal Bonds (1-30 yr)	0.7%	7.5%
	TIPS (1-10 year)	1.0%	6.9%
	EM Aggregate	2.1%	13.1%
	US High Yield	2.6%	14.3%
Equities	S&P 500 INDEX	9.1%	31.5%
	Russell 3000	9.4%	31.4%
International Equities	Europe, Asia, Far East	8.2%	22.8%
	Emerging Markets	11.7%	18.6%
Commodities	Gold	3.3%	18.0%
	Commodities	4.0%	5.4%
	Crude Oil	16.2%	35.6%





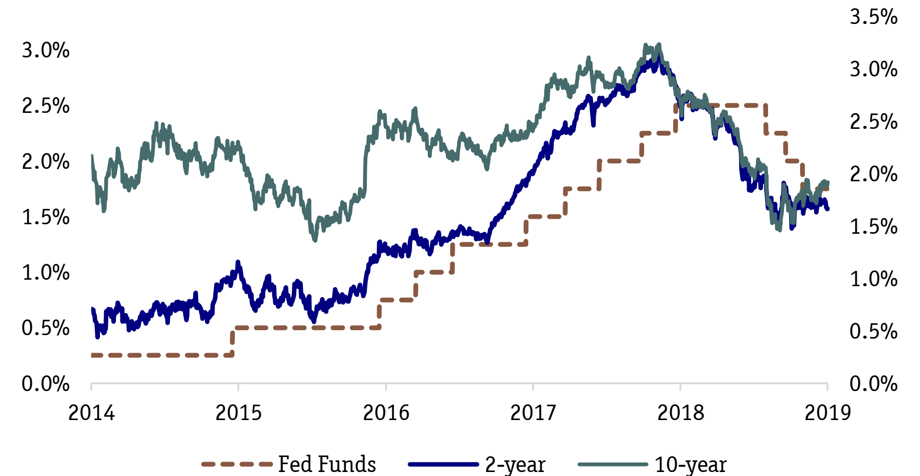


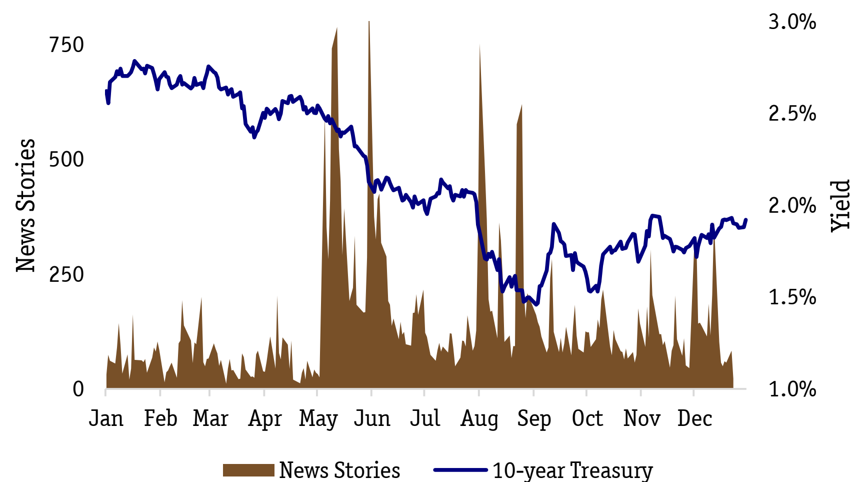
Returns	3-mth	2-yr	5-yr	10-yr	30-yr
4Q19	0.46%	0.38%	-0.34%	-1.82%	-4.92%
YTD	2.29%	3.28%	5.75%	8.84%	16.38%

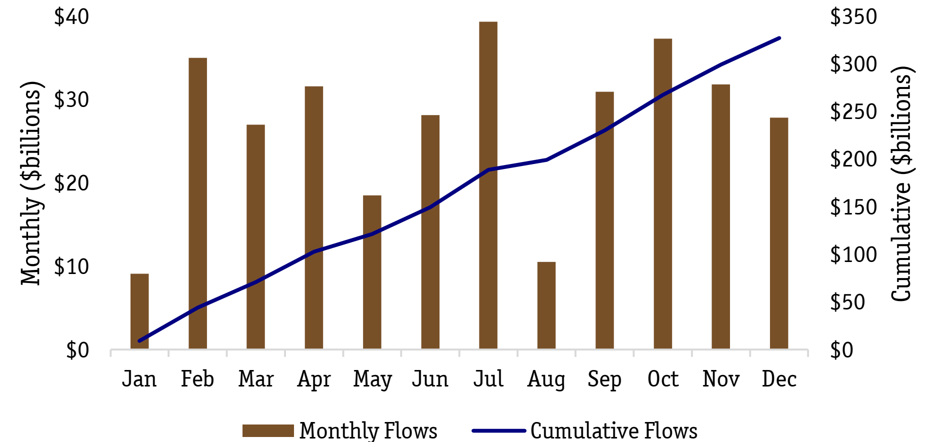
Sources: Madison, Bloomberg.

Factors Influencing Fourth Quarter 2019 Returns

Fourth quarter returns were primarily driven by Federal Reserve policy decisions, uncertainty specific to global trade policies and investors allocating funds into fixed income vehicles. Returns along the maturity spectrum differed as performance of shorter maturities (less than 5 years) benefited from stable to lower yields while prices on longer maturities declined as yields rose and the slope of the yield curve steepened.







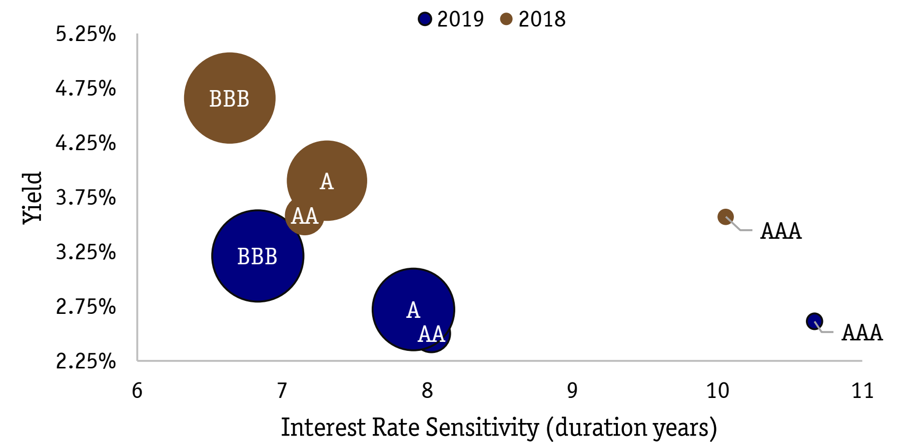
Sources: Madison, Bloomberg

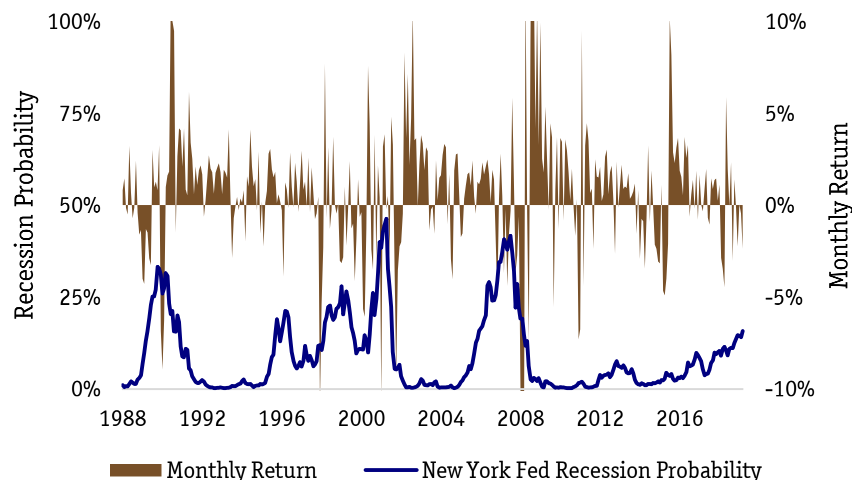
Risk Outlook - Fourth Quarter 2019

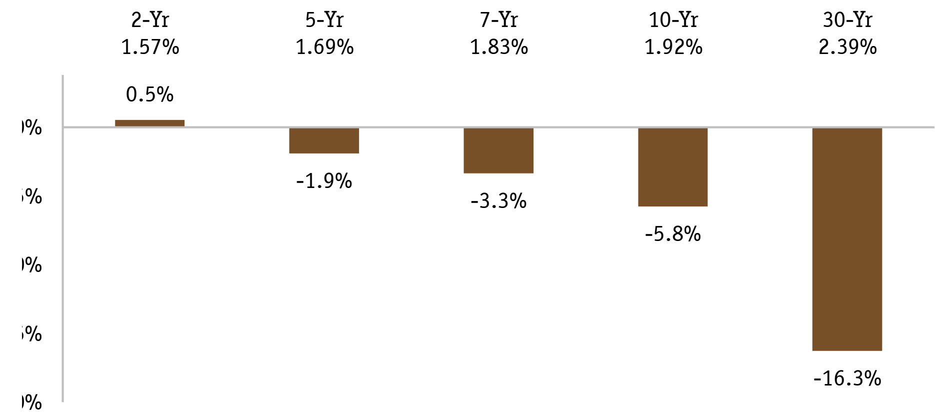
We believe risk within the fixed income market continues to increase and we caution investors to remain vigilant in terms of evaluating credit metrics and yield curve positioning. As shown at right, during 2019 investors collectively increased exposure to interest rates while accepting lower compensation (i.e. yield).

Below is the performance of CCC-rated bonds which is often a precursor for what may occur within the investment grade corporate bond market. This year's abysmal performance for CCC-rated bonds may be an aberration due to stellar 2018 CCC-rated returns and misinterpretation of U.S. recessionary signals, but it warrants attention.

In our opinion, Treasury valuations remains too high given the favorable economic backdrop. Similarly, many corporate issues appear fully valued despite the presence of warning signs.







Sources: Madison, Bloomberg

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Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 35% of the total market capitalization of the Russell 1000® Index. As of the latest reconstitution, the average market capitalization was approximately $3.7 billion; the median market capitalization was approximately $2.9 billion. The largest company in the index had an approximate market capitalization of $10.3 billion.

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January 14, 2020

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The Bloomberg Barclays Intermediate Govt/Credit Bond Unmanaged index that tracks the performance of intermediate term US government and corporate bonds.

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Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Market Index: The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

January 14, 2020