ASTOR INVESTMENT MANAGEMENT

FUNDAMENTALLY DRIVEN.

OUTLOOK 2020

"...gonna party like it's nineteen ninety-nine"
- from "1999" by Prince

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2019 can be summed up like this: stocks went up, and we didn't have a recession. For much of 2019, though, there were two camps. On one side of the fence were those (not including Astor) who believed the economy was weak and the market's steep decline in early October 2018 had signaled the start of something far worse. An inverted yield curve led to several forecasts of recession, and technical traders were getting signals that it was time to get short.

In the other camp were those who thought weakness in late 2018 amounted to an exaggerated move, and there was more upside to be had as the U.S. economy continued to grow. Thanks to our proprietary Astor Economic Index® (AEI), we were firmly in this camp. Although the rate of economic growth did slow over the course of 2019, the economy remained at or around "average" growth, which hardly signaled a recession or a reason for sustained market weakness.

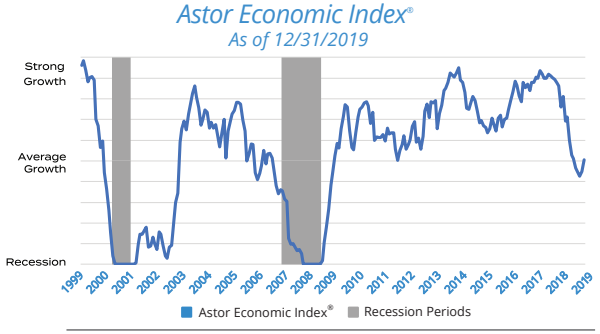

Chart 1: Astor Economic Index (AEI)

When looking at the AEI (see Chart 1), it's clear the economy was growing at an average pace in 2019 (and continues to do so as of this writing). The pace of that growth, however, was visibly below what it had been a year earlier. Based on that economic reality, we at Astor made the decision to reduce high levels of beta (exposure to stocks) in our portfolios, starting in June 2019. We did not eliminate equity holdings; rather, we de-risked our portfolios, while still maintaining some equity exposure.

Fortuitously, the market recovered from Q4 2018 lows (and then some) before we began to reduce exposure. This was not some "lucky timing"—we don't time at all, nor do we ever want to give that impression. Rather, based on the AEI and our economic analyses, we would have made the same beta adjustments, whether the market recovered or not.

As the AEI indicated, the second half of 2019 was still a good time to hold stocks. The market resumed its upward climb (see Chart 2), then began to accelerate in October 2019; the S&P 500 gained nearly 3% in December alone.

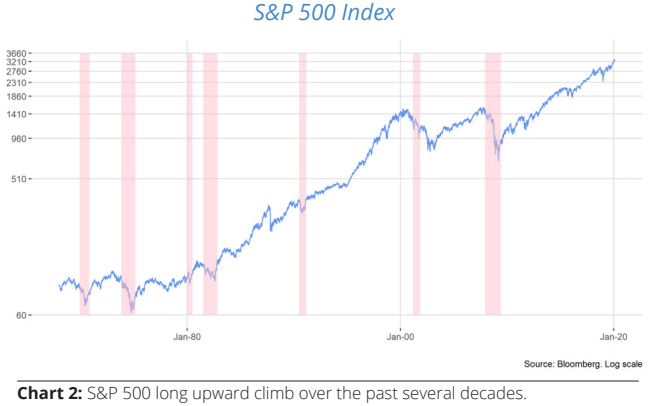

Chart 2: S&P 500 long upward climb over the past several decades.

It's interesting to note, however, that the last leg of the upward move in 2019 eerily correlates with the additional liquidity the Fed added to the overnight market (see Chart 3). It wouldn't surprise me or even change my view (unless fundamentals changed) if a portion of that rally was retraced until economic fundamentals accelerated. If that occurs, it could provide an opportunity to add more exposure to equities.

M2 and S&P 500 MoM % Change, 12m Rolling Mean

Chart 3: Money supply (M2) and S&P 500.

Additionally, it's important to note that not all markets achieved new highs in 2019. In fact, very few of them did as Chart 4 illustrates.

World Markets

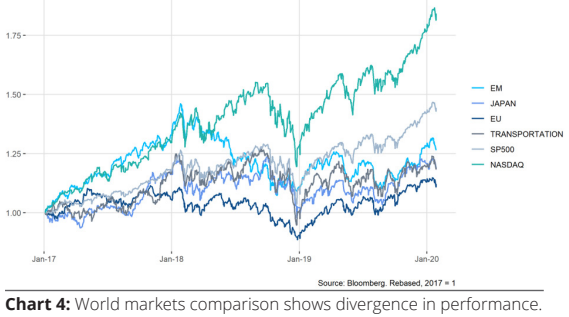

Chart 4: World markets comparison shows divergence in performance.

While very few markets surpassed their 2018 highs, let's focus on several factors specific to the S&P 500 particularly in late 2019. As we all know, though it bears repeating, markets don't like uncertainty. Months of fear and uncertainty from trade wars triggered market volatility and recessionary fears until a trade agreement was finally reached with China. That calmed fears in the market, along with the realization that the trade war wasn't having a widespread impact on the $20 trillion U.S. economy.

A bigger factor, as discussed above, was liquidity added by the Fed—a theme that continues into 2020, and hence the parallel we're drawing to 1999 (more on that in a moment). First a recap: The Fed raised interest rates in December 2018, then did a quick about-face on rate policy, lowering rates three times in 2019. While Fed Chairman Jerome Powell described it as a "mid-cycle adjustment," it might more accurately be described as a "do over." The market rallied on the 2019 rate cuts, then really zoomed as the Fed added fuel to the fire.

In October 2019, the overnight "repo" market (balances that banks trade with each other to square up their balance sheets) essentially froze. The Fed immediately added substantial liquidity to address what it called "technical issues." Months later (as of this writing), the Fed is still adding massive amounts of liquidity to the overnight market, almost daily. While the Fed didn't call its actions "quantitative easing" (QE), the injection of significant liquidity had a similar impact on stock prices as QE did back in the Fed intervention days, with new all-time highs reached in the S&P 500, Dow, and Nasdaq in late 2019.

Just because the Fed put a Band-Aid on the overnight market doesn't disguise the fact that it is broken, and a more permanent solution is needed. While the Fed has not telegraphed when or if it will stop intervening in the overnight market, I can foresee a different solution: reversing the practice of paying interest on excess reserves (IOER), which the Fed began in late 2008. It seems logical to me that if the Fed stopped this practice, there would be more liquidity in the overnight market; however, that action would be less favorable for the stock market and might also be the beginning of banks reaching for yield. Something to think about....

THE LOOK AHEAD: PARALLELS TO 1999

With the Fed standing ready to act on liquidity and interest rates, it may appear that nothing can materially impact the economy (and the stock market). As I see it, this liquidity has been finding its way into risk assets. It seems possible in my opinion that the additional liquidity is increasing traders' ability to take on larger positions, and maybe even with additional leverage.

This is reminiscent of 1999, when the Fed pumped liquidity into the system because of Y2K fears—the concern that the "00" year could result in massive computer system shutdowns. At the time, the Fed said it would provide as much as an extra $50 billion in cash to banks. The Y2K liquidity injection coincided with the last gasp of the tech bubble. To recap briefly, as the year 2000 got underway, the dotcom economy was looking unstoppable. On March 10, 2000, the tech- and internet-dominated Nasdaq Composite reached a peak at 5048.62, then began to decline and finally crashed (the index reached a low in August 2002 below 1200).

During this time, cracks in the economy also began to become more visible. As the economy weakened in 2000, our proprietary indicators raised concerns about the health of the economy. While no one could have predicted the tragic events of Sept. 11, 2001, the aftermath pushed the already weakened U.S. economy into recession.

This, I believe, is where today's parallel to 2000 diverges. The current state of the economy appears stronger as of this writing than we saw in 2000. To say it another way, the support beams in today's diversified economy are stronger than two decades ago—strong enough even to withstand and recover from the impact of a tragic event should one occur.

However, a continuation of the low interest rate, high liquidity environment that we've seen in the U.S. will likely not have the same desired impact in the future. We may have gotten all we can from lower rates. In fact, it's possible the additional liquidity and lower rates acted like an antibiotic to curing the economy and hence the stock market. So, is it possible that now the economy has built up an immunity to lower rates? We will see, I guess.

One more thing to note: as we look at countries outside the U.S. that have embarked on negative interest rate policies, those actions have not produced the desired growth.

AS FOR WHAT 2020 MIGHT BRING, HERE'S THE QUICK SUMMARY:

Equities

We would not be surprised to see the markets on either side of "0," which in the aggregate would still confirm that above-average amounts of beta were the right portfolio position for the last few years. We do not foresee changing our beta levels unless the economy drops below "average growth." Given the strength and duration of the current bull market, even if equities were to drop, say, 10% from here, the net gain would still be significant. Depending on where you measure, the overall gain might change from +30% to +20%, but that's hardly a reason to complain. As we've said, and it bears repeating, we're not market timers, nor do we predict price targets or return levels. While we do want to own stocks when the economic conditions are favorable, whether the return is 5% or 50%, we make the most of what the market gives us.

Beta Levels

Beta exposure isn't a switch—on or off. It's a dial, like a thermostat. We're comfortable with current levels of beta, particularly if economic growth does slow further. If that occurs, we're only a mouse click away from reducing beta materially or even getting defensive in our portfolios.

Tough Economic Data Comparisons

While some indicators (like ISM) have been weak others have been incredibly strong—unemployment is at 50-year lows. As we enter the new decade, this makes for tough comparisons that will make great data look only good—and good data look average.

Manufacturing/ISM

While the economy didn't deteriorate in 2019, there were certain components that needed to be watched closely. One area of concern was manufacturing, which brought monthly ISM manufacturing reports into sharper focus (see Chart 5). The PMI (Purchasing Manager's Index) has been below the 50-level since August, and in December came in at 47.2 percent, the lowest level since June 2009. Within manufacturing, autos were arguably in a contraction during 2019 due to rising costs and weaker sales. The impact of weakness in manufacturing, however, was counterbalanced with strength elsewhere, such as technology and the service sector. This decade the ISM service sector deserves closer attention.

ISM Manufacturing & Services Index

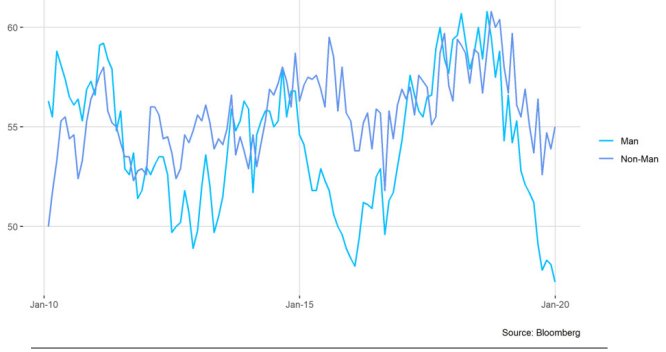

Chart 5: ISM Manufacturing Index (aqua line) shows steep decline in 2019, vs strength in Services Index (non-manufacturing).

Inflation

The Fed is committed to keeping interest rates low with a 2% inflation target. However, there are other factors that can creep into inflation. With the job market so tight, and wages inelastic on the downside, even if the job market stops accelerating, employers won't be able to take back higher wages. Wages have grown about 3% per year for the past few years (see Chart 6). That's meaningful! (Wages are a key component to inflation, and it would seem difficult to achieve higher prices on all goods without more money in the system—particularly in the hands of consumers who account for 70+% of the overall economy.

Average Hourly Earnings & Inflation, YoY

Chart 6: Rising wages in a tight labor market could spark inflation going forward.

Dollar

It appears the dollar has found an equilibrium point (see Chart 7), and we would expect levels in 2020 will not deviate much from what we've seen in the recent past. Initially the dollar appreciated based on interest rate differentials favoring the U.S. and trade flows. However, as the balance sheets of other countries start to look better on a relative basis compared to the U.S. (in terms of debt levels, trade deficit, and unfunded liabilities compared to GDP and income levels), it would not surprise me if the dollar weakened. If/when that happens, hard assets would likely appreciate, at least temporarily.

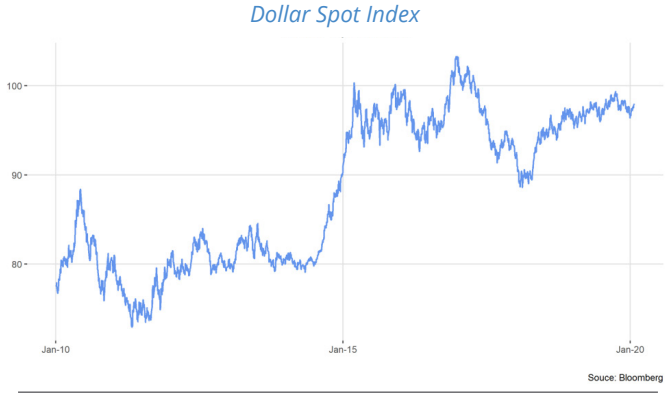

Chart 7: U.S. dollar finds its equilibrium—at least for now.

Housing

Real estate and housing are viewed differently these days than in the past, when the prevailing thought was "buy the biggest house you can afford and watch it increase in value." Today, housing is no longer viewed as a store of value that you ultimately retire on especially by millennials. Rather, housing is more aligned with people's real needs. There is also a growing discrepancy between new and existing housing, which is not too dissimilar to what has existed in the auto market. The adage that a new car starts depreciating the minute you drive it out of the dealer's lot can now be applied to housing, at least in some parts of the country. I have observed existing real estate is often "depreciated" compared with new construction (see Chart 8).

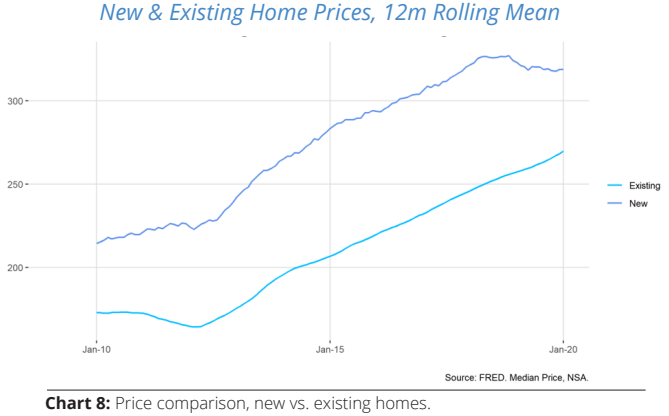

Chart 8: Price comparison, new vs. existing homes.

Emerging Markets

With the U.S. economy experiencing average economic growth and substantial market outperformance performance, we see the potential for emerging markets and other non-U.S. equities to play catch up (note these markets didn't make new highs in 2019). As a result, we're beginning to slightly favor emerging markets, in some cases over the U.S. Some emerging economies that clearly are not as mature as the U.S. have better balance sheets on relative terms.

THE DIVERSIFIED ECONOMY

As I wrap up this discussion, I want to return to the theme of the diversified economy. Large numbers of people today are employed in industries, sectors, and companies that did not even exist a decade ago when blockchain wasn't a household word and internet-of-things wasn't in the dictionary.

In the new economy, whenever and wherever contractions occur, they will likely be contained within certain industries and sectors. This a change from years past when a contraction in a major sector such as energy would impact other sectors and lead to a recession (which are contractions in multiple sectors). Given how diverse the economy has become, it's hard to see how even an energy market contraction will have a widespread effect. Looking ahead, if a recession occurs, it will most like be because of small contractions in multiple sectors simultaneously. The result would be shallower, though longer in duration, recessions.

IT'S BECOME MORE EFFICIENT TO BECOME EFFICIENT

A decade of change has occurred. When social, economic, and political changes converge, that's when real change occurs. Looking ahead (and as I'll discuss in more detail in upcoming reports), several influences could spark new and noteworthy changes.

It's becoming more efficient to be efficient, particularly as industries and sectors get disrupted by aggressive, nimbler competitors—disruptors, if you will. Smaller, newer companies are benefitting from technological advancements (think of small businesses that couldn't take credit cards in the past, but now can, thanks to an app). As a result of such efficiencies, margins could shrink.

Social changes are pushing political and economic agendas. For example, there has been a change in thinking, as articulated by the Business Roundtable, that the purpose of the corporation is to serve stakeholders, not just shareholders. What that will mean for investors remains to be seen. But when shareholders are not the only interest, it's possible that maximizing dollar profits could get compromised. However, and equally as important, other stakes will be impacted in a positive way; for example, better attention to environmental issues, a closing of the pay gap, better quality of life, and improved working conditions. These factors have an equally important value as maximizing dollar profits.

Another social/political/economic hot button is CEO compensation versus the average worker's pay. As I've explained in the past, labor, management, and capital come together to make a profit. Of the three, capital typically gets the preferential treatment because it's a scarce resource. But labor is going to be rewarded differently in a way that meaningfully closes the gap with CEOs. In my view, we are embarking on a period in which the rewards will be distributed differently among CEOs/executives, workers, and shareholders. Society is ready for a change of this magnitude, and so are politicians, which makes it more likely to become reality.

Last, but hardly least, is the potential fallout from the rush to passive investing. Passive investing—buy an index and wait—has become extremely popular in the current bull market (see Chart 9). But when the sell signals hit, all those passive investors whose portfolios are on autopilot will be heading for the exit door at the same time. As a result, a market dislocation or an economic speedbump could end up causing an exacerbated drawdown in the market that, in my opinion, could be material. My view is there will be clear signs before the next recession occurs with many options of safety. The passive investor who has had a good run could be at risk of being damaged the most. If passive truly was the best strategy all the time, economic rules would suggest no one would ever invest in the inferior product and they wouldn't exist. To be clear, investors must do their homework and feel comfortable with how much to allocate to an active strategy, but the benefits of doing are clear.

Continued on next page

Far better is staying watchful and alert, with an active approach. At Astor, we keep our finger on the pulse of the economy and closely monitor money flows into and out of the market. Our goal as active managers is to be poised and ready to react, not to every little zig or zag, but when the data show us something material is happening. At the risk of being self-serving, we believe the current environment makes a strong case for active management, to avoid the herd-mentality stampede of passive investing. ■

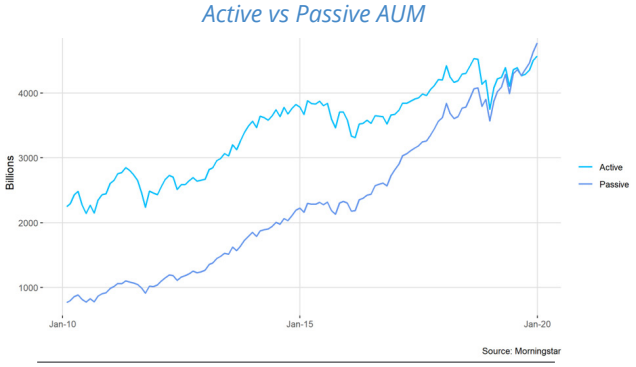

Chart 9: Active (top line) versus passive strategy assets under management.

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