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John C. Robinson
Chief Executive Officer
Tel: 404-883-2577
john@consequentcm.com

Capital Markets Review and Outlook

By: Cyril M. Theccanat, Chief Investment Officer

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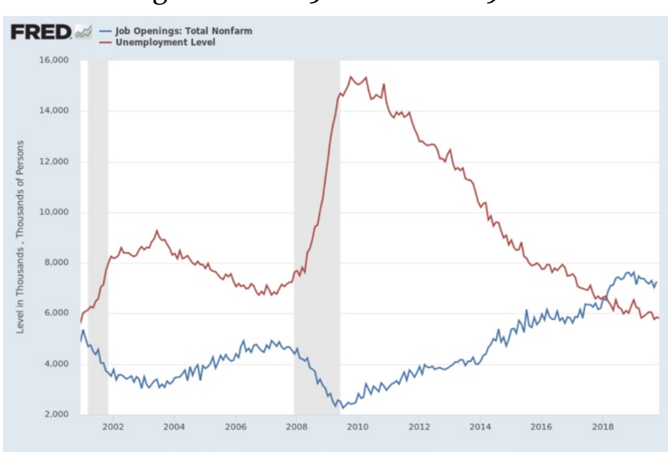
Economy and Outlook

2019 ended on a positive note with the removal of a wide range of uncertainties in key areas. A Phase One trade deal was reached between the United States and China culminating over 1 1/2 years of turmoil in trade negotiations between the two countries. On the North American trade front, there was bipartisan support for a USMCA trade accord between the United States, Mexico and Canada to replace the former NAFTA trade agreement. In Britain, a decisive general election win by the Conservative party assured a speedy and orderly Brexit agreement between the UK and the European Union. Lastly, the White House reached a budget deal with Congress to avoid a government shutdown. The removal of all these uncertainties is positive for both business and consumer confidence. Furthermore, after the FOMC's last meeting for 2019 in December, the Federal Reserve signaled that it was on hold on interest rates for a longer period than it had previously indicated. No interest rate hikes are now expected in 2020. Monetary policy accommodation is also unfolding globally in the form of interest rate cuts and balance sheet expansions by global central banks. Additionally, governments are embarking on fiscal stimulus. Japan has approved $120 billion in spending, while other countries ranging from the United Kingdom and Germany to Korea and Hong Kong are also implementing or considering spending measures. With all these favorable developments, investors' fears about an impending recession have faded away. Global economic growth is also picking up. The International Monetary Fund (IMF) expects the global economy to grow by 3.4% in 2020 after slowing down to a 3% rate in 2019. In the United States, the resiliency of the economy is underscored by the continued firmness in employment. While an unemployment rate at 50-year lows has grabbed the news headlines, the chart on the left shows that the number of available jobs in the U.S. exceeds the number of unemployed Americans continuing a trend seen since early 2018.



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Although the backdrop for risk markets now appears constructive across the board, there are various signs for caution. On the geopolitical stage, the continuation of violent protests in Hong Kong and renewed tensions in the Korean Peninsula and in the Middle East are sources of concern. The upcoming U.S. presidential and congressional elections are another area of uncertainty, especially with the polarized and contentious rhetoric surrounding the election campaigns. At a more fundamental level, there are concerns about rising debt levels and leverage. For example, over the past 10 years, the amount of debt held by U.S. consumers tied to auto loans has almost doubled to $1.3 trillion. Meanwhile, the delinquency rate in subprime auto loans has more than doubled to almost 8%. In China, private sector companies are defaulting on bonds in record numbers. While private sector company bonds only account for 10% of the total corporate bond market in China, the default and profitability trends are worrisome. Rising budget deficits in the world's largest economy are also an area of concern. The U.S. federal budget deficit is projected to exceed $1 trillion over each of the next ten years. After the strong performance in risk markets in the first decade of the 21st century, risks are rising for a market reversal in the short to medium term.

Equity Markets

The equity markets continued their streak of positive returns with the broad domestic equity market represented by the Russell 3000 Index posting a return of +2.9% in December. For the full year of 2019, the Russell 3000 Index rose an astonishing +31% bringing once again to reality the old adage of a 'market climbing a wall of worry'. 2019 was indeed a year marked by potholes of 'worry' ranging from trade wars and impeachment hearings of a U.S. president to weakening global economies. In terms of performance by market capitalization, Small Cap's three-month streak of outperformance over Large Cap ended in December. While Small Cap underperformed Large Cap by just -1 bp for the month, Small Cap outperformed by +90 bp for the fourth quarter. For the full year, however, Large Cap continued its extended dominance with an outperformance of +590 bp. Historically, the underperformance of Small Cap has continued for a prolonged period - for the past 10 years, Small Cap has underperformed Large Cap by an annualized -171 bp per year. From a style perspective, there was a differentiation by capitalization. While Growth continued its outperformance over Value in the Large Cap space with an outperformance of +27 bp in December, Value outperformed Growth in Mid Cap and Small Cap by +187 bp and +121 bp respectively. However, for the fourth quarter as well as for the full year, Growth retained its outperformance over Value across all capitalizations. For calendar year 2019, the outperformance of Growth over Value ranged from +610 bp to almost +1,000 bp. Similar to the long-term underperformance of Small Cap, the underperformance of

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Value has also persisted over the long term. For the past 10 years, Value has underperformed Growth by an annualized -335 bp per year. Stock sector performance in December continued the general trend seen in 2019. Cyclicals outperformed Defensives for the most part on continued investor buoyancy; this marked the fourth consecutive month of outperformance for Cyclicals. Technology was the leader both for the month (+4.5%) and for the year (+50.3%), while Industrials was the worst performer (-0.1%) for the month. Though considered Defensive, Energy was the best performer in December with a return of +6.0% on rebounding oil prices as OPEC+ reached an agreement to further curtail supply. However, for the year, Energy had the lowest sector return (+11.8%).

International equity markets outperformed the U.S. for the month on improving economic growth and relative value prospects as well as a weaker U.S. dollar. The MSCI Developed Markets equity index increased +3.3% in December which brought its return for 2019 to +22%. Emerging Markets rocketed +7.5% for the month and ended the year up +18.4%.

Fixed Income Markets

The continued rally in equity markets pushed Treasury yields higher with long maturity yields rising by +14 to +18 bp. However, interest rates on shorter maturities declined on the Fed's stated view that official interest rates were likely to remain unchanged in 2020. As a result, the Treasury yield curve resumed its steepening trend with the 2-year/10-year Treasury yield spread differential widening by +17 bp to end the quarter at +34 bp.

Mirroring the strong performance in the equity markets, corporate bond spreads tightened for the fourth consecutive month. The spread on the Bloomberg Barclays Investment Grade credit spread closed below 100 bp at 90 bp resulting in an outperformance over duration-matched Treasuries of +111 bp. Risk-on investor sentiment was reflected in a flattening of both the corporate credit curve and the quality curve. Long maturity corporate bonds outperformed short and intermediate-term issues by an average of +143 bp, while the BBB-rated sector outperformed higher quality sectors by an average of +84 bp for the month. Reflecting the sharp rally in energy prices, energy-related sectors were the best performers in December. The sectors representing Oil Field Services, Midstream and Exploration & Production outperformed Treasuries by an average of +250 bp. The worst performing sectors for the month were Supranationals and Home Construction with excess returns of 0 bp and +18 bp respectively. The High Yield market ended the year on a strong note.

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Despite rising Treasury yields, the Barclays U.S. High Yield Index posted a total return of +2% for December which brought its return for the full year to +14.3%. The recent streak of underperformance in lower quality high yield credits ended as the CAA-rated index outperformed higher quality high yield sectors in December. The total return for the CCC Index was 5% compared to +1.2% for the BB-rated index. However, for the full calendar year, the lower quality sectors underperformed by a significant margin - the CCC-rated return for 2019 was +9.5% compared to +15.5% for the BB-sector. Despite higher yields across developed markets, the weaker U.S. dollar enabled the non-dollar government bond market to outperform in December with a return of +0.8% compared to -0.6% for the U.S. Treasury index. However, for the full year 2019, the non-dollar government bond market's return of +5.3% trailed the Treasury Index's return of +6.9%.

			Returns as of 12/31/19 (In %)			
		Month	QTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	2.9	9.1	31.0	14.6	11.2
Russell 1000®	US Large Cap Equity	2.9	9.0	31.4	15.0	11.5
Russell 1000® Growth	US Large Cap Growth	3.0	10.6	36.4	20.5	14.6
Russell 1000® Value	US Large Cap Value	2.8	7.4	26.5	9.7	8.3
Russell Midcap®	US Mid Cap Equity	2.3	7.1	30.5	12.1	9.3
Russell Midcap® Growth	US Mid Cap Growth	1.2	8.2	35.5	17.4	11.6
Russell Midcap® Value	US Mid Cap Value	3.0	6.4	27.1	8.1	7.6
Russell 2000®	US Small Cap Equity	2.9	9.9	25.5	8.6	8.2
Russell 2000® Growth	US Small Cap Growth	2.3	11.4	28.5	12.5	9.3
Russell 2000® Value	US Small Cap Value	3.5	8.5	22.4	4.8	7.0
MSCI ACWI ex-US	Global Equity ex-US	4.3	8.9	21.5	9.9	5.5
MSCI EAFE	Global Developed Mkts Equity	3.3	8.2	22.0	9.6	5.7
MSCI EM	Emerging Mkts Equity	7.5	11.8	18.4	11.6	5.6
Bloomberg/Barclays US Agg	US Core Fixed Income	-0.1	0.2	8.7	4.0	3.0
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	0.2	0.5	6.7	3.3	2.6
Bloomberg/Barclays US Credit	US Corporate Bonds	0.3	1.1	13.8	5.8	4.4
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	0.3	0.7	6.4	3.2	2.6
Bloomberg/Barclays US Corp HY	US High Yield	2.0	2.6	14.3	6.4	6.1
FTSE Non-US WGBI	Global Fixed Income ex-US	0.8	-0.1	5.3	4.5	1.9