ISSUE
19
DEC
2019

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December 2019 Commentary & Outlook

Optimism Continues

U.S. and Canadian stocks continued to extend their gains through the month of November and into December, with consumer and service-based sectors leading the charge.

Markets continued to push higher against a background of positive consumer sentiment surveys, low interest rates and supportive central banks, plus a favorable labour market overall, albeit recent Canadian employment numbers have turned sharply negative.

The U.S. and China continue to muddle along in their trade talks, with a short-term deal not to impose more tariffs and Trump now suggesting that there is not likely to be a full resolution until closer to the 2020 elections. However, with services rather than manufacturing now by far the dominant part of U.S. GDP, investors have largely shrugged off the receding prospect of any settlement.

Phase 1 and Done?

The China-U.S. 'mini-deal' announced just before mid-December headed off yet another round of tariffs, which were set to take effect December 15th.

While we had suggested in our December Portfolio Managers' Brief video that investors needed to be cautious ahead of the next phase of tariffs, much of that concern had been centered around the manufacturing sector. Although, with stock market returns being largely driven by strong consumer and services sectors, this prospect was having little impact on the current uptrend.

However, if realized, Trump's threat to impose additional tariffs on $156 billion worth of Chinese-made consumer goods just ahead of Christmas would have likely dampened U.S. consumer optimism, and thereby risked impacting the ongoing market rally.

Now, with an initial "Phase 1" trade agreement reached (albeit not signed) and the near-term risk of additional tariffs behind us, optimism continues to run at an all-time high and the stock market continues to get expensive as valuations stretch.

We think that there is still the potential for modest growth, but any sustainable premium must come from both increased corporate earnings and upward revisions to earnings-per-share forecasts into early 2020. This latest breakthrough in China-U.S. trade relations should help support this outlook.

Price Targets and Models

Financial market price targets based on macroeconomic models also call for a continued, yet modest climb. At the time of this writing, probabilities indicate that the Fed will hold interest rates steady until mid-year. At such a time, the chance of a rate cut vs. further holding becomes more balanced, and the likelihood of further equity market expansion will be more muted.

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Looking at macroeconomic drivers of earnings per share, new orders of capital goods are near a twelve-year peak and seem challenged to move higher. Manufacturing ISM numbers in the U.S., which are now below a level of 50, also suggest contraction, although still not low enough to threaten recession.

On a positive note, services ISM numbers remain resilient as do unemployment numbers. Nonetheless, macroeconomic drivers of equity EPS growth are not as strong as we'd like them to be.

Optimistic Yet Defensive

As we close out 2019, we continue to remain optimistic yet defensive in our portfolio management approach. Many of the risks that continue to underlie what appears to be an unshakeable bullish market have yet to be resolved.

Despite what appears to be some progress in China-U.S. trade relations, we believe there is a lot more work yet to be done and this, along with Brexit and a risk of a global recession, continues to be of moderate concern.

On the other hand, the impeachment of President Trump, which will almost certainly fail in the U.S. Senate, is likely to have little to no impact on the markets, other than perhaps shaking the support for Trump as he campaigns for another term.

Whether you love Trump or hate him, he is certainly hanging his hat on being the primary influencer for the success of the stock market over the last couple of years.

Democrats vs. Republicans

Where we do see the potential for disruption is around the Democrats' leadership race in the push toward the 2020 election. With the fiscal and monetary policies coming out of the Democrats' camp being less than supportive to big business, the potential for a Democratic Whitehouse means the stock market will likely remain sensitive to U.S. political events as they unfold.

January Pull Back Likely

The S&P 500 index has added 3.40% in November and another 1.60% for December so far. With nothing appearing to stand in its way in the short term, and not much time left in the year, this bullish run is likely to persist through the close of 2019.

However, stock markets never move in a straight line and the further the stretch, the higher the probability of a pull back. Based on technical analysis, the stock market in general is overdue for a retracement, perhaps in January, which we will look to as an opportunity for reinvestment.

So, based on our continuing analysis of market risk and opportunity, we are set to remain actively defensive in managing assets through the close of 2019 and into the first quarter of 2020.

This approach will include taking profits as company valuations continue to stretch, being selective in which companies we

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invest in, having more cash on hand to take advantage of pullbacks, and supplementing with tactical option strategies to help enhance returns and reduce overall portfolio volatility.

Cautiously Optimistic

While such caution has its costs and we have slightly underperformed the major equity indices to date, we feel our defensiveness this year has been warranted, given the underlying macro and geo-political risks, and should, in the medium-to-longer term, result in better overall returns for our clients.

All the Best to You and Yours!

In closing, on behalf of the Croft Financial Group, we would like to wish you and your family the best over the holidays and a healthy, happy and prosperous New Year!

R N Croft Financial Group
1.877.249.2884
www.croftgroup.com

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