2020 Market Preview

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MarquetteAssociates

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2020 Market Preview

U.S. Economy

SIGNS OF SLOWING?

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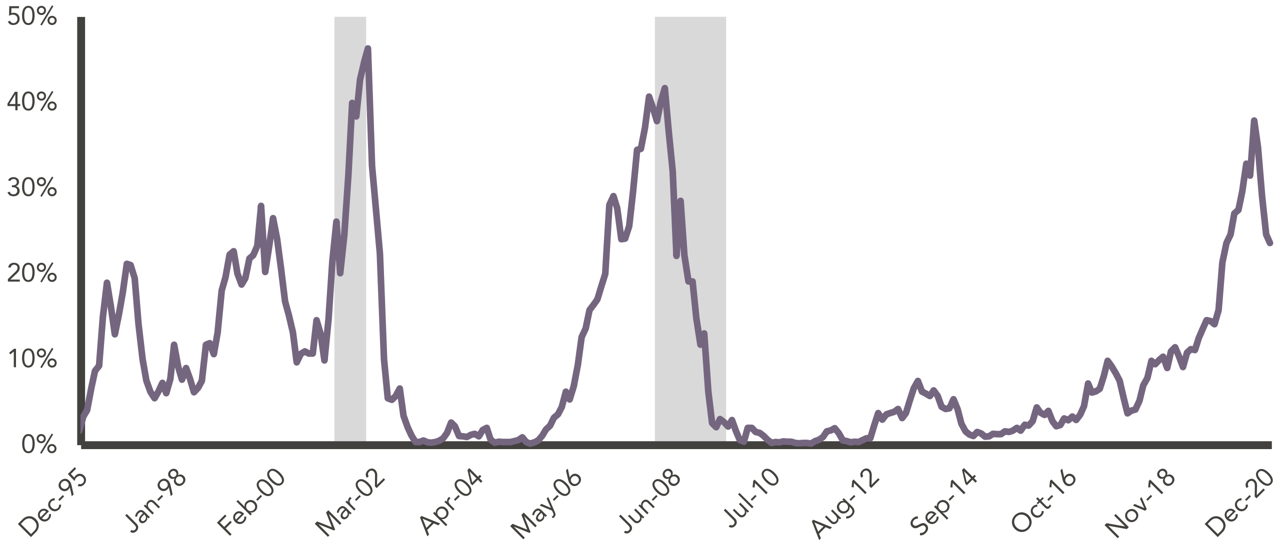
In 2019 the economic expansion hit the 10-year mark, making this the longest bull market in history since WWII. Throughout the year many of the main economic trends seen from the previous few years continued. While economists and investors were nervous heading into the year, especially given a volatile 4Q in 2018, 2019 proved to be another positive year for the U.S. economy. But while fundamentals remain strong, some signs are pointing towards slowing economic growth. This, coupled with geopolitical unknowns, investors once again must ask the question — is this the year that it all comes to an end?

One central theme that will likely continue into 2020 is the role of interest rates. The first, and perhaps most important, part of this is yield curve inversion. While the inversion was brief and rates are now mostly upward sloping, this was still alarming to investors. Yield curve inversion is a historically accurate predictor of recessions with a downturn usually occurring 1–2 years after the inversion. It is so accurate that the NY Fed calculates the likelihood of a recession in the next year based on the shape of the yield curve. As shown in Exhibit 1 on the next page, because of this inversion the odds spiked to about 40%. Thankfully as rates have normalized the odds of a recession in 2020 have come down to about 23%. Heading into 2020, we expect the curve to remain upward sloping, but will be on the look-out for any signs of further inversion.

Many of the complications surrounding interest rates have come from Fed policy. After three years of raising the federal funds rate, the Federal Reserve reversed course in July by cutting rates. This came as there were concerns about the economy slowing as well as significant political pressure. Since then, the Fed cut rates another two times, reducing the Federal Funds Rate to a range of 1.50–1.75%. Going forward, the Fed is anticipating leaving rates unchanged for 2020, which should provide further stability to the economy.

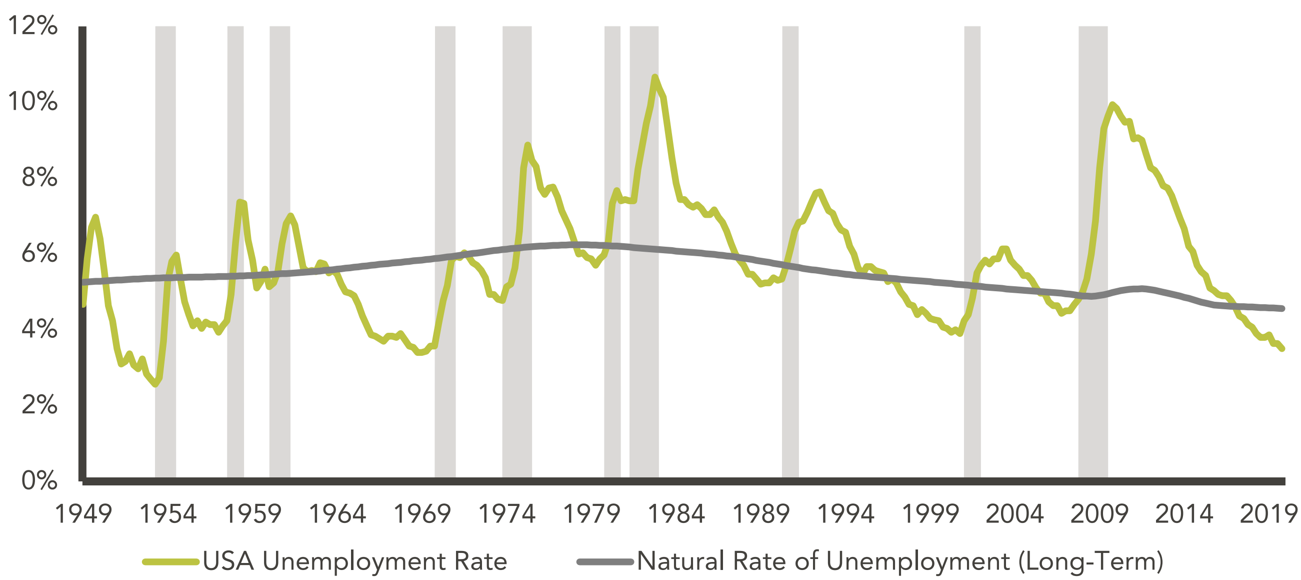
Exhibit 1: Odds of a Recession Fall as Yield Curve Normalized in 4Q19



Source: NY Federal Reserve; shaded bars reepresent recessions

The two main indicators the Fed considers when deciding on interest rate changes are unemployment and inflation, the first of which remains low and further suggests we are near the end of the market cycle. As of year-end, the unemployment rate was 3.5%, and averaged an additional 180K nonfarm jobs per month in 2019. Comparing this headline unemployment rate to the natural rate of unemployment — which calculates unemployment net of aggregate demand — we see in Exhibit 2 that the general unemployment rate is lower. This suggests that the economy is overheated and due for a correction. Historically, the unemployment rate dips below this natural rate about 32 months before a recession. Currently it has been about three years since unemployment was first lower in this expansion, suggesting that a downturn may be on the horizon.

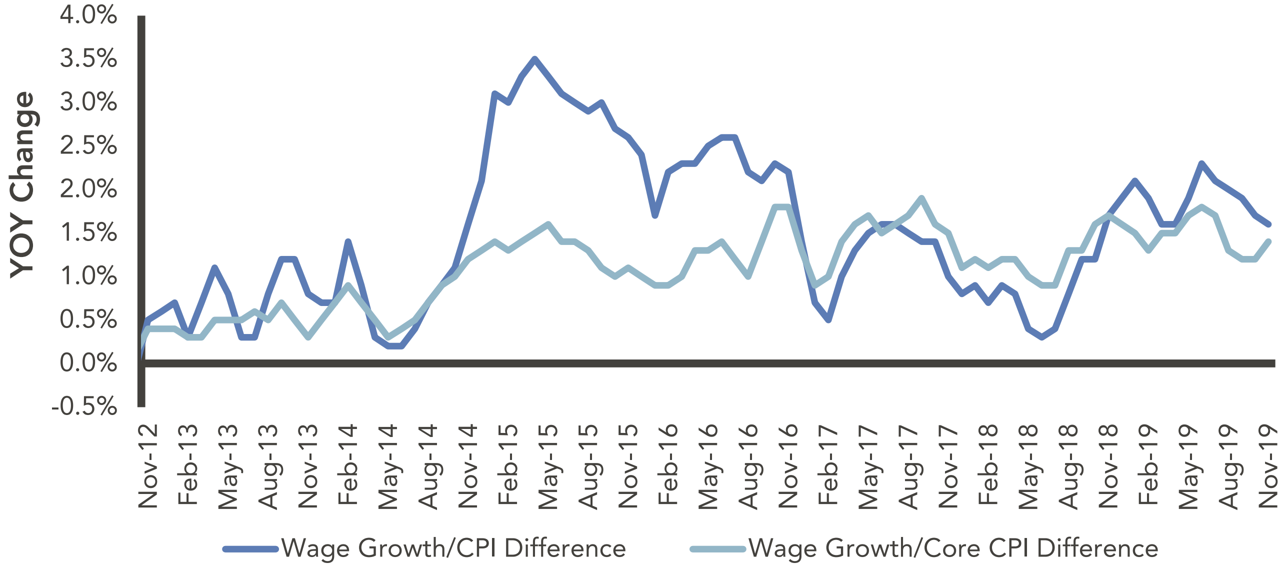
Exhibit 2: Unemployment Rate Currently Sits Below Natural Rate of Unemployment



Source: Bloomberg; shaded bars represent recessions

The other central indicator for the Fed is inflation. Many were concerned that this could become a major issue due to falling rates and the Fed cutting interest rates. Both in theory lead to higher consumer spending and therefore higher inflation. However, with interest rates normalizing, inflation has remained largely unchanged. CPI grew 2.1% over the last 12 months while Core CPI, which excludes food and energy prices, grew 2.3%. Both are close to the Fed's target of 2%. Further good news on this front is that wage growth has well outpaced these inflation rates. Wages grew an average of 3.6% over the last 12 months, meaning that consumers' purchasing power is growing.

Exhibit 3: Wage Growth Outpaces Inflation



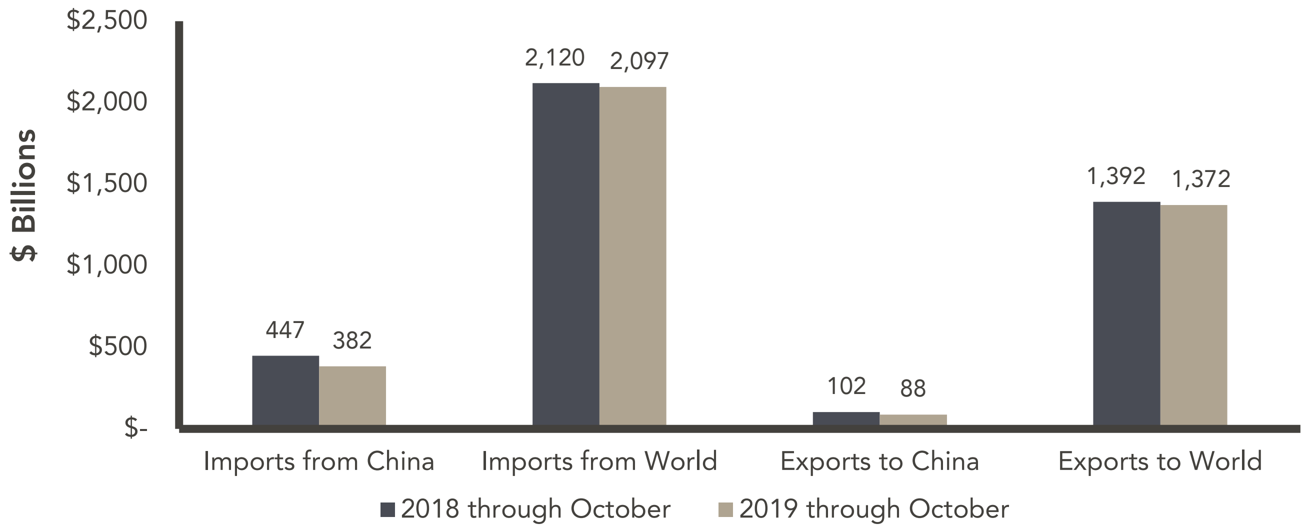
Source: Bloomberg

Given these strong fundamentals, there are concerns that we are nearing the peak and that a recession may be coming, as shown by some of the previous exhibits. Of course, there generally has to be a catalyst for an economic downturn. In many investors' minds, it is most likely that the culprit will be geopolitical, most notably the trade war with China. After a series of new tariffs implemented between the two countries, as well as multiple fake outs regarding a deal, negotiations may finally be making progress.

Earlier this month, both parties signed a "Phase One" deal, in which the U.S. agreed to cancel plans for new tariffs as well as reduce the tariff rate on some of the imported goods. China in turn also eliminated some tariffs, committed to purchasing $50 billion in U.S. agricultural products, and pledged some structural reforms. Although good news and favorably received by the markets it is still limited in scope, as other tariffs that were implemented will remain and future "phases" are necessary to entirely extinguish the trade differences between the two countries.

With that said, it is possible that the trade war has not been as damaging to the U.S. as often viewed. Exhibit 4 on the following page compares the differences in U.S. trade between 2018 and 2019. As shown, both imports and exports with China are down about 15%. However, U.S. trade globally is down only about 1.5%, as countries such as Vietnam and Mexico have picked up much of the slack. While China is still our largest trading partner, this suggests that the U.S. is less reliant on them than previously thought.

Exhibit 4: U.S. Trade Is Not Dependent on China



Source: Bloomberg

The counter-argument to this is that some sectors are more heavily impacted than others. Many farmers have suffered from the trade war, particularly soybean producers, as well as manufacturers. The ISM PMI index is a survey of manufacturers and measures the overall strength of the manufacturing sector. A measure over 43 suggests the overall economy is expanding while a reading over 50 indicates the manufacturing sector is growing. Over the past year this measure fell and dropped below the 50 threshold the last few months. While this means manufacturing is declining, there is hope that this measure is bottoming out as these manufacturers have changed suppliers to other countries and are now better equipped to deal with the trade war. While further tariffs will likely still have some impact on them, the trade deal may prove to be a boost for the sector, sending it back into positive growth territory.

Exhibit 5: Manufacturing Decline

Source: Institute for Supply Management

Finally, 2020 is another presidential election year, with a wide variety of candidates and beliefs. While it is far too early to make any meaningful predictions, the likely Democratic candidates are split between more moderate ideologies (Joe Biden, Pete Buttigieg) and progressive beliefs (Elizabeth Warren, Bernie Sanders). Even if these candidates are elected, there will still be limitations to the plans they are able to pass, making it difficult to forecast policy for the coming years. What we can say is that while we may have a new president elected in November, it is unlikely any major legislation will be passed in the coming year.

Ultimately, we think 2020 will be a year with more of the same. While the attempt to remove Trump from office is probably futile, it is unlikely that he will make significant policy changes beyond the phase one trade deal signed into effect on January 15th. We believe that while a full resolution to trade probably won't occur in 2020, the worst is probably behind us. Interest rates will hopefully continue to be normal, while inflation and employment hold steady. We anticipate another year of slow, but positive, growth as we begin the next decade.

2020 Market Preview

Fixed Income

THE NEW ROARING TWENTIES — WILL IT BE DIFFERENT THIS TIME?

Ben Mohr, CFA
Director of Fixed Income

As we head into the 2020s, one of the top-of-mind questions among investors is will it really be different this time? With the equity markets at all-time highs, bond spreads at all-time tights, and a yield curve that has just undergone an inversion between the two-year and 10-year, will our economy really avoid a Great Recession like what followed 2008, or worse, a Great Depression like what followed the 1920s?

The fact that we are in an election year will make this question especially difficult to answer, and one might make a seemingly convincing case for either outcome based on the data. The case for the notion that this time it's different and that the long-in-the-tooth market cycle we're in still has more to go includes the fact that the yield curve is back to upward sloping now, much of the inversion we experienced in 3Q19 was from foreign buying and therefore an unprecedented "artificial" dynamic making the 2s/10s inversion[1] less of a harbinger for a recession, the inversion was only in the 2s/10s and not at all in the 2s/30s that did take place leading up to 2000 and 2008, corporate and consumer fundamentals are currently moderate-to-cautious versus their frothy levels leading up to 2000 and 2008, and the post-'08 reforms are doing their job. The case for the notion that this time it's not different, i.e., a major correction and recession are imminent, includes the notion that there is fraud somewhere in the markets lying beneath the surface, there is a bubble somewhere in the markets that could be devastating enough and contagious enough to create a domino effect, the concerning and relentless retirement demographic trend that could continue to choke productivity and depress interest rates, potentially inflated issuer EBITDAs due to overly liberal add-backs that may be severely skewing the markets, and the Trump tax cuts that have only been a temporary boost resulting in a growing deficit that will have to be paid back someday. Perhaps the 2020s will be another decade of excess much like the roaring 1920s that ended up in the Great Depression. Only time will tell, but in the meantime, as investors we need to stay vigilant in tracking and interpreting the key data, which is what follows in this Market Preview.

A REVIEW OF FIXED INCOME IN 2019

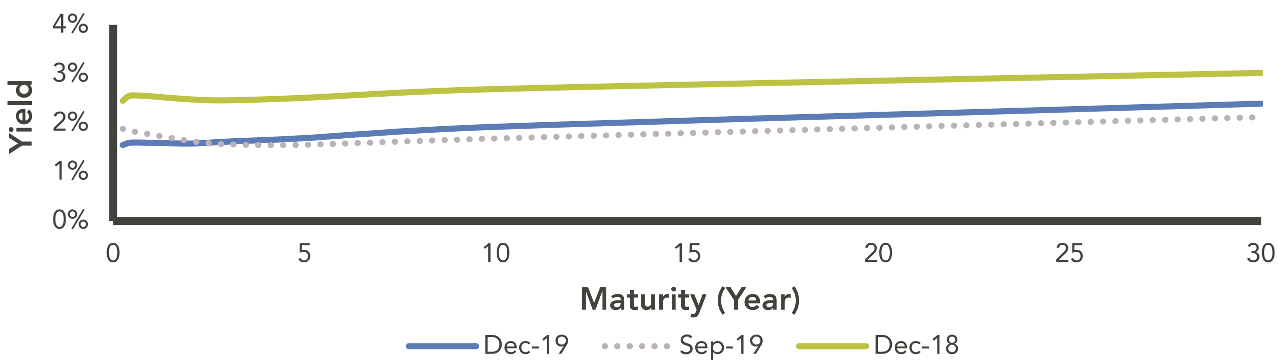
2019 began with both the Fed and ECB signaling no further hikes as the U.S. yield curve was inverted on the very short end. Bank loan, high yield and emerging markets debt spreads started the year showing moderate value after the 4Q18 correction. The trade war was in full swing. By the end of 1Q19, yield curve inversion intensified, and the Fed signaled impending rate cuts as a response. Credit rallied and spreads fell to halfway between long-term averages and all-time tights. In the second quarter there was a bifurcation in the markets as bond markets showed pessimism with yields pushing down as the 10-year — which began the year at 2.66% — tumbled to 2.00% by the middle of the year, while equity markets showed optimism with ever-higher P/E ratios. In the third quarter, with no end in sight for the tariff war, global growth continuing to slow, Argentina's shift to populism, and inversion in the 2s/10s, the Fed cut rates twice as the 10-year bottomed at 1.47%. Finally, in the fourth quarter the Fed cut a third time and the 10-year rebounded to 1.92% at year-end with a steepening curve due to brightening trade deal hopes. The Fed rate cuts reduced yields on the short end of the yield curve, while the trade war drove both foreign and domestic buying on the long end. The end result was a duration-driven tailwind for all fixed income asset classes, with the full brunt of the tax cuts aiding credit. Bonds generally did very well. The Agg returned 8.7% in 2019 as bank loans returned 8.2%, high yield returned 14.3% and emerging markets debt returned 15.0%.

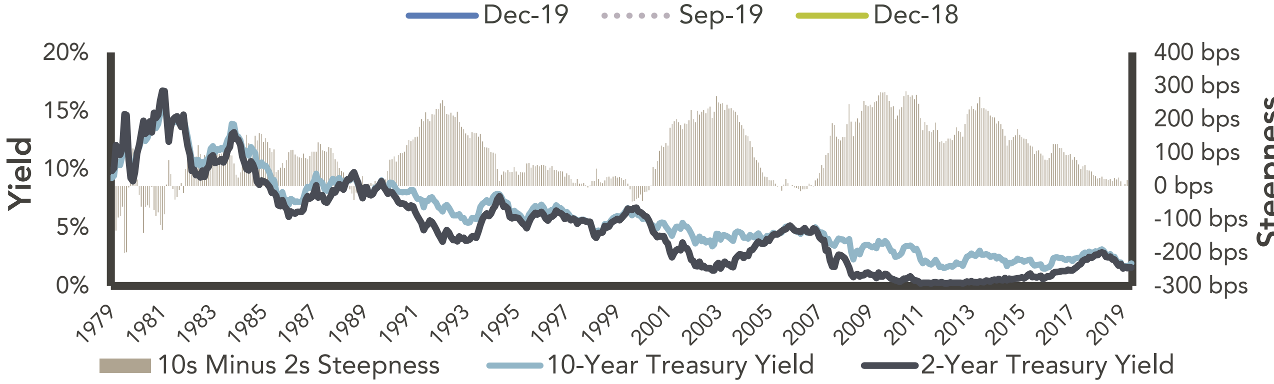
KEY ISSUES AND EXPECTATIONS FOR FIXED INCOME IN 2020

Core Bonds

Core bonds, while not showing much value due to their spreads being near all-time tights, still provide moderate yield and strong protection in market downturns due to their duration. With the tailwind from the easing trade tensions, the yield curve has steepened now to almost entirely upward sloping following 2s/10s inversion in 3Q19, as shown below in Exhibit 1.

Exhibit 1: Yield Curve (top) and 10s/2s Treasury Steepness (bottom)





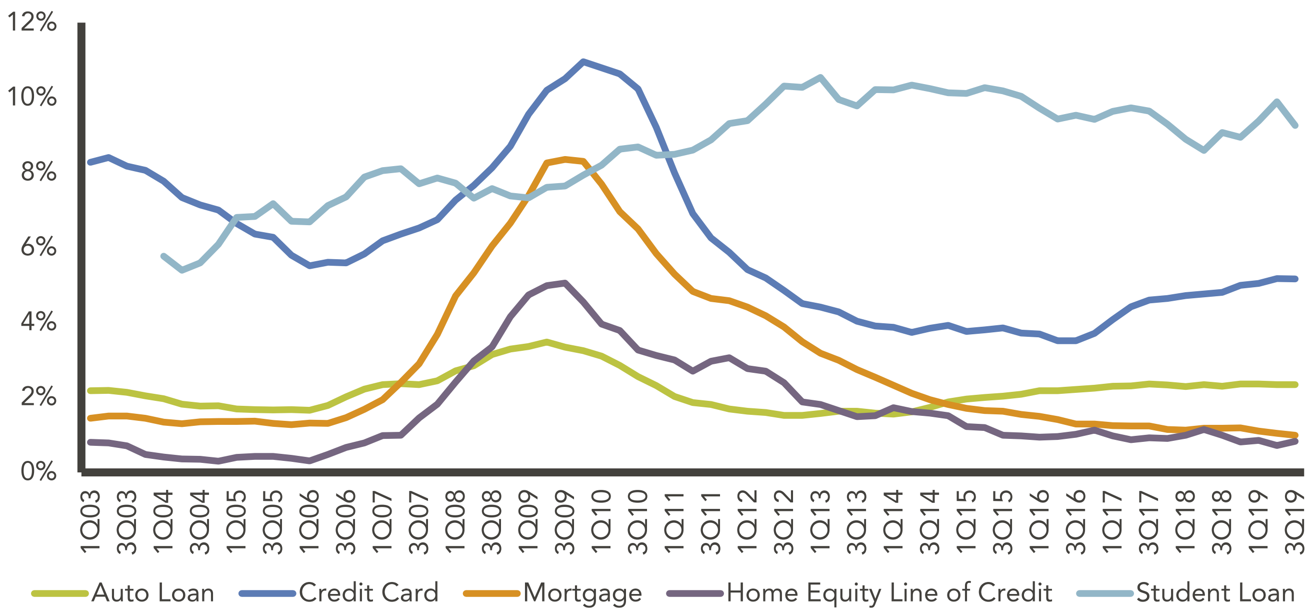
Source: Federal Reserve as of December 31, 2019

The next Fed rate cut with an over 50% probability as deemed by the fed fund futures market has been pushed out to the November 2020 FOMC meeting, as the Fed reduces its accommodative stance. However, an aging demographic trend persists globally, which may potentially pressure rates down in the long term, barring any technological revolution that boosts productivity and raises rates.

The outcome of the U.S. presidential election will inevitably have some effect on interest rates. Our preliminary projections for each candidate[2] show a slight boost to GDP hand-in-hand with growth in the U.S. deficit for all candidates, with deficit growth the highest in a Trump 2nd term scenario. This slight GDP boost in all cases may stave off further rate declines a bit, at least for the short term.

We will next examine U.S. consumer fundamentals here before examining corporate fundamentals. Fortunately, there was a downtick in consumer bankruptcies and student loan delinquencies in the latest available quarter showing a strong U.S. consumer. Exhibit 2 shows consumer delinquencies on student loans, credit cards, and auto loans. Student loan delinquencies are higher than that of '07, while credit card delinquencies are lower than that of '07, and auto loan delinquencies are roughly at '06 levels. Mortgage and home equity delinquencies are still very low. Together these show that the average U.S. consumer today looks very different compared to how he/she did in '07, with a better housing debt profile, but poorer student debt profile.

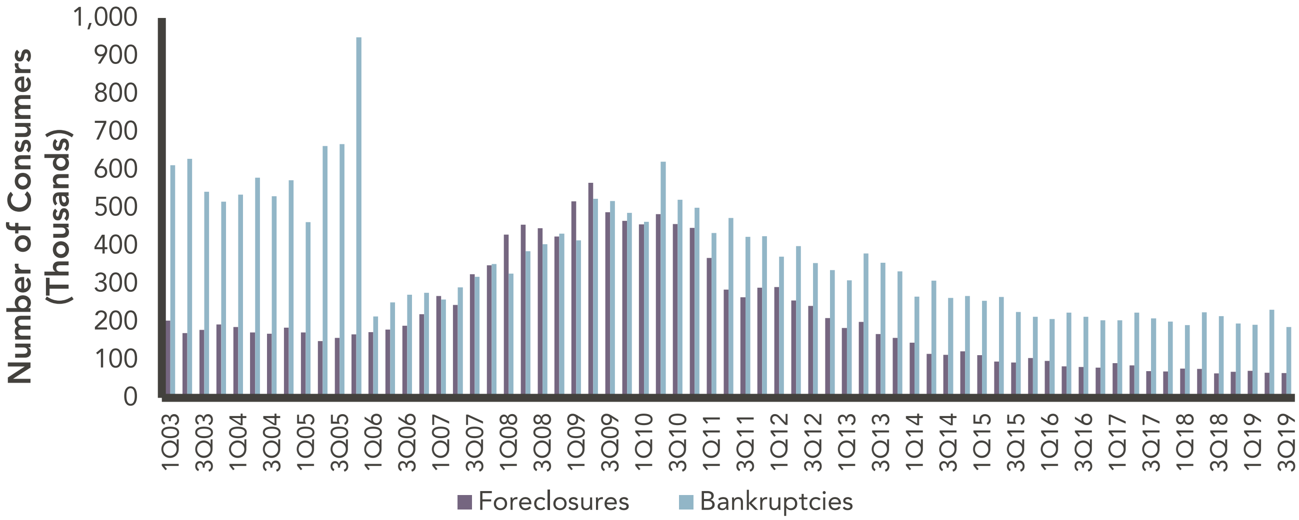
Exhibit 2: Transition into Serious Delinquency (90+ Days) by Loan Type



Note: 4 Quarter Moving Sum
Source: NY Fed Consumer Credit Panel/Equifax, 3Q19 latest as of December 31, 2019

From Exhibit 3 below, the U.S. consumer remains strong with low foreclosures and fairly low bankruptcies.

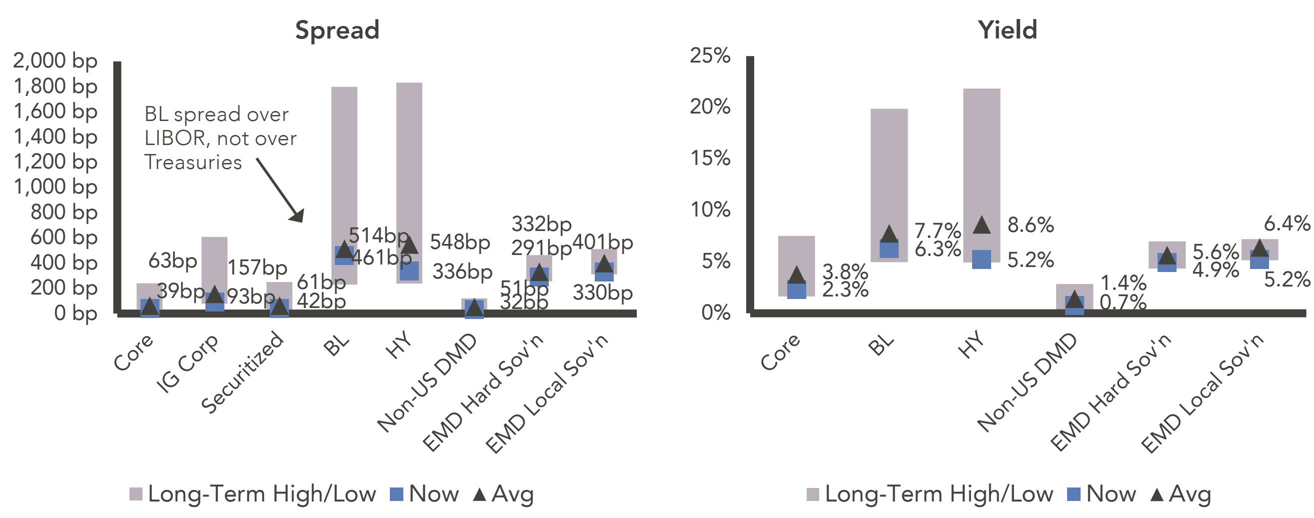
Exhibit 3: New Foreclosures/Bankruptcies



Note: Bankruptcies were higher in 2005 and earlier due to prior law
Source: NY Fed Consumer Credit Panel/Equifax, 3Q19 latest as of December 31, 2019

In terms of bond valuations, tight spreads exist generally across the board for fixed income, as shown in Exhibit 4 below. They are at all-time tights for core bonds, investment grade corporates, securitized bonds and non-U.S. developed markets debt, as these sectors have been where investors have moved for duration and for lower-risk fixed income as a hedge against their risk-taking in equities during 2019.

Exhibit 4: Fixed Income Asset Class Spreads



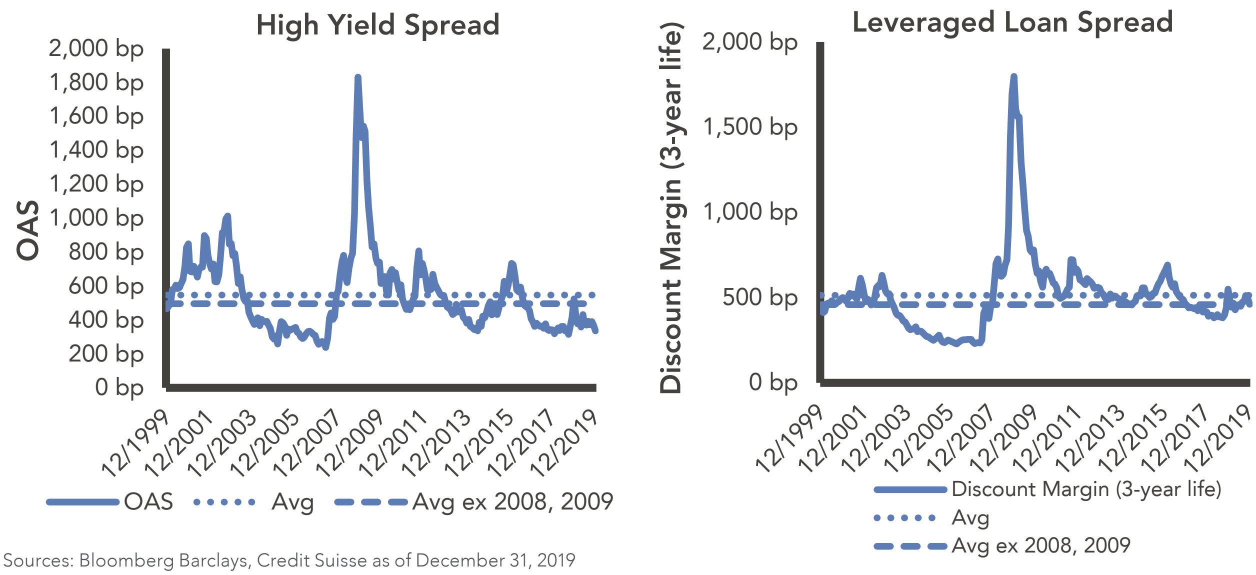
Note: Long-term high/low spans 20 years except for Non-US DMD and EMD, which span 10 years
Sources: Bloomberg Barclays, Credit Suisse, Deutsche, JPMorgan as of December 31, 2019

In general, we believe that if the overall U.S.-China trade deal — including the impending phase two and potential phase three portions — ultimately materializes, rates would be expected to rise and in turn be a headwind for bond returns. On the other hand, if the overall trade deal is unsuccessful, rates would be expected to decline, thereby potentially boosting bond returns. In all cases, we continue to advocate a healthy allocation to core bonds as their duration provides strong principal protection in market corrections.

Bank Loans/High Yield Bonds

Corporate fundamentals as viewed from key below-investment grade metrics are in the moderate to cautious range. Bank loan spreads are now tighter than long-term averages while high yield spreads are now approaching all-time tights, as shown in Exhibit 5 below.

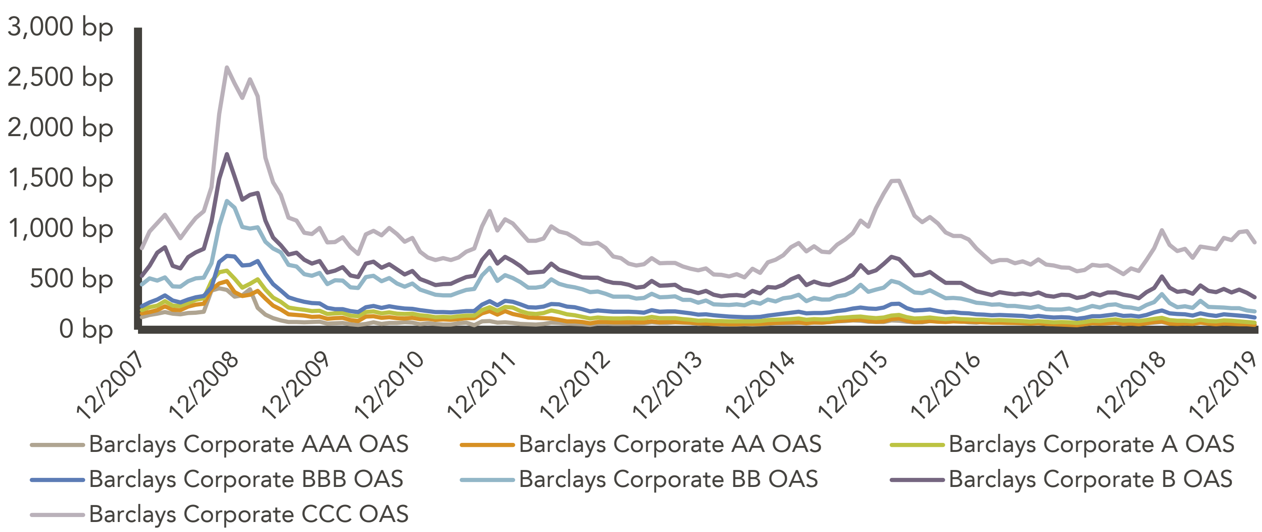
Exhibit 5: Bank Loan and High Yield Spreads



Sources: Bloomberg Barclays, Credit Suisse as of December 31, 2019

Additionally, dispersion between the lowest quality credits and higher quality credits *(Exhibit 6)* is expected to continue as lower quality issuers struggle to refinance. Active management in all fixed income asset classes is now more important than ever. This is because active fixed income strategies benefit from the insight of credit analysis to avoid the struggling lower quality credits.

Exhibit 6: Dispersion — Barclays Corporate AAA–CCC Spreads



Source: Bloomberg Barclays as of December 31, 2019

New sub-investment grade bond issuances' uses of proceeds, leverage, and coverage reveal further moderate-to-cautious corporate fundamentals. It is still somewhat a Goldilocks market — not too hot, not too cold — but it may be time to take some risk off the table given the tight spreads and these moderate-to-cautious corporate fundamentals. From Exhibit 7, we see that refinancings as the use of proceeds for both high yield and bank loan issuance is high, a positive fundamental, as sub-investment grade issuers are able to tap both the high yield and bank loan markets to keep refinancing their debt, and they are choosing to refinance over other uses of proceeds. We look at bank loans and high yield because they are first in line to show any weakness before investment grade bonds. Additionally, high yield issuance use of proceeds towards acquisitions and LBOs is low, which is a positive as high yield issuers are not taking too much risk in the form of aggressive transactions. However, a lot of high yield issuance for acquisitions and LBOs has been substituted for bank loan issuance towards acquisitions and LBOs, which is why we see that red 54%[3] today. The good news here is that it subsided a bit in 2019 versus the 65% high in 2015 and 63% value in 2018. The CEOs and CFOs of sub-investment grade companies do not appear to be taking as much risk as they did in 2007. Another positive signal is that CCC high yield and 2nd lien bank loan issuances are still well below their 2007 levels, further reinforcing the notion that risk-taking by sub-investment grade issuers remains subdued.

Exhibit 7: Below-Investment Grade Barometer — Use of Proceeds & Aggressive Issuance

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
U.S. High Yield Bonds													
Refies	32%	43%	68%	61%	52%	55%	53%	51%	48%	62%	64%	61%	65%
Acquisitions/ LBOs	52%	37%	6%	16%	18%	18%	19%	32%	35%	23%	19%	20%	16%
CCC	33%	23%	8%	13%	15%	16%	19%	14%	10%	10%	15%	17%	10%
U.S. Bank Loans													
Refies	19%	11%	42%	32%	50%	45%	47%	27%	19%	36%	37%	27%	32%
Acquisitions/ LBOs	65%	75%	29%	40%	34%	33%	32%	53%	65%	48%	47%	63%	54%
CCC	8%	5%	6%	3%	3%	6%	7%	10%	4%	3%	6%	6%	2%
Cov-Lite	30%	4%	10%	5%	26%	38%	64%	71%	72%	75%	75%	84%	84%

Source: Bank of America Merrill Lynch, latest available as of December 31, 2019

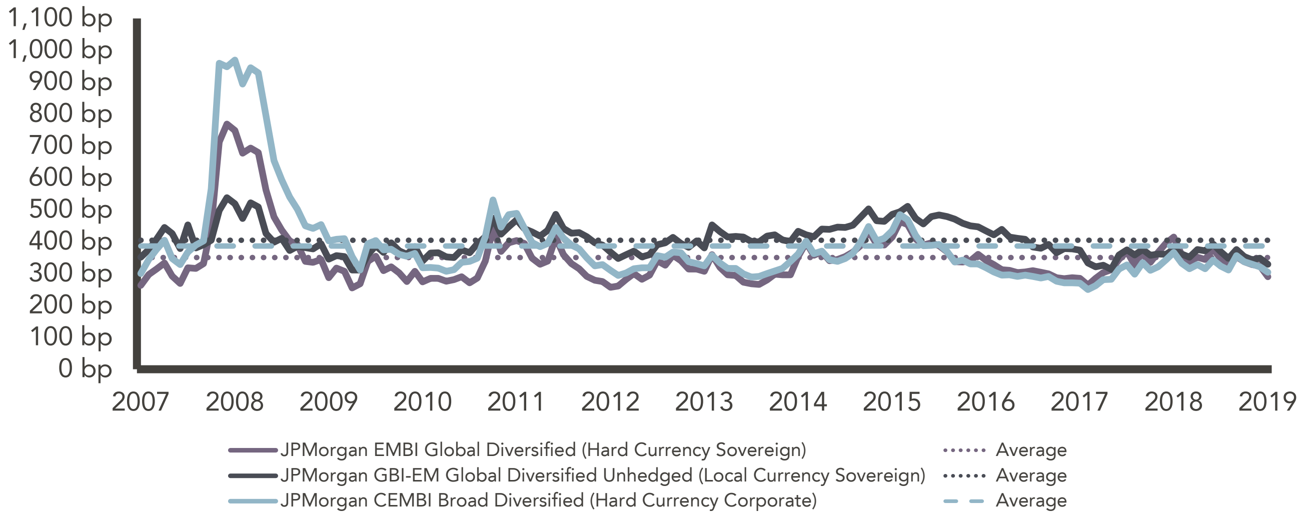
One caveat here is the growing level of liberties taken by issuers in accounting for their EBITDA, as some are aggressively using add-backs to inflate their EBITDAs (an example of an add-back is a non-recurring restructuring expense, and an unjustified add-back may be a recurring expense that issuers are accounting for as non-recurring and therefore adding back to their EBITDA to inflate their EBITDA). That might be a contributing factor behind why these numbers do not look so frothy, at least at face value (a strong EBITDA on paper allows issuers to issue seemingly higher quality debt and less CCC/2nd lien debt). This is a growing concern that we are hearing from bond managers, causing many of them to become more defensive in their positions quarter by quarter.

In summary, we would recommend continuing to hold sub-investment grade credit for strategic allocations to benefit from their 5-6% yields. However, we would advocate trimming risk around the edges due to the tight spreads and moderate-to-cautious fundamentals discussed above.

Emerging Markets Debt

EMD spreads are now near all-time tights, shown in Exhibit 8. Spreads have tightened following pro-business Macri's loss to populist Fernandez in the 4Q19 Argentine election; thoughts have now turned to a potential Argentine debt default as a major headline/sentiment risk.

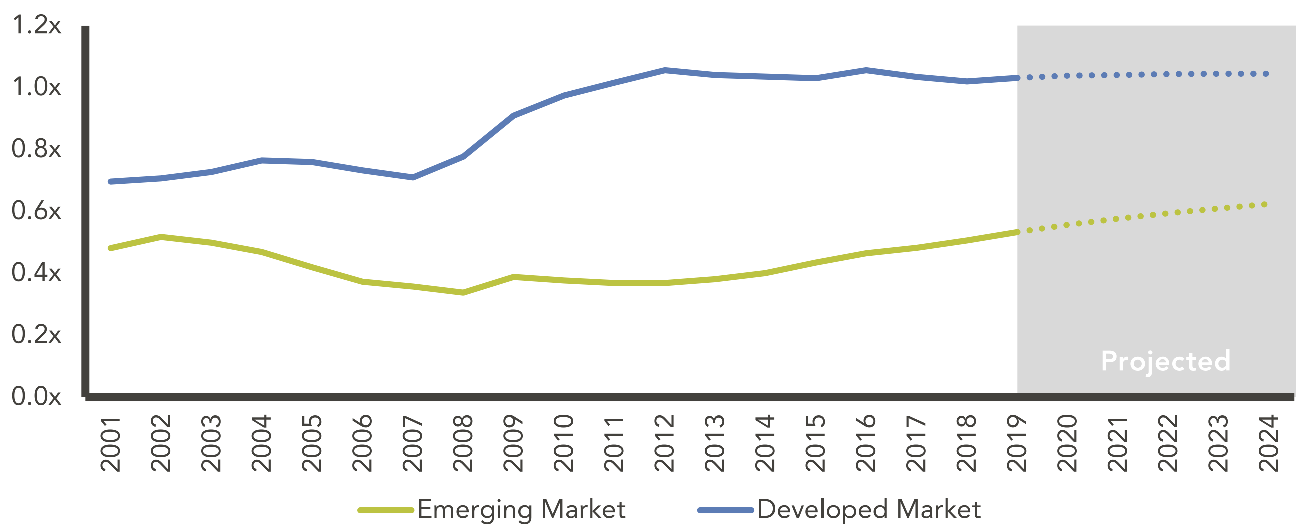
Exhibit 8: EMD Spreads



Source: JPMorgan as of December 31, 2019

That said, EMD primary fundamentals — current accounts, growth, leverage — remain favorable, with Exhibit 9 showing how much lower emerging markets leverage remains versus developed markets.

Exhibit 9: EM vs. DM Leverage (Debt/GDP)



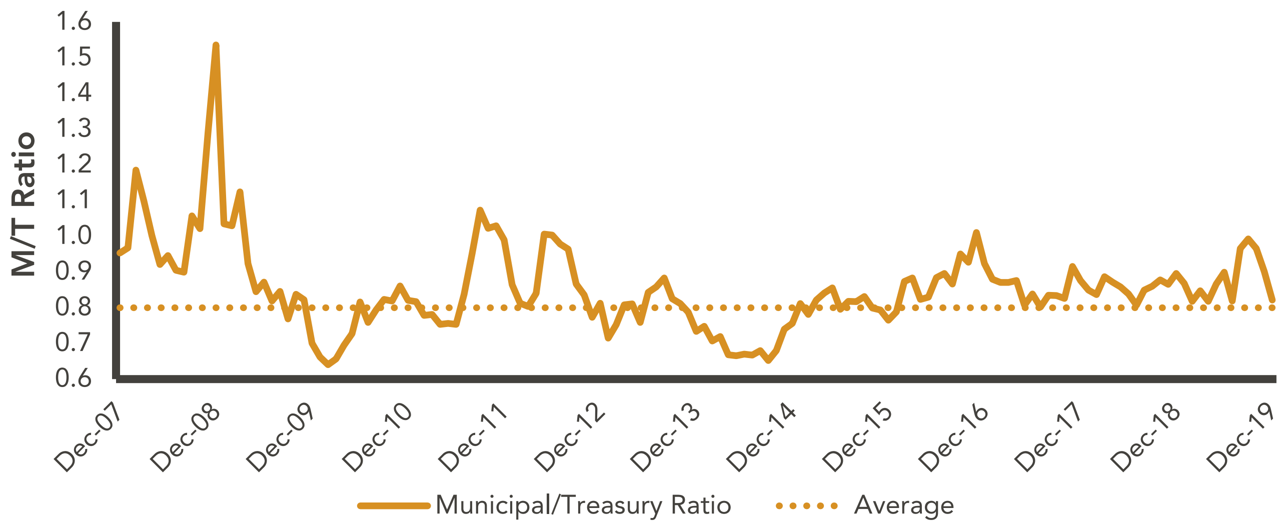
Source: IMF as of October 2019 (updated twice a year, April and October)

As a key takeaway for EMD, we would recommend trimming some risk around the edges of EMD allocations as well due to tight spreads and headline/sentiment risk but keeping strategic exposures due to strong fundamentals.

Municipal Bonds

The municipal yield curve "bull steepened" during 4Q19 as the short end declined and long end remained flat while Treasuries "bear steepened" as long Treasury yields rose, reducing the muni/Treasury ratio. But, as highlighted in Exhibit 10, the muni/Treasury ratio is still above 0.8, thus still showing value for municipal bonds over Treasuries for taxable investors.

Exhibit 10: Muni/Treasury Ratio



Note: Municipal/Treasury ratio defined as the Barclays AAA Municipal Bond Index YTW divided by the 10-year Treasury Bond yield.
Sources: Bloomberg Barclays, Federal Reserve, as of December 31, 2019

In investment grade municipal bond portfolios, pre-refunded bonds continue to provide the best high-quality value. Highly rated general obligation bonds, essential service revenue bonds (water/sewer/electric) and private university bonds will also be important strategic municipal bond sub-sectors for 2020. Furthermore, net negative issuance is still expected for 2020, a tailwind for the asset class.

CONCLUSION

Collectively, corporate and consumer metrics paint a moderate-to-cautious picture for fixed income fundamentals, probably not at the concerning levels of 2007, but more like 2005 or 2006 levels. There is some level of deterioration, but we do not believe a recession to be imminent. The trade agreement and U.S. election may boost or hinder growth in the short term, so these are wild cards that we will keep track of closely. Over the longer term, interest rates are expected to continue grinding lower due to the global aging demographic phenomenon, barring any technological revolution that boosts productivity and raises rates.

For 2020 and beyond, we recommend maintaining a healthy allocation to core bonds for their duration protection and maintaining strategic allocations to credit but trimming risk around the edges given the tight spreads and moderate-to-cautious fundamentals. If the need arises, we would additionally recommend that investors consider diversifying their fixed income portfolios from the standard core-satellite set, with the primary satellites bank loans, high yield bonds, and emerging markets debt. Secondary satellites could include CLOs, catastrophe bonds, and taxable municipal bonds; these asset classes may potentially help by adding yield and diversification. Ultimately, the role of fixed income is unchanged: provide liquidity, diversification, and income for investors as part of a multi-asset class portfolio. Though market conditions are always changing, fixed income's role remains constant, and 2020 should be no different.

NOTES

[1] 2s/10s inversion means that the 10-year Treasury yields less than the 2-year Treasury, a sign that the market expects lower interest rates, and therefore lower growth, in the future. 2s/30s inversions means that the 30-year Treasury yields less than the 2-year Treasury, a stronger signal that the market expects lower interest rates, and therefore lower growth, in the future.

[2] Marquette developed GDP and deficit projections for each candidate.

[3] In Exhibit 7, figures highlighted in red show a frothy metric, while those highlighted in green show a metric that is not concerning, relatively speaking.

U.S. Equities

CLIMBING THE WALL OF WORRY

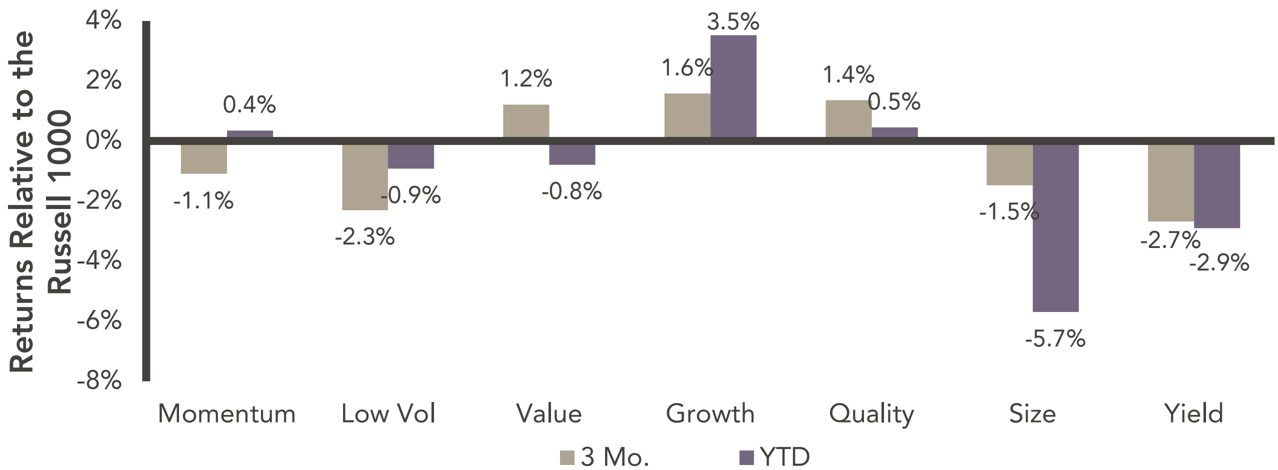
Rob Britenbach, CFA, CIPM
Research Analyst, U.S. Equities

U.S. equities ended the year near all-time highs amid declining earnings, decelerating economic data, and minimal progress on U.S.-China trade negotiations.

2019 began with a strong rebound after nearly hitting bear market territory in December 2018. As measured by the S&P 500, equities recorded their best January performance since 1987 and best first quarter return since 1998. Concern regarding a global economic slowdown began to take effect in the second quarter; however, the Fed's late-cycle dovish pivot and three interest rate cuts over the span of 2019 helped to provide a more supportive backdrop. Equities continued their rise during the remainder of 2019 and finished with an exuberant year-end showing, posting 22 of 35 total new closing highs during the 4th quarter alone.

Geopolitical uncertainty, specifically sentiment around U.S.-China trade progress, had a strong effect on equity markets throughout the year. Trade sentiment, at various points in the year, either provided a boost or weighed on the market and its effects could be seen on cyclical sectors which lagged on a relative basis for the year. Similarly, small-caps lagged their larger-cap peers, experiencing a greater decline in earnings than large-cap and a general risk aversion by investors towards economic sensitivity. Small-caps tend to carry more cyclicality and leverage, both of which are attributes investors sought to avoid in 2019. Lower interest rates and the expectation for a more accommodative Fed benefitted bond proxy areas as well as longer-duration growth assets in 2019. The technology sector continued its bull market lead having its best returning year since 2009 but was subject to brief risk-off selloffs at points during the year. Factor leadership shifted dramatically in early September as the spread between growth/momentum and value reached historically wide levels. The sharp reversal towards value caused many investors to question if a turning point had occurred in growth's longstanding bull market outperformance. However, growth quickly came back in favor with factor trends for the fourth quarter ending up mixed.

Exhibit 1: Brief Value Factor Reversal in the 4th Quarter

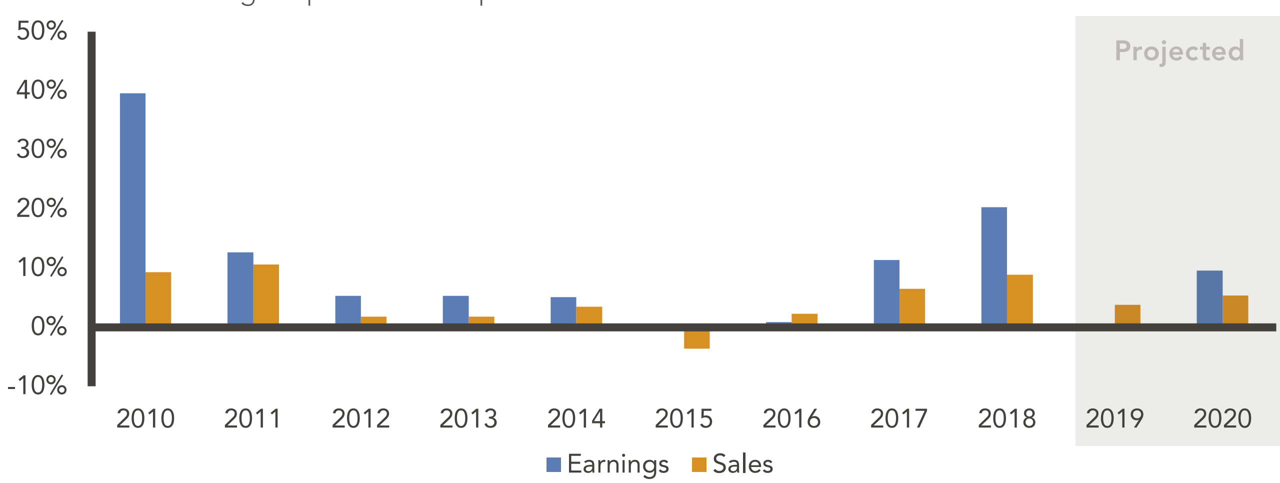


Source: Bloomberg as of December 31, 2019

STRONGER EARNINGS EXPECTED IN 2020 VS. 2019

In 2019, the S&P 500 returned +31.5% and 35 new closing highs were logged. Despite numerous reasons for uncertainty, U.S. equities ended up having a stellar year. In fact, 2019 was the 4th highest returning calendar year over the past 30 years, only surpassed by 1995, 1997, and 2013. Nearly all the S&P 500's return in 2019 came from multiple expansion. For the year, earnings growth increased by just 0.3%. A difficult year-over-year comparison due to the 2017 corporate tax overhaul coupled with margin pressure — caused at least in part by the U.S.-China trade war — weighed on company earnings in 2019. Fortunately, equities had the tailwind of the Fed reversing its policy course, short-term interest rates being cut three times, and similar accommodative moves made across global central banks. The Fed is likely to be in a "wait and see" mode over the course of 2020, attempting to gauge the impact of its recent policy decisions. Given this, we think investors will place a greater emphasis on earnings growth in 2020 to justify valuation levels. According to FactSet, earnings growth for the S&P 500 is projected to increase by nearly 10% for calendar year 2020. Earnings projections are often revised downward throughout the course of a year, so the actual value is likely to be lower than 10%; however, an improved earnings growth picture relative to 2019 would be a positive for equities.

Exhibit 2: Earnings Improvement Expected in 2020

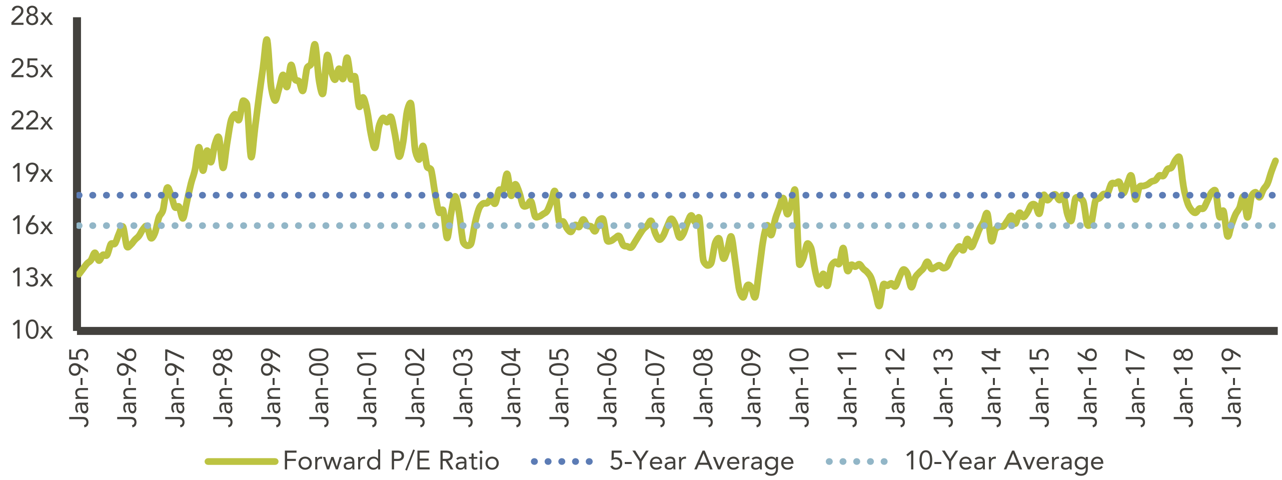


Source: FactSet as of January 3, 2020

VALUATIONS ELEVATED TEN YEARS INTO THE BULL MARKET

At the end of 2019, the S&P 500 traded at 19.8x forward earnings. This is well above its 10-year historical average of 16x forward earnings. There are only a few instances over the past two decades when forward earnings were higher, notably the early 2000's. It is not surprising to see valuations above their longer-term averages this far into a bull market; however, it is important to acknowledge that elevated valuations tend to act as a headwind for investors. Starting valuation is an important factor affecting long-term future returns, but equity returns over the short-term are often determined by factors other than valuation and fundamentals. A key question heading into 2020 is just how much a lower interest rate environment, generally mild inflation, and an improving earnings picture can support or extend current valuations.

Exhibit 3: S&P 500 Forward P/E Ratio



Source: Bloomberg as of December 31, 2019

Valuation levels are not uniform across U.S. equities. The table on the right shows the nine U.S. equity style box forward P/E multiples as a percentage of their 19-year averages. A 19-year average was used since it is the longest common inception date among Russell indices. While all style boxes trade above their long-term averages, the mid and large-growth segments stand out as trading at the highest relative premiums. Growth stocks led U.S. equities over the course of this bull market and while they may face valuation headwinds longer-term, their path over the span of 2020 is less certain. Small- and mid-value segments trade with the smallest premium on a forward P/E basis; however, these areas generally carry greater cyclicality and thus greater risk should the economic environment weaken. If further progress is made on trade beyond the Phase One deal and the manufacturing slowdown reverses, these areas would see tailwinds.

Exhibit 4: Forward P/E as a % of 19-Year Average

	Value	Core	Growth
Large	112%	123%	136%
Mid	105%	114%	132%
Small	101%	109%	120%

Source: Bloomberg as of December 31, 2019; A 19-year average was used since it is the longest common inception date among Russell indices.

UNCERTAINTY IS UNLIKELY TO GO AWAY

While uncertainty overall remains high, many similar themes from 2019 carry over into the new year and show no near-term signs of resolution. 2020 is likely to feature continued political uncertainty stemming from a presidential impeachment trial and what is expected to be an especially polarized presidential election. Consequently, the U.S. is unlikely to see any significant changes to fiscal policy leading up to the presidential election in November; however, the range of fiscal and policy implications depending on which candidate gets elected is wide. Corporate taxes may increase, a wealth tax may be instituted, and changes to industry regulations are all fair game depending on the outcome of the 2020 election and have the potential to influence many areas within equity markets. Sentiment around the likelihood of such potential changes will play a greater role in equity markets leading up to the November election.

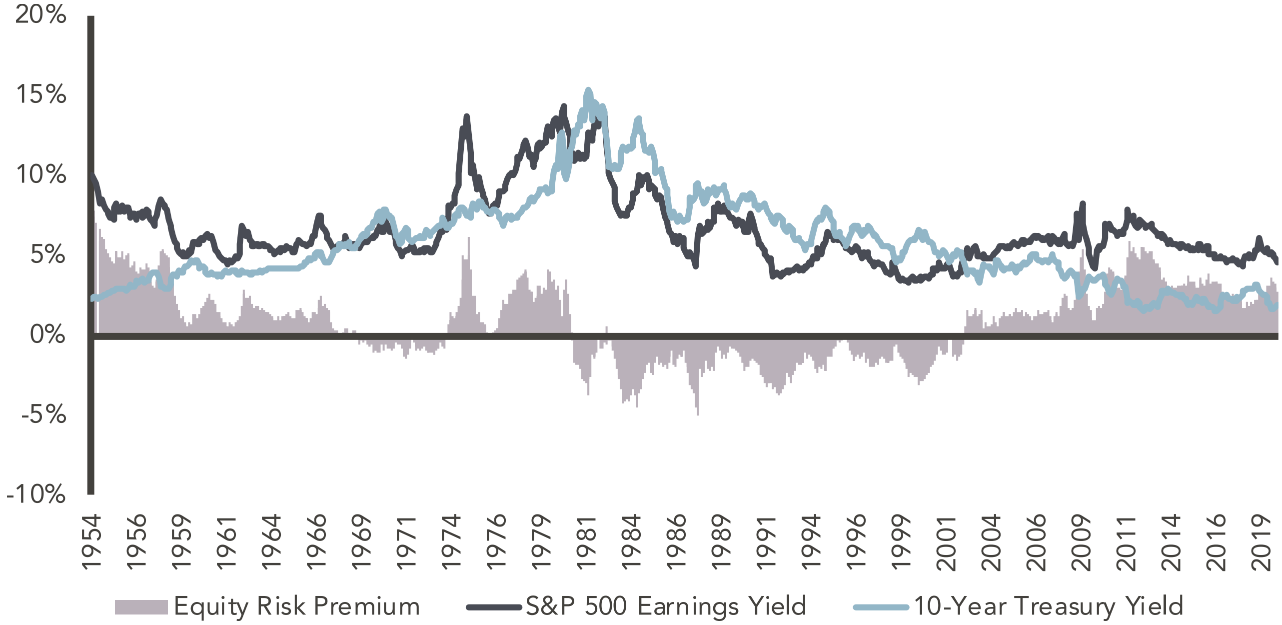
Macro risks remain largely the same with slowing global economic growth and the U.S.-China trade war continuing to dominate investor concerns. The fourth quarter of 2019 had the tailwind of a phase one trade deal appearing to be accomplished with a rollback of tariffs and agricultural purchases by China announced. However, a phase two trade deal will target intellectual property and technology transfer rights. The U.S. and China appear to be at a much greater philosophical impasse on these topics, so we are unlikely to see any tangible progress on these fronts over the near-term. Tariffs and trade uncertainty will continue to weigh on input prices, business spending plans, and consumer prices. Any negotiation setbacks or escalation in tariffs will not be received positively by equity markets. The low interest rate environment and accommodative global central bank backdrop is expected to remain and may help extend this market cycle. The Fed stated that it would need to see a significant increase in inflation before considering raising short-term rates again. This appears unlikely over the short-term with the Fed content to let the economy "run hot."

FEAST OR FAMINE: RISK CONSIDERATIONS FOR 2020

The current U.S. economic expansion officially hit its 11th year in June 2019, marking the longest-running post WWII expansionary period to date. Despite being the longest, it has also been one of the shallowest with respect to economic growth. Economic expansions and bull markets do not last forever, so many investors and business leaders are rightfully concerned that we are due for a recession. The key question is not if, but when. Many are calling for a recession as early as late 2020; however, there are reasons to suggest an extended cycle is possible. Low economic growth, low inflation, and near zero interest rates can all assist in the economy muddling along even further. Additionally, the U.S. economy has experienced mini recessions in recent years with energy markets in 2015 and the manufacturing economy in 2019. However, manufacturing comprises a relatively small portion of the U.S. economy today. Consumption accounts for roughly 70% of U.S. GDP and the consumer appears to be in relatively healthy shape with low unemployment, low inflation, wage growth, and consumer spending holding up. Concern surrounds whether the manufacturing recession will spill over into the broader economy. Any signs of distress in consumer health or spending would be a significantly negative development given their resilience thus far.

Another possibility is that we see a melt-up scenario occurring to end this bull market. The latter portion of bull markets tend to enjoy strong returns, often comprising a significant portion of total bull market gains. U.S. equities have seen persistent outflows relative to other asset classes in recent years, so participation and sentiment is far from euphoric this late in the bull market. With the Fed reversing its policy course in 2019 and providing a more accommodative backdrop, it is possible to see a resurgence in excessive risk taking or yield seeking behavior under a lower for longer interest rate environment. The term "there is no alternative" or "TINA" has been used to describe investing in equities when there are no other good alternatives. While price multiples are very high, equity valuations are attractive relative to bonds on an earnings yield basis. The chart below shows the equity risk premium for U.S. equities (the earnings yield of the S&P 500 minus the yield on the 10-year Treasury bond). As of 2019 year-end, the S&P 500 had an earnings yield of 4.6% versus a yield of 1.9% for 10-year Treasury bonds. This methodology assumes that the risk of equities is equivalent to that of long-term Treasuries and historically has not been very accurate in its predictive ability for future equity returns. Nevertheless, equities today appear undervalued relative to bonds thus reinforcing the TINA effect.

↘ **Exhibit 5:** Equities are Attractive Relative to Bonds

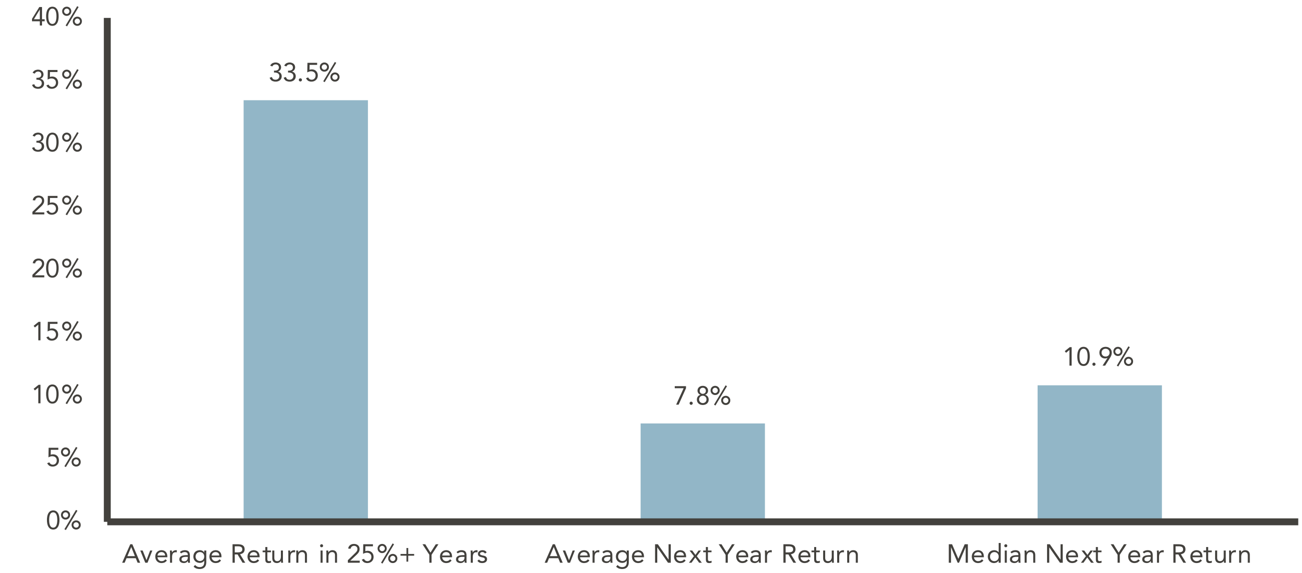


Source: Bloomberg as of December 31, 2019

CONCLUDING REMARKS

Overall, similar themes from 2019 carry over into 2020. An accommodative monetary backdrop, trade deal news dominating the headlines, volatility leading up to the 2020 presidential election, continued late-cycle concerns, and above average valuations all remain. Earnings expectations for 2020, thus far, are better than we saw in 2019. Another year of strong multiple expansion appears unlikely and the 10% projection for earnings growth will likely be revised downward. After such stellar returns in 2019, lower returns in 2020 are to be expected with single digit positive returns appearing a realistic estimate. We expect to see greater volatility and sharp rotations occurring within equities throughout the year. Sentiment around U.S.-China trade progress as well as the 2020 presidential election are sure to play a significant role in this regard. With equities trading near all-time highs eleven years into a bull market and no shortage of risks that can impact prices, it is important to recognize that market drawdowns are inevitable in equity investing. On average, equities see a 5% pullback four times per year, a 10% pullback once per year, and a 20% correction once every five years. Even with above average valuations, equity returns can still be positive after recording a year of strong returns. Based on historical data going back to 1928, the S&P 500 produced an average return of +7.8% in the year following a 25%+ return. In fact, the following year's return was positive 74% of the time. It remains to be seen what 2020 will bring, but history shows that it is better to stay invested than attempt to time the market.

Exhibit 6: Was 2019 as Good as It Gets? Returns Are Often Positive Following a Year of Strong Gains



Source: Bloomberg as of December 31, 2019

KEY TAKEAWAYS

1. **Large-Cap**: Quality attributes are typically sought later in an economic cycle. Large-cap stocks are generally more profitable and better positioned to weather any supply chain disruptions or margin pressures caused from rising input costs or wage growth.
2. **Mid-Cap**: Mid-cap stocks are likely to remain a sweet spot for investors in terms of risk-reward. Mid-cap should continue to benefit from M&A activity and private equity take-outs as large multi-national companies seek to buy growth and private equity investors put dry powder to work.
3. **Small-Cap**: Small-cap trades at a steep relative valuation discount compared to large-cap; however, small cap is more dependent on the overall economic environment and its effects on earnings and margins. With economic growth expected to remain low, small caps may continue to lag their larger cap peers.
4. **Growth-Value**: Growth's outperformance over this bull market has resulted in a wide performance spread between growth and value. The potential for a reversion back to value is strong but such divergences can persist longer than expected. A sustained pick-up in economic activity may be needed to reverse this trend.
5. **Sectors**: Cyclical areas such as industrials and materials could see strong relative performance if economic growth improves or additional progress is made on U.S.-China trade negotiations. Energy companies may benefit from rising oil prices if supply disruptions emerge. Financial sector valuations are attractive on a relative basis, but a flat yield curve hurts net interest margins. Defensive sectors such as consumer staples, utilities, and REITs trade at elevated valuations yet may see continued interest in a risk-off or yield seeking environment. Growth areas trade at high valuations but may continue to benefit from risk-seeking behavior in a low growth environment as well as investors seeking out longer-term secular trends.

Non-U.S. Equities

BIG EXPECTATIONS, LITTLE WIGGLE ROOM

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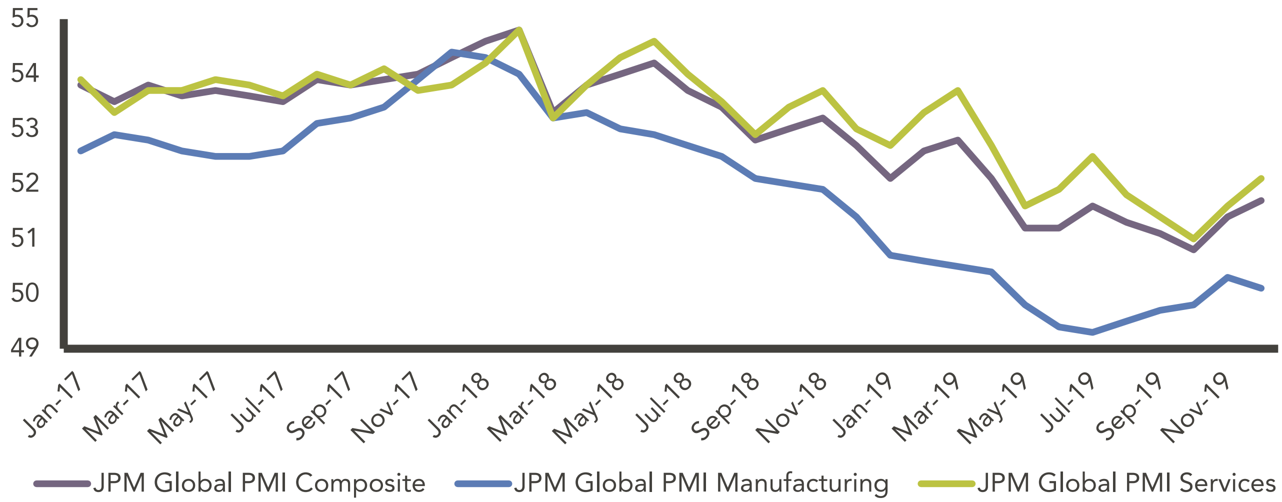
After a weak 2018 performance, when most broad benchmarks produced double-digit losses, non-U.S. equities snapped back with double-digit gains in 2019.

Developed markets (22.0%) outperformed emerging markets (18.4%). Small-caps outperformed in developed markets (25.0%) but trailed in emerging markets (11.5%). Why the sharp reversal in performance between the two calendar years? Earnings and economic momentum remained poor through 2019, a trend that started in 2018. Macro-risk factors continued to hang over global equity markets. The Brexit drama dragged on and took out former Prime Minister May in the first half of the year. The outlook for a U.S.-China trade deal seemed to change week to week, whipping investor sentiment from positive to negative and back again. Given these issues, the strong performance seems surprising. However, markets sold off dramatically in 2018, leading to attractive valuations at the start of the year. Additionally, central banks throughout the globe pivoted to more accommodative polices, giving investors hope for a rebound in global economic momentum. Looking ahead to 2020, we are much more cautious on non-U.S. equities than at the start of last year. Valuations have risen sharply as the vast majority of 2019 returns came from multiple expansion rather than earnings growth. We need to see a reversal in recent earnings trends to support returns in the year ahead.

ECONOMIC UPDATE

In the second half of 2019, we saw flashes of economic stress and growth slowdown throughout the world as a handful of countries — including Germany — teetered on technical recessions between their Q2 and Q3 productivity reads. The OECD's composite leading indicator index fell to its lowest level in almost ten years, at 99.1 as of October 2019, which is indicative of a momentum downturn. Global composite PMI managed to stay within the expansionary zone throughout the year, despite its manufacturing component plummeting below the 50 threshold in March and largely remaining there until the November read of 50.3. Surprisingly, the JP Morgan Global PMI Composite Output Index posted a 4-month high of 51.5 in November, up from a 44-month low of 50.8 in October.

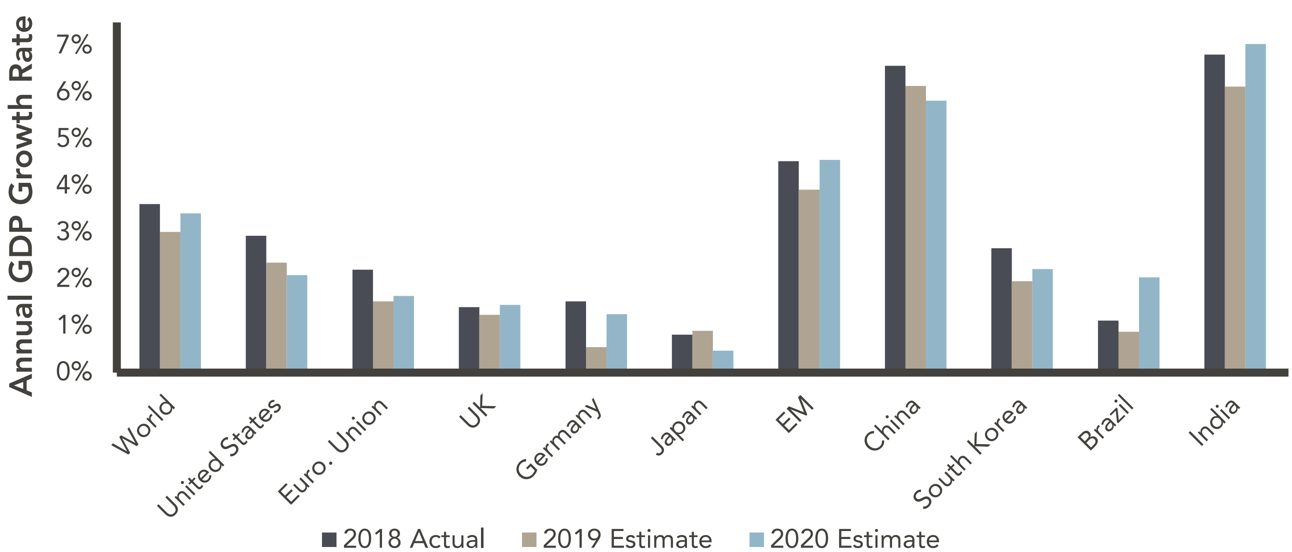
Exhibit 1: JPM Global PMI Over the Last Three Years



Source: Bloomberg

In terms of aggregate productivity, the global GDP growth rate is expected to come in at 3.0% for 2019, almost 19% behind the International Monetary Fund's October 2018 projection of 3.7%. This is the lowest global growth forecast since the Great Financial Crisis of 2008–2009. Japan is the only developed non-U.S. market expected to contribute an accretive GDP growth rate. It is also anticipated that China's GDP growth rate will decline from an estimated 6.1% in 2019 to 5.8% in 2020. Emerging markets GDP growth rate, as a whole, is expected to have declined in 2019 once final data is released.

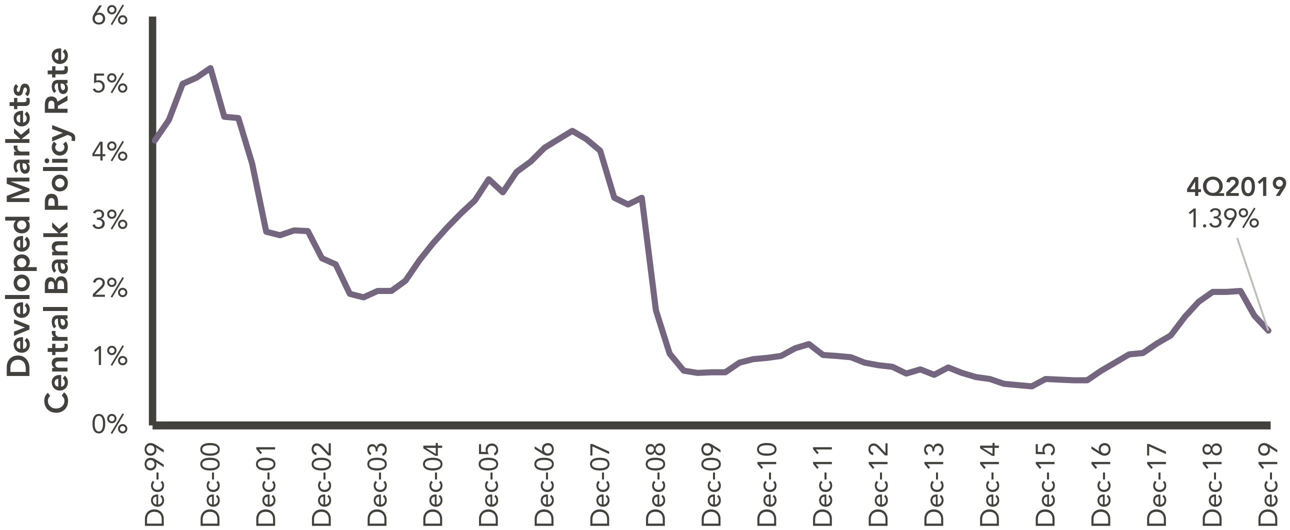
Exhibit 2: GDP Growth Estimates



Source: International Monetary Fund, World Economic Outlook, October 2019

However, given the accommodative stance of global central banks, these slowing momentum signs may take a slight corrective turn or at least offer the potential to do so in 2020. The European Central Bank and global central banks continued to cut rates in 2019, in an effort to jumpstart the slowing global economy. The ECB cut rates to -0.5% in September and announced a new bond-buying program. The Reserve Bank of India cut its repo rate by 35 basis points and unleashed a $20B fiscal stimulus package. China has thrown out a litany of monetary and fiscal measures to combat the impact of increased foreign tariffs and its economic slowdown; most notable are letting its currency fall below $7 USD, cutting reserve requirements on banks, and reducing some taxes. While the global economy stalled in 2019, central bank policies have given investors hope for a rebound in 2020.

Exhibit 3: Developed Market Central Bank Policy Rate

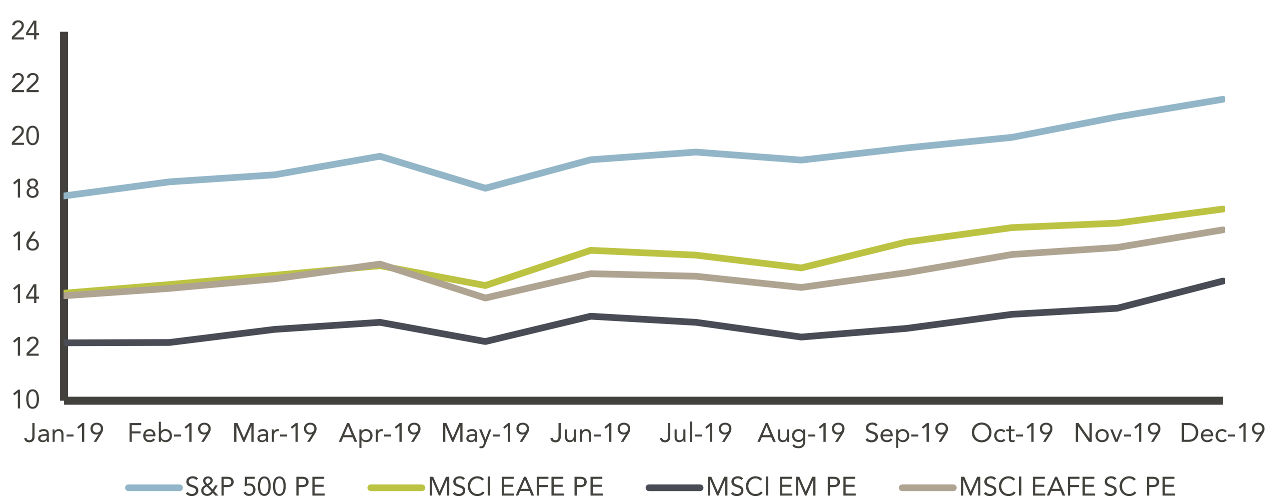


Sources: Bloomberg, Developed Economies (OECD) Central Bank Rate (%)

EARNINGS AND VALUATIONS

In 2018, earnings revisions were negative — a normal occurrence for markets — as analysts typically start the year more optimistic. While momentum fell, the absolute level of earnings growth remained positive. In 2018, the aggregate earnings for the MSCI EAFE and MSCI EM indices grew by 4.0% and 6.3%,[1] respectively. In 2019, earnings momentum remained negative and earnings growth was sharply lower, -0.8% and -0.4%.[2] What happens when prices move up and earnings move down? Valuations become more expensive and that is what we see in Exhibit 4, where P/E ratios rose dramatically from the start of 2019. The MSCI EAFE and MSCI EM trailing 12-month P/E ratios[3] rose by 31% and 30%, respectively.

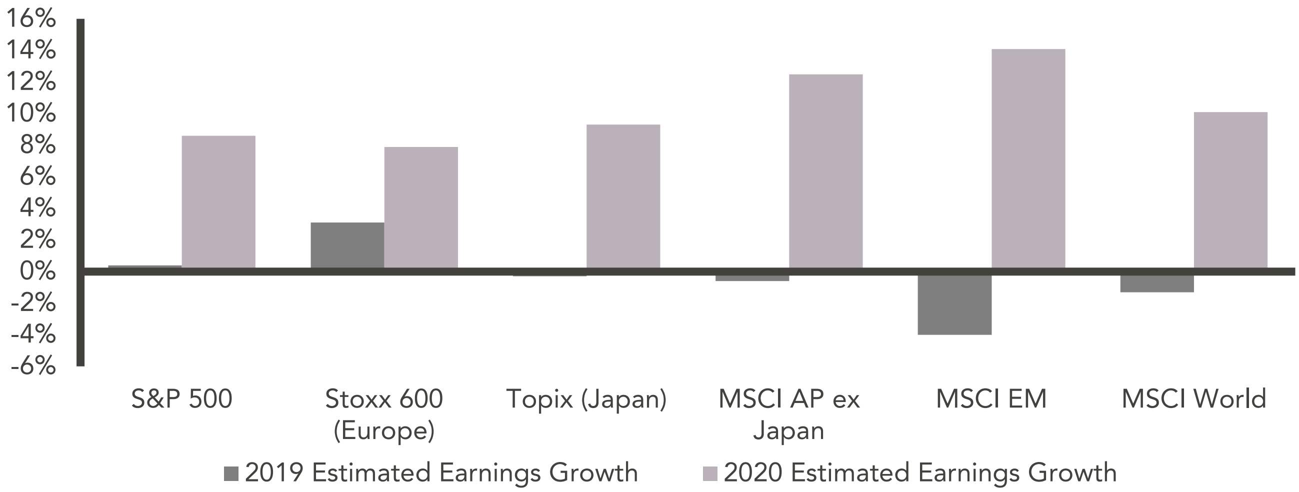
Exhibit 4: Valuations Climbed for all Equities in 2019



Source: Bloomberg; 12-month trailing PE adjusted for negative earnings

Looking forward to 2020, earnings are projected to be much stronger with estimates ranging from 8% to 14%. It is important to note however that these are projections, and as stated earlier, it is common to see projections come down through the year. High levels of global uncertainty muddy the future earnings outlook. This fact, combined with elevated valuations, lead us to a cautious outlook on non-U.S. equity returns for 2020. Unlike the start of 2019, there is considerably less wiggle room for multiple expansion. Therefore, substantial earnings downgrades would likely lead to negative returns. While earnings disappointed last year, valuations were also much lower. Additionally, in 2019 investors reacted positively to the accommodative actions taken by the Fed, ECB, BOJ, BOE and central banks of several emerging countries. We would argue that a slight rebound in momentum is currently priced in to equity markets, so there is more room to the downside should economic and earnings data not meet market expectations.

Exhibit 5: 2019 and 2020 Earnings Expectations



Source: Goldman Sacks Global Investment Research as of January 6, 2020

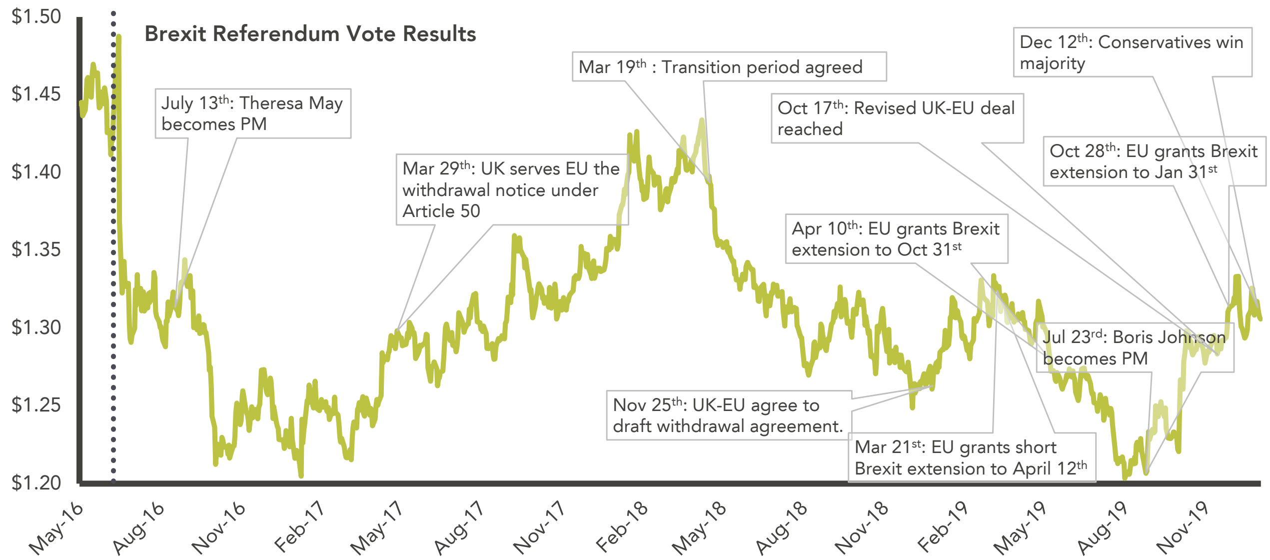
RISKS

The geopolitical and trade tensions that plagued developed international and emerging markets in 2018 raged forward into 2019 as the U.S.-China trade spat hit a new crescendo of increased tariff threats and aggressive rhetoric. The Brexit quandary remained unresolved, while protectionism tactics spread into new frontiers and caused bouts of civil unrest.

Starting with the largest source of commotion, U.S.-China trade negotiations were a constant source of volatility in 2019. As the tweets, threats, and schedules of potential tariffed Chinese goods increased over the year, particularly during the holiday season, we experienced some of the most volatile days in both developed and emerging markets. Fortunately, on December 13th it was announced that U.S. and Chinese officials had reached a preliminary agreement to halt the trade war, with the U.S. suspending the next round of tariffs planned for roughly $160 billion on Chinese imports and Beijing agreeing to some new economic rules as well as unspecified purchases of American agricultural goods and other products. This "Phase One" agreement would also reduce the tariff rate from 15% to 7.5% on a previous tranche of tariffs with an underlying value of roughly $120 billion worth of goods. The Phase One trade deal was signed by all parties on January 15th, 2020, and further negotiations and phases will be coursed out slowly throughout the remainder of 2020.

On the Brexit front — and to the chagrin of most market participants — the indecision that became synonymous with Brexit talks in 2018 continued into 2019. Over the course of twelve months, we saw three additional agreement extensions, PM Theresa May resign in June, PM Boris Johnson elected in July, and a prorogation of the House of Parliament. With each turn, we saw the Pound Sterling exchange rate lurch in various directions, with GBP hitting a new post referendum low in early September.

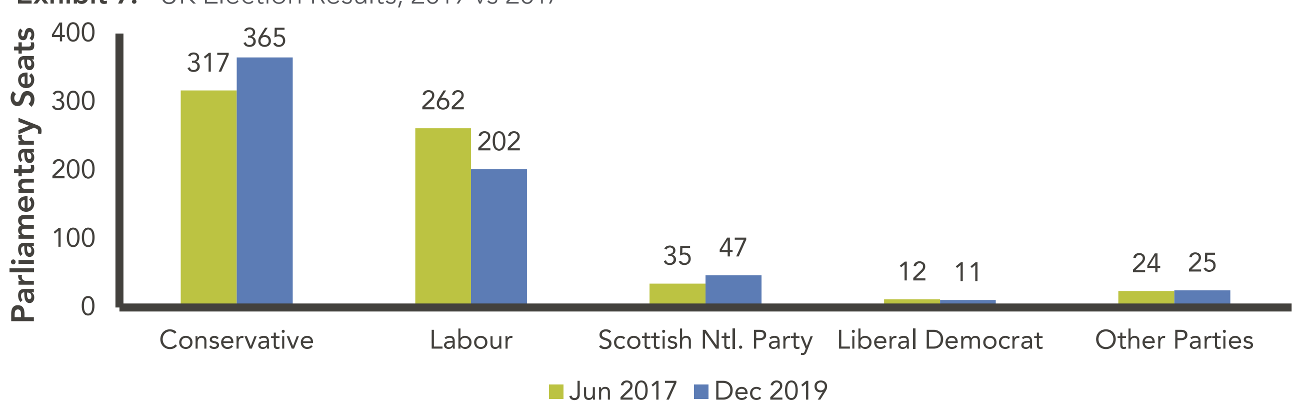
Exhibit 6: Pound Sterling Rides Waves of Brexit Twists



Source: Bloomberg through Jan 10, 2020

However, we ended 2019 with a crumb of certainty and calm on the Brexit path forward. In contrast to the 2017 elections, Conservatives won a commanding 56.2% majority in the December 12th snap general election, thus securing that PM Johnson's Brexit deal with the EU would likely be finalized and pushed through Parliament by the January 31st deadline. PM Boris Johnson now has greater flexibility to manage, and even extend, the 11-month transition period needed to ratify trade and customs terms with the EU, although he has pledged to stick to the existing timeline. The market's response has been welcoming thus far to the certainty of the Conservatives' win and eventual withdrawal of the UK from the EU by December 31st, 2020. However, time is of the essence and European leaders have already hinted that the current transition period could be too short to finalize a trade deal similar to the frictionless, current status quo. As final terms are negotiated, the market may still feel Brexit aftershocks as the UK attempts to chart a trade deal, sans ongoing adherence to EU rules, with the 27 member states and European Parliament. If PM Johnson and Britain's negotiation team fail to come to a final trade deal, the UK faces potential tariffs on exports to the EU.

Exhibit 7: UK Election Results, 2019 vs 2017



Sources: UK Parliament, House of Commons Library

On the heels of these two major trade negotiations, the spread of protectionism rhetoric within Asia added an additional layer of uncertainty to the markets in 2019. Of considerable note from a global economic standpoint, the trade spat between Japan and South Korea, coupled with the continued civil unrest in China's crown jewel, will likely pose ongoing risks in 2020. Beginning with the standoff between Japan and South Korea in July 2019, we saw Tokyo place tighter controls on mission critical semiconductor chemical exports to Seoul. Japan's government took this stance largely in retaliation to a South Korean Supreme Court decision to uphold a ruling requiring Japanese companies to compensate a group of South Koreans who were forced into work for them during Japan's occupation on the Korean Peninsula. This snowballed into Japan announcing the removal of South Korea from its preferred, whitelist trade partners on August 2nd, which sent the Nikkei 225 index down 2.11% and the KOSPI index down 0.95% that day alone.

Meanwhile, in June 2019, political protests erupted in Hong Kong in response to a Chinese extradition bill that would require criminal fugitives to be sent to mainland China, undermining the region's autonomy and Hong Kong peoples' civil liberties. These nonstop demonstrations carried deep economic ramifications, with Hong Kong tourism falling by 40% and Hong Kong GDP contracting by 2.9% in the third quarter. With the landslide pro-democracy election win in December and continued, intensified protests, there will likely be continued social and political unrest in China for 2020.

Lastly, looking ahead to the next trade front, the Trump Administration signaled in the latter half of 2019 that the European Union was in its crosshairs for potential tariffs. In October, the U.S. slapped a 10% tariff on Airbus planes and 25% duties on French wine, Scottish and Irish whiskies, and an assortment of European cheeses as punishment for EU's aircraft subsidies. On December 13th, the Office of the United States Trade Representative published a list of additional European goods it is now considering for 100% tariffs amid the further fallout over Airbus aid, the EU's plan for tit-for-tat tariffs based on the U.S.'s unlawful Boeing subsidies, and France's new digital services sales tax which is poised to hit American tech giants acutely. As the U.S. and EU tensions increase, we can expect rumbles in the international markets.

CONCLUSION

Despite high levels of global uncertainty, lackluster earnings, and weak economic data, non-U.S. equities rebounded in 2019 after a disappointing 2018. Multiple expansion accounted for the strong returns as accommodative monetary policy boosted investor sentiment. Looking forward, geopolitical events like the Brexit, U.S.-China trade relations, and U.S. elections are likely to influence markets and create bouts of volatility. Additionally, in contrast to the start of 2019, market expectations and valuations at the start of 2020 are higher, increasing the likelihood of downside surprises. However, central banks continue to support markets and several economic data points showed signs of a bottom in late 2019. Finally, positive outcomes from the aforementioned geopolitical events can boost returns further. Ultimately though, for 2020 we are cautious on non-U.S. equities given the elevated valuations and market expectations.

NOTES

[1] Bloomberg
[2] Eaton Vance, FactSet as of 12/31/19
[3] P/E ratio is adjusted for negative earnings

Hedge Funds

RISING GEOPOLITICAL RISKS AND A U.S. ELECTION COULD LEAD TO TEMPERED EXPECTATIONS

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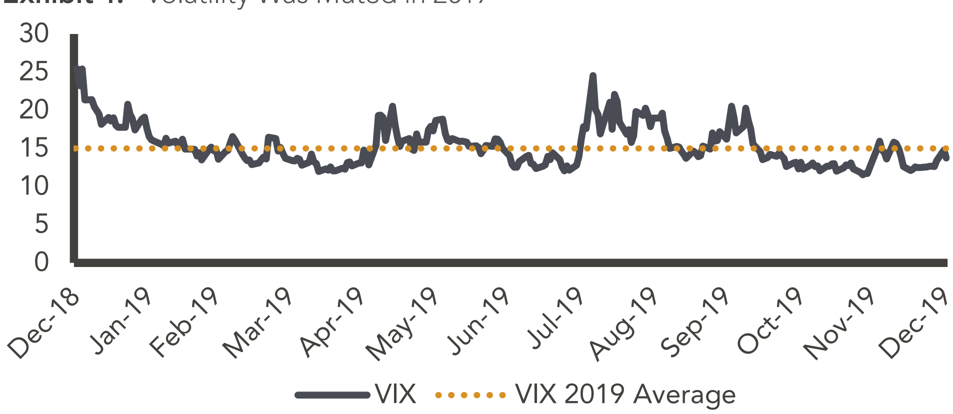
Hedge funds bounced back in 2019 following a difficult 2018 thanks to a risk on environment where both equities and fixed income performed exceptionally well throughout the year. A supportive monetary policy along with a healthy economic backdrop coupled with a late-breaking apparent trade truce between the U.S. and China helped deliver strong returns across the board. Global financial markets moved in concert throughout 2019, as strong gains were observed across equities, fixed income, commodities, and currencies. This strong global performance led to the best hedge fund returns seen in over a decade.

Equity hedge strategies finished the year up 13.9%,[1] as market volatility remained relatively muted except for short spurts around trade war concerns, Medicare regulations, and economic recession fears. The below chart shows the daily VIX index price movements throughout 2019. The average of the index was 15 which saw quick spikes of volatility and a subsequent snap back to calm with no time period of sustained volatility.

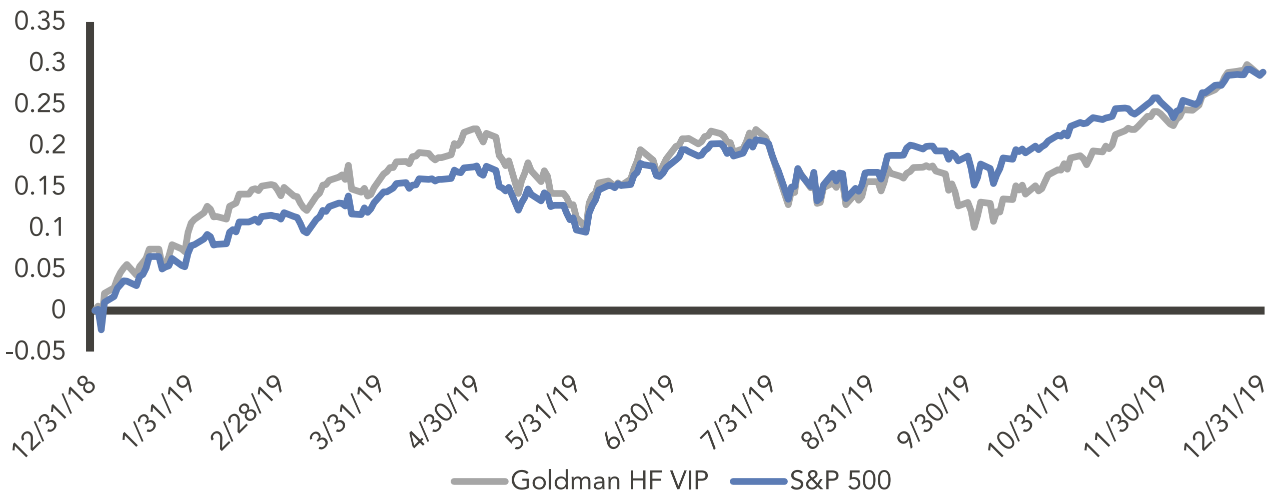
Exhibit 1: Volatility Was Muted in 2019



Source: Bloomberg

TMT (tech, media, telecom) positions continued to dominate commonly held hedge fund holdings throughout the year, causing a basket of the most widely held hedge fund holdings to perform in-line with the S&P 500 in 2019. The Goldman Sachs Hedge Fund VIP Index is heavily weighted towards Info Tech, Communication Services, Health Care, and Consumer Discretionary. This basket of common hedge fund holdings held up against the S&P 500.

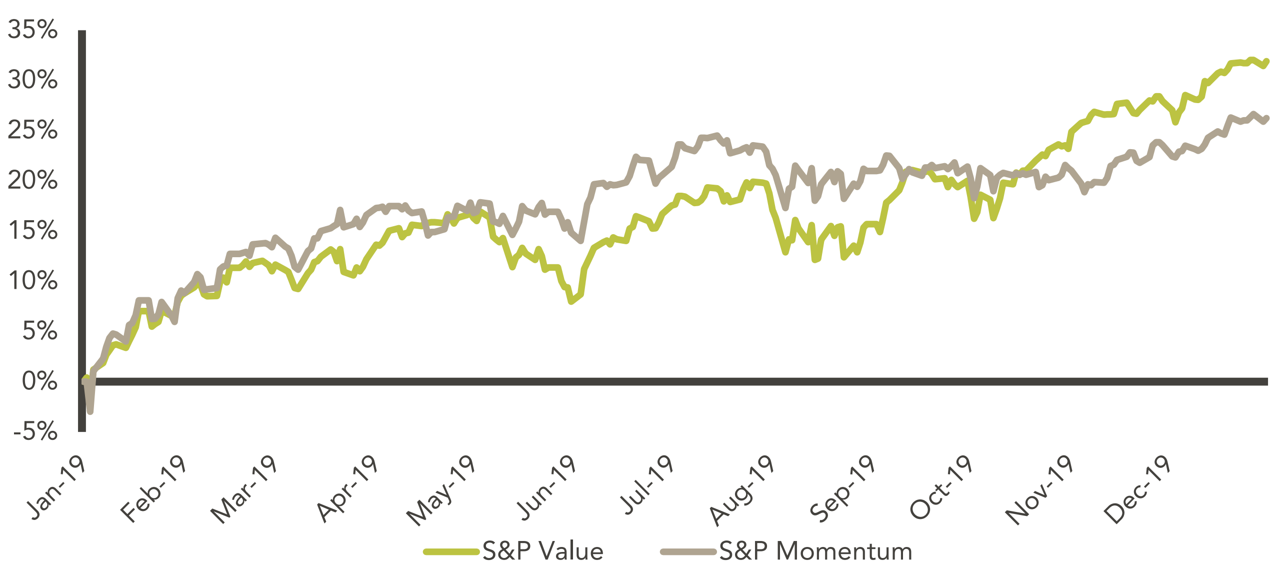
Exhibit 2: Hedge Fund Favorites Kept Up with the S&P



Source: Bloomberg

In September, equity hedge managers with a growth focus experienced a sharp sell-off during the month, as the momentum factor sold off violently while the value factor rallied, which produced one of the worst months for alpha generation since 2010 according to Morgan Stanley Prime Brokerage. Momentum recovered the following month, but this was a good reminder of how quickly growth names in the TMT sector can sell off without any warning. The following chart shows this dynamic playing out in September and how the value factor outperformed for the remainder of the year.

Exhibit 3: Momentum Rolled Over During the Third Quarter



Source: Bloomberg

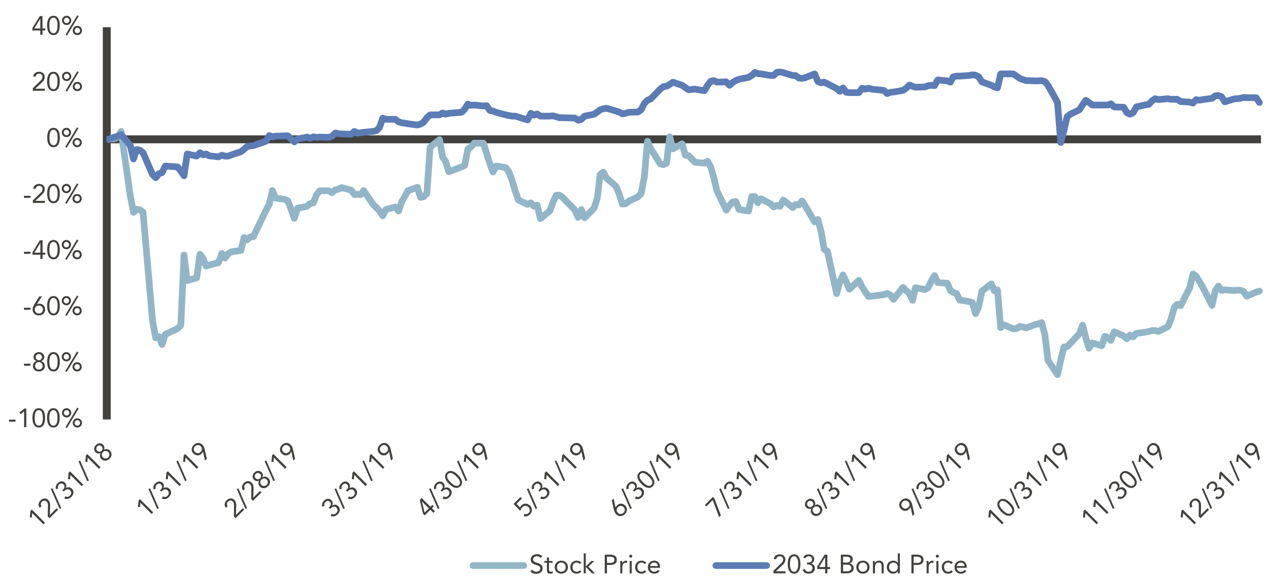
Merger Arbitrage finished the year up 6.8% as large deals were announced throughout the year, with companies taking advantage of cheap financing to acquire growth late in the cycle as they prepare themselves for an overall slowdown in the economy. Companies across all sectors and industries continue to face technological disruptions which has inspired cross-sector deal activity. Notable positions during the year included the Anadarko/Occidental deal that closed in early August after Anadarko shareholders voted to approve the deal. Altaba made a substantial distribution of $51.50 per share in September as part of its previously announced liquidation program and filed a certificate of dissolution in October. The bulk of Altaba's remaining assets are comprised of cash and cash equivalents, including amounts held in reserve for potential tax liabilities. The company expects to make additional distributions over the next few years.

Convertible arbitrage strategies returned 10.7% as one of the best performing strategies on the year. An uptick in single name volatility, coupled with a robust new issuance calendar — the highest in over a decade — provided macro tailwinds. The technology sector was the main driver of new issuance in 2019.

Relative value ended the year 7.6% higher as strategies that provided liquidity to less liquid fixed income strategies were able to generate attractive returns during the year. Some large idiosyncratic positions that were widely held did go against credit managers, but many were able to recover and finish positive for the year.

PG&E was one of the most widely held companies by hedge funds during the year after the company filed for bankruptcy due to $30B+ in liabilities related to wildfires in 2017 and 2018. Credit and distressed hedge funds entered the picture following the bankruptcy filing buying up both the debt and equity of the company. Their rationale for doing so was on the basis that liability payments will be smaller than originally expected and both the equity and debt prices would recover, or they would help navigate the company through bankruptcy. In August the PG&E bankruptcy judge allowed a civil trial to move forward on whether the utility's equipment caused the Tubbs Fire, the second worst wildfire in California history — causing the equity to sell off aggressively while the bonds experienced very little pressure following the ruling.

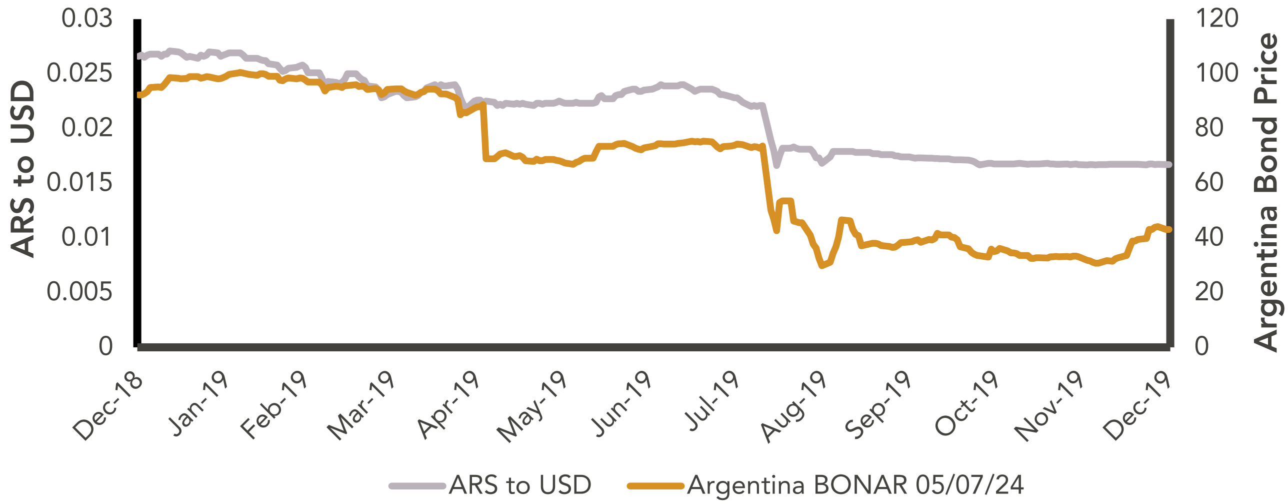
Exhibit 4: PG&E Equity Caused Pain for Distressed Hedge Funds



Source: FactSet

Distressed and macro hedge funds accumulated large positions in Argentina bonds with the view that the country wouldn't default on its debt. Those bets proved punishing after the country's pro-business President Mauricio Macri had a disappointing showing in a primary election in August. That sent markets tied to Argentina into turmoil because the outcome indicated he would lose his re-election bid. Argentina debt traded to distressed levels following the primary results on fears the new administration would likely default on the debt. Despite this sell-off hedge fund managers believe the new administration headed by Alberto Fernandez will continue to pay creditors. The following chart shows the price action of the domestic Argentina BONAR bond due on 05/07/2024 and the exchange rate of the Argentine peso vs. the U.S. dollar.

Exhibit 5: Hedge Funds Lost on Argentina Bets



Source: Bloomberg

Macro hedge funds returned 6.2% for the year as managers were able to generate performance on yield curve trades in UK and Japanese rates along with long positioning across U.S. and European equities. Losses among managers throughout the year largely stemmed from emerging markets and some European markets.

2020 OUTLOOK

As we enter an election year we expect market volatility as more clarity comes to the forefront on who will be the eventual democratic nominee to face President Trump in the election. Given the uncertainty around the U.S. election Marquette recommends focusing on managers who take a hedged approach to investing. When it comes to equity hedge managers, we tend to favor those focused on a specific or limited number of sectors. Those managers tend to be experts in their sectors and best able to pick winners and losers depending on market movements and election dynamics. In Europe, the outlook remains challenging, as Brexit uncertainty continues and GDP growth across many of the largest countries slows further. The European Central Bank (ECB) stepped in due to these concerns and delivered the largest monetary stimulus package over the last three years in hopes of restarting growth across the region. Given all the uncertainties across many European countries managers that are running with a lower net exposure would be better positioned to profit off increased volatility across European countries. In Asia, central banks have also loosened monetary conditions and governments have been introducing policies to boost domestic growth and boost consumer sentiment. Managers that are running a hedged approach across the region will be positioned to profit as more news comes out regarding the U.S.-China trade developments.

When we look at the credit markets in 2020, we see a more benign environment as corporate credit spreads remain near all-time tights despite decreasing market liquidity, U.S. political elections, Brexit, and trade tensions. Retail demand for yield supported much of the new issuance in high yield throughout 2019 but cracks are starting to show up, as higher rated credits (BB) outperformed lower rated credit (CCC) and weakness has popped up in energy, retail, and health care. This has started to provide distressed hedge fund managers with some opportunities but not yet enough to justify an investment at this point.

In the leveraged loan market concern is growing as the Fed pivoted and lowered interest rates causing money to flow out of leveraged loan ETFs and mutual funds. This loss of capital has left the leveraged loan market heavily reliant on CLOs, which now account for the majority of the new issue market. The concern is as more issuers get downgraded CLOs turn into forced sellers at the B3 and B- levels, with CCC exposure at many CLOs capped at 7.5%. As the flood of B-rated issuance faces the prospect of widespread downgrades, CLOs are starting to proactively reduce exposure in order to avoid breaching CCC limits. This could provide distressed investments for managers as loans get dropped out of these structures, but Marquette recommends staying away from CLOs in the coming year as they are likely to face more of these issues in 2020. Marquette remains positive on credit managers that can invest both long and short across the credit spectrum. Given decreasing liquidity across the credit spectrum we would recommend a diversified approach to investing in the structured credit space.

In merger arbitrage, we expect an increase in corporate activity ahead of the U.S. election as rates still remain attractive to finance such deals. This could change if disappointing news comes out regarding the U.S. and China trade dispute or a surprise were to pop up ahead of the U.S. election in November.

In the macro space, a number of situations remain top of mind for investors as we enter 2020, including Brexit, U.S.-China trade negotiations, and additional accommodative central bank policy actions. Areas of opportunity for macro managers center around volatility associated with central bank actions, which are likely to create opportunities around curve trading and cross-country relative value trades.

With all the uncertainty expected in 2020 manager selection remains paramount when structuring a hedge fund portfolio. Marquette recommends focusing on managers that have a track record of generating alpha over an extended time period both on the long and short side. Experience will be critical as managers will likely need to dynamically adjust their portfolio as market conditions change rapidly. Marquette continues to believe hedge funds are a valuable part of clients' portfolios given the diversification they provide, but investors must be prudent when selecting hedge fund managers and strategies.

NOTES

[1] All returns in this Market Preview are based on HFRI as of December 31, 2019.

2020 Market Preview

Real Estate

WHAT WILL HAPPEN NEXT?

Real estate has thrived since the Global Financial Crisis as a result of economic growth, falling interest rates, and low inflation. While we don't expect these market conditions to go away completely, the macro environment is changing.

What has worked in the past is unlikely to work going forward in the face of anticipated slowing global growth, trade war uncertainty, political polarization, heightened asset values, and disruptive technology. However, it is not all doom and gloom for the asset class. Potential tailwinds include an ongoing low interest rate environment, stable fundamentals, and favorable demographics.

Real estate performance as measured by the NCREIF Open-End Core Equity Fund Index ("NFI-ODCE") is on pace to deliver a 5% gross total return for calendar year 2019. The NFI-ODCE returns continue to slow in this mature market environment as a result of falling retail property valuations and depreciation from mark-to-mark debt adjustments[1] due to lower interest rates. Net capital flows within the NFI-ODCE were -$909 million in the third quarter of 2019, well below the second quarter's -$73.7 million net outflows. Over the last year, fund flows were -$2.8 billion which is a major shift from earlier in the cycle when flows were positive. Much of the redemption activity was a result of investors redeeming from poorer performing funds and reallocating to better performing funds and perceived favorable sub-sector allocations (i.e., higher exposure to industrial and multifamily and lower exposure to retail).

The top five performing markets within the NCREIF Property Index (NPI) over the trailing 1-year time period (as of September 30, 2019) were Riverside, Austin, San Francisco, Seattle, and San Jose. Industrial and technology exposures were the key drivers of outperformance in these top markets. Conversely, Chicago, New York, Houston, Washington D.C., and Dallas were among the bottom five performing markets. In regard to property type performance, industrial continued to lead with a total return of 13.6% while retail was the worst performing sector with a 1.4% total return.

Jeremy Zirin, CAIA

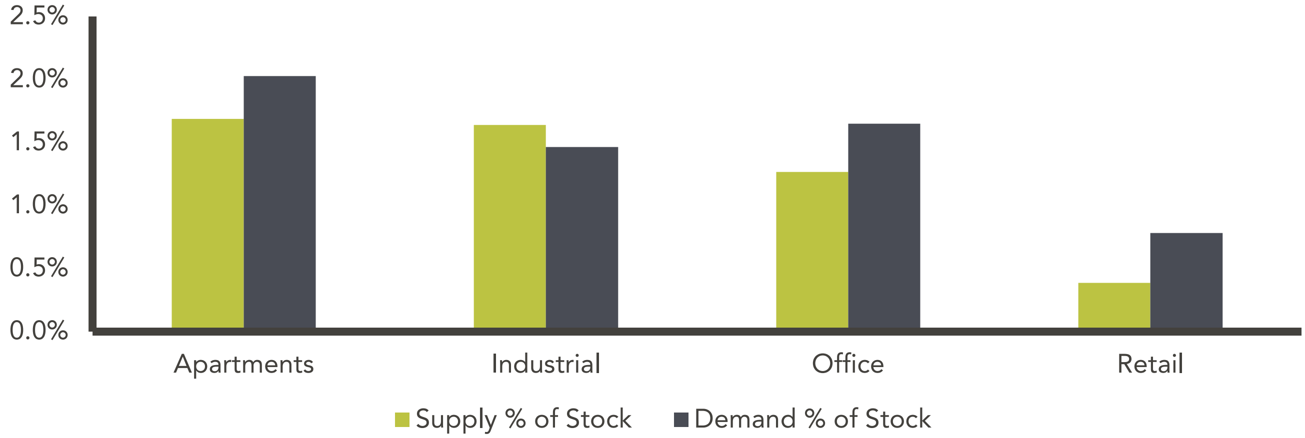
Senior Research Analyst,
Real Assets

Looking forward to the next couple years, the Pension Real Estate Association ("PREA") consensus expects further moderation of returns ranging from 4–6% with the majority of return coming from income and appreciation continuing to trend lower.

FUNDAMENTALS

For the most part, real estate fundamentals remain healthy as illustrated in the following exhibits. Exhibit 1 illustrates that demand is outpacing supply in every sector except industrial. Labor shortages and disciplined construction lending are keeping a lid on development. A disproportionate amount of the industrial supply has been in a handful of markets: Atlanta, Chicago, Dallas, and the Inland Empire (east of Los Angeles).

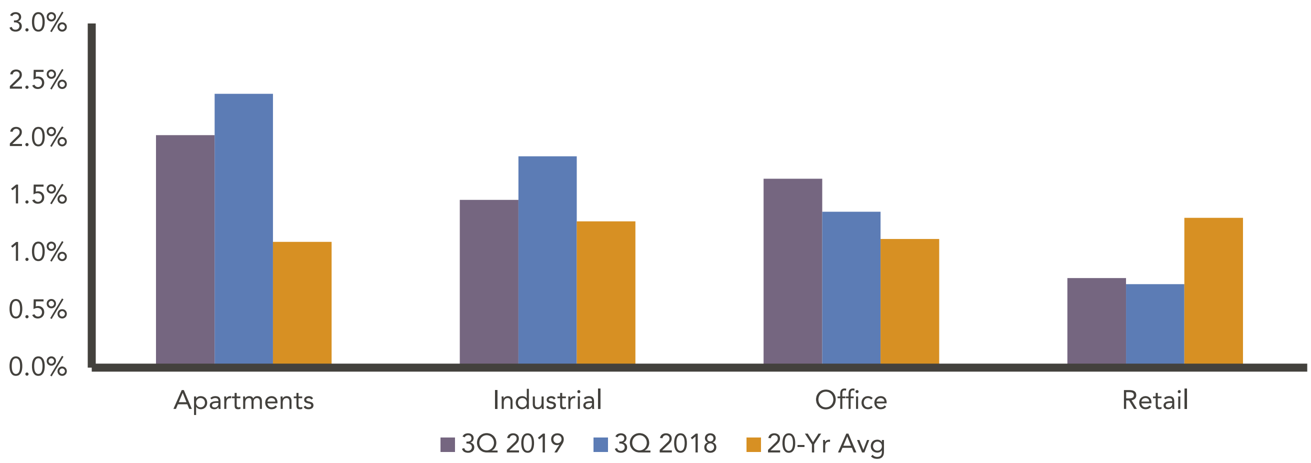
Exhibit 1: Supply and Demand as a % of Stock



Sources: CBRE Econometric Advisors, Axiometrics, DWS Research

Exhibit 2 illustrates demand has been above historical averages in all sectors except retail. Even there, demand is growing despite negative headlines about store closures. Demand slipped slightly in 2019 for apartment and industrial but remains strong. For industrial, it is worth nothing that the threatened tariffs pulled forward some inventory accumulation and demand into 2018 and this contributed to the drop in demand for 2019. Also of note is an increase in office demand despite slightly slower job growth; a possible sign that the office densification trend — putting more people into less space — may be ebbing.

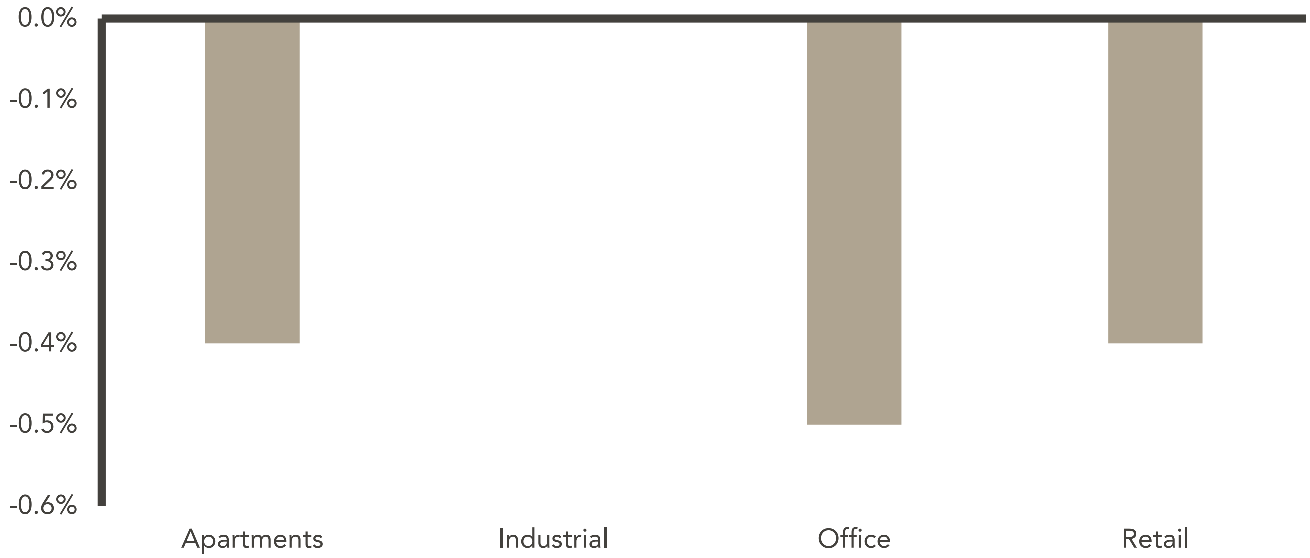
Exhibit 2: Absorption Trends as a % of Stock (Annual)



Sources: CBRE Econometric Advisors, Axiometrics, DWS Research

Exhibit 3 illustrates that vacancies continue to fall from near-record lows except for industrial, where vacancies are extremely low already. In fact, a lack of available space might be crimping demand in the industrial sector.

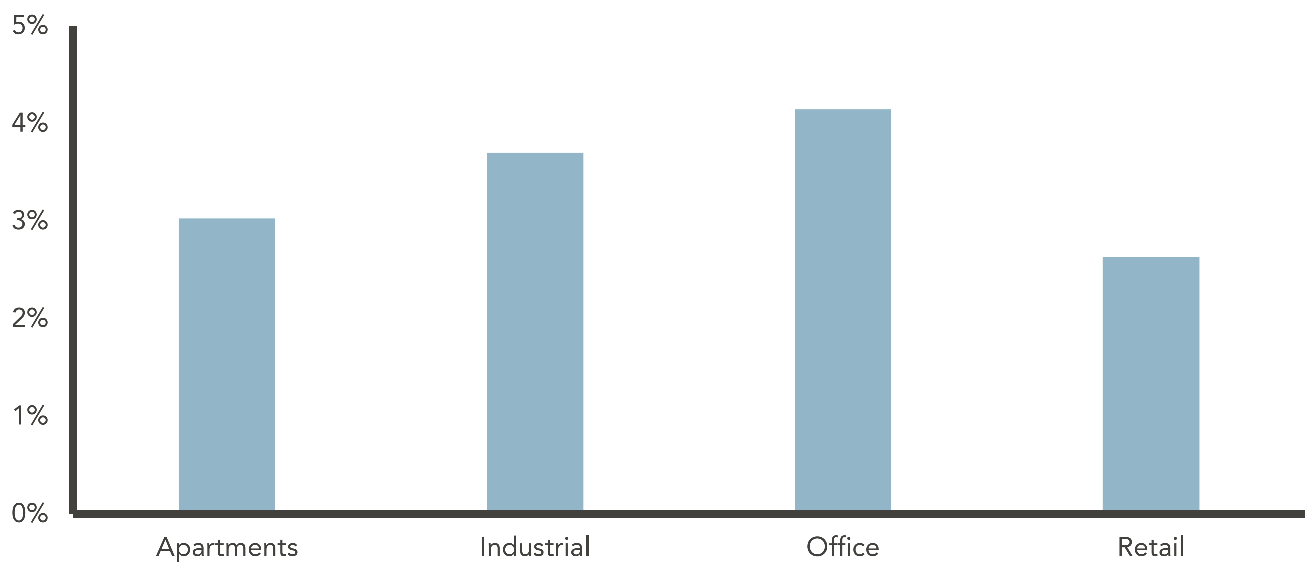
Exhibit 3: YoY Vacancy Change as of 3Q19



Sources: CBRE Econometric Advisors, Axiometrics, DWS Research

Exhibit 4 illustrates that with vacancies low and falling further, building owners have a lot of pricing power. Rents are increasing 3%–4% annually, twice the rate of inflation. The data on retail is a little better than investors might expect given the negative sentiment around the sector. It should be noted that the rental increases are better for neighborhood and community centers (primarily grocery-anchored strip centers) vs. malls, especially lower-quality ones, which are faring worse.

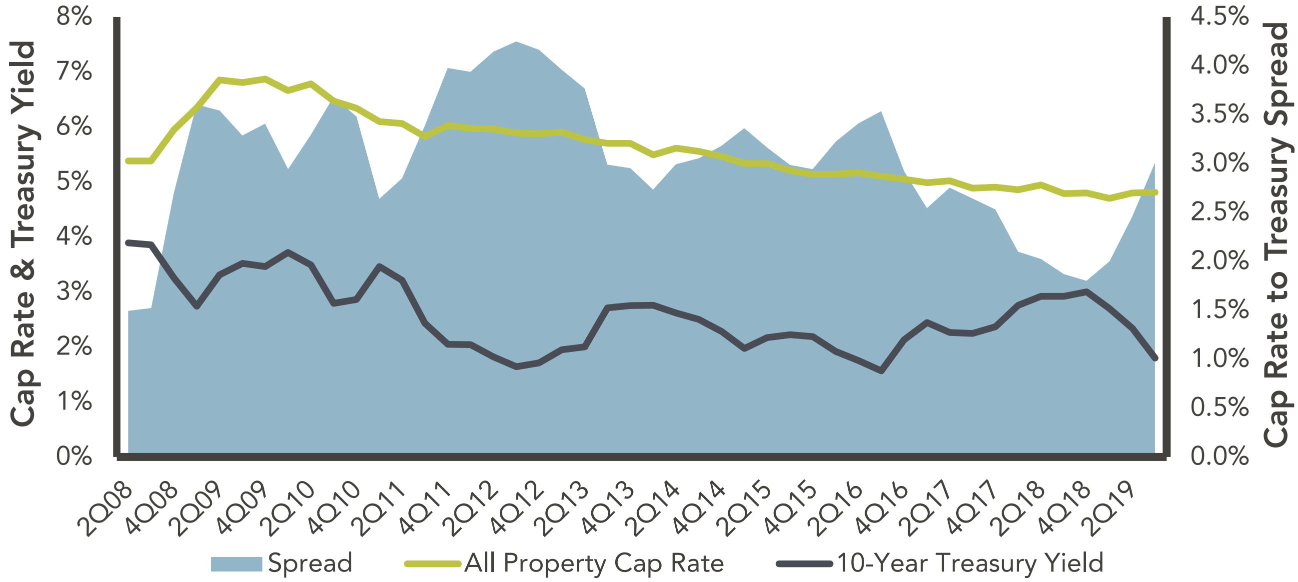
Exhibit 4: Annualized Rent Increases as of 3Q19



Sources: CBRE Econometric Advisors, Axiometrics, DWS Research

The spread between core real estate cap rates for major property sectors and the 10-year Treasury Yield, illustrated in Exhibit 5, continues to widen as a result of lower U.S. interest rates. Thus, even if interest rates were to rise, real estate will continue to offer a more attractive yield than Treasuries.

Exhibit 5: All Property Cap Rates and 10-Year U.S. Treasury Yield Spreads

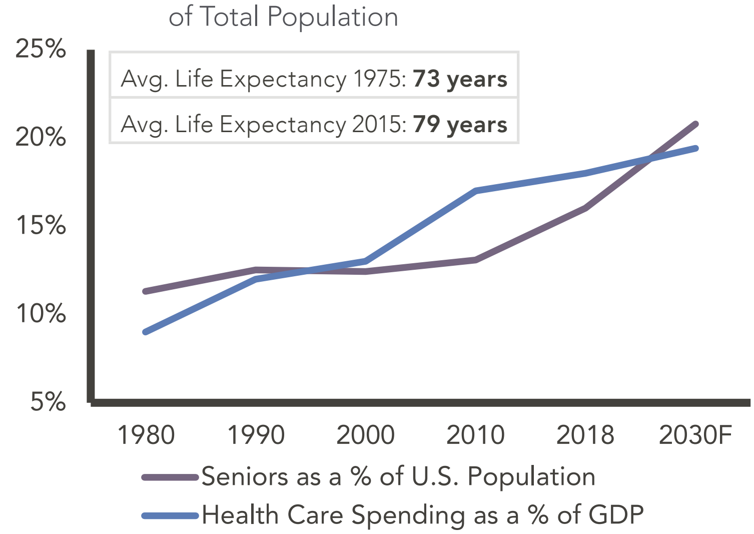


Source: Bloomberg, NCRIEF as of September 30, 2019

LOOKING AHEAD

What is likely to drive real estate going forward is the less understood sub-sectors that are propelling demand such as data centers, fitness, gaming, life sciences, sustainable energy, and even cold storage. These sectors are likely to perform better in a slow growth market environment and even in a downturn, largely as a result of their secular demand. Additionally, specialized sectors that require operational expertise are growing and provide diversified income streams compared to traditional property sectors. For example, powerful demographic trends are boosting demand for life sciences and healthcare given the aging population and desire to cure diseases as illustrated in Exhibit 6. Decades of research and development have led to new drugs and medical treatments ready for commercialization. Compared to traditional office buildings, life sciences and lab offices are difficult to operate and require close relationships between property management and tenants. From an investment standpoint, the life science sector is a high-growth real estate sector with above-market NOI growth that outpaces traditional office buildings.

Exhibit 6: Health Care Spending Rises with Seniors' Share of Total Population



Sources: Eastdil Secured, Clarion Partners Investment Research, August 2019

RETAIL

Retail, based on the NPI, remains the worst performing property sector with an abysmal 0.22% total return comprised of 1.18% income and -0.96% appreciation in the third quarter of 2019. The table below illustrates that all retail within the NFI-ODCE peaked in the beginning of 2018 and has trended down since. ODCE funds have been taking write downs across the retail sector for several quarters now. Outside of the mall space, most of these write downs have been property-specific and/or tenant-specific. The following table details the appreciation performance (to illustrate the impact of write downs without offsetting income) of retail based on NFI-ODCE data which includes all retail properties in ODCE funds:

Exhibit 7: Retail Appreciation Performance

Mall Classification	Peak	Depreciation (performance) since peak as of 3Q 2019
All ODCE Retail	1Q 2018	-5.2%
All ODCE Regional Malls	1Q 2017	-12.3%
All ODCE Community Centers	1Q 2018	-3.5%
All ODCE Neighborhood Centers	1Q 2019	-0.3%

Source: NCREIF

In 2020, we anticipate further downward pressure on regional/super-regional mall valuations, power centers, and lifestyle centers driven by tenant credit considerations, increased capital requirements, and negative investor sentiment toward those brick and mortar retail formats. Neighborhood and community centers were the top performing subsectors within retail over the last one-year period (through 3Q) and that trend is likely to continue this year as well. In general, those properties are supported by necessity-based consumption and/or discount department stores with considerable consumer appeal and limited e-commerce interaction. Critically, they are often bordered by service-oriented businesses with models more limited to the impacts of e-commerce or that partner well with e-commerce (think fast-casual dining with the ability to order ahead and pick up in-store). The retail sector will likely continue to be quite nuanced and investors will be selective.

High street retail, on the other hand, has struggled in some markets (particularly New York, parts of Miami, and Chicago) after several years of dramatic escalation in rents. This is more difficult to measure given there is not sub-sector specific reporting available from NCREIF, but anecdotally, high street retail rents are down considerably with tenants reluctant to commit to high cost “branding” space and are instead focused on locations with strong expected productivity and resultant profitability. Given the amount of capital still looking to invest in private equity real estate vehicles, we don’t anticipate pricing erosion or material upward pressure on cap rates for class A centers in strong locations with credit tenancy. Shopping centers — even neighborhood and community centers that don’t fit that bill — may be more challenged in the coming year.

CONCLUSION

Real estate investments have undoubtedly been accretive to client portfolios over the last decade with annualized returns of almost 9%, but with limited future cap rate compression and anticipated slowing global growth, trade war uncertainty, political polarization, heightened asset values, and disruptive technology, future returns are unlikely to duplicate the last ten years. However, it is not all doom and gloom for the asset class. Looking forward, potential tailwinds that will likely drive real estate performance include an ongoing low interest rate environment, stable fundamentals, and favorable demographics. Real estate should continue to play an important role in portfolios as a source of income and diversification, but the overall magnitude of returns will be in the mid-single digits.

NOTES

[1] Nearly all ODCE fund managers have elected to mark debt to market and do so in accordance with NCREIF PREA Reporting Standards. As a generalization, when the cost of debt falls (borrowing rates decrease), the mark-to-market may result in a negative adjustment. Alternatively, when the cost of debt increases (borrowing rates increase), in-place debt issued at lower rates may result in a positive adjustment. In much of 2019, the debt mark-to-market detracted from portfolio performance due to compression in Treasury yields that decreased the cost of borrowing for most property sectors and asset profiles.

Infrastructure

THE ENERGY REVOLUTION IS DRIVING THE FUTURE OF INFRASTRUCTURE

Economic uncertainty and continued monetary policy accommodation imply that interest rates will remain low for longer than initially expected, which has triggered many investors to de-risk their portfolios — if only marginally — in response to a weaker global outlook. In this "lower-for-longer" interest rate world, investors have started to consider investments in infrastructure, which tend to be more attractive in this environment as they provide diversification, solid expected returns, less volatility, and lower correlation to traditional asset classes.

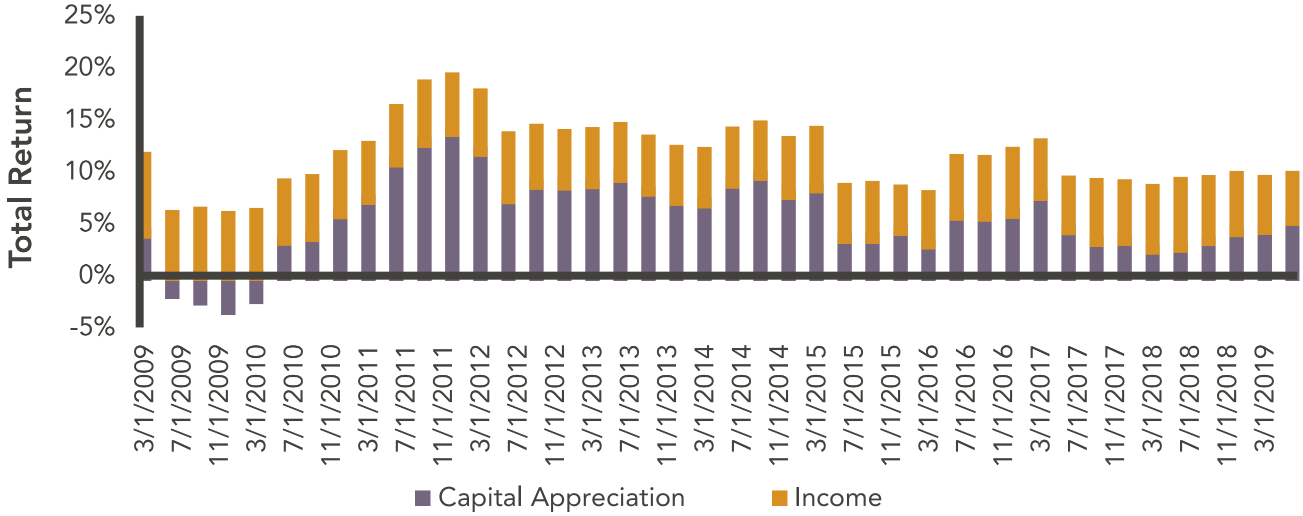
Jeremy Zirin, CAIA
Senior Research Analyst,
Real Assets

Infrastructure investments have continued to garner significant interest from institutional investors, specifically over the past several years as dry powder and aggregate capital raised have continued to increase. In 2019 the market saw dry powder reach $212 billion, 88 fund closings, and $98 billion of capital raised. The search for stable returns and recurring yield in a low yield market environment has fueled this steady increase in fundraising over the past several years and is expected to persist in the near future. This trend has prompted investors to steadily increase their allocations to the infrastructure asset class, which has driven a massive expansion in the private infrastructure market. According to Preqin data, at the start of 2020 there are 253 funds in the market targeting $203 billion in capital for unlisted infrastructure strategies, thus underscoring the interest in the asset class.

The market expansion and elevated levels of dry powder have helped lift infrastructure asset valuations to the upper end of historic ranges. This has made for an attractive exit environment, which many fund managers have actively taken advantage of; however, there is in some instances a material separation of valuations from fundamentals, which in turn can exert downward pressure on future returns. All in all, a normalization of valuation levels back toward long-term averages could result in a substantial drag on returns, which investors should be mindful of as they head into 2020.

As depicted in Exhibit 1, the return for global infrastructure based on the MSCI Global Infrastructure Index remains robust, as returns from income are expected to remain high in the coming years, supporting a high single-digit expected total return. In addition to an attractive total return premium, the asset class continues to provide investors with a high cash yield. As a large proportion of infrastructure assets receive their revenues from contracts or serve a regulated market, their income (distributions) are relatively stable.

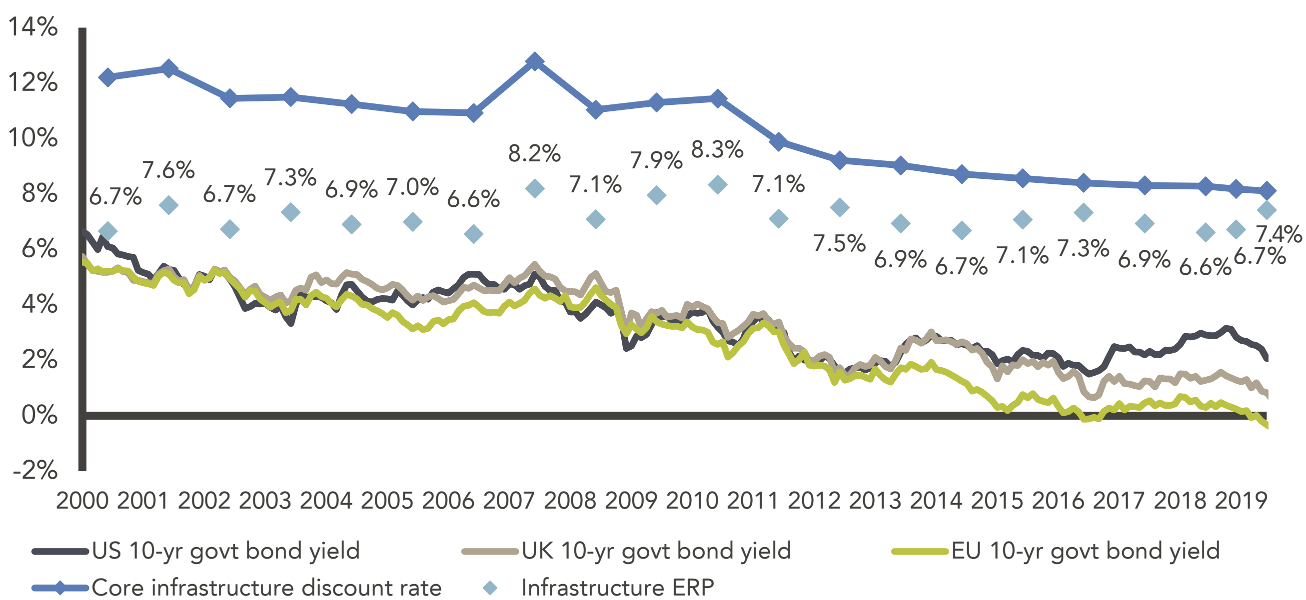
Exhibit 1: Rolling 4-Quarter Returns from Income and Capital Appreciation (1Q 2009 – 2Q 2019)



Source: MSCI. Infrastructure returns represented by the "low risk" category of the MSCI Global Quarterly Infrastructure Asset Index. Data shows rolling 1-year returns from income and capital appreciation. The chart shows the full index history, beginning in the first quarter of 2009.

Greater investor interest has driven the inherent discount rate lower for infrastructure; however, this decline is less than the drop in global government bond yields, so this risk premium has actually risen, as illustrated in Exhibit 2. Longer term, as discount rates for private infrastructure have declined in conjunction with global yields, the risk premium in private infrastructure has remained stable, averaging 7.2% since 2000.

Exhibit 2: Estimates for Core Infrastructure Discount Rates vs. Risk-Free Rate Proxies



Sources: Bloomberg, JPMAM as of June 2019. 2019 discount rate represents year-to-date transactions. Risk premiums represent the difference between the core infrastructure discount rate and the geographically weighted annual average government bond yields.

2020 INVESTMENT OPPORTUNITIES

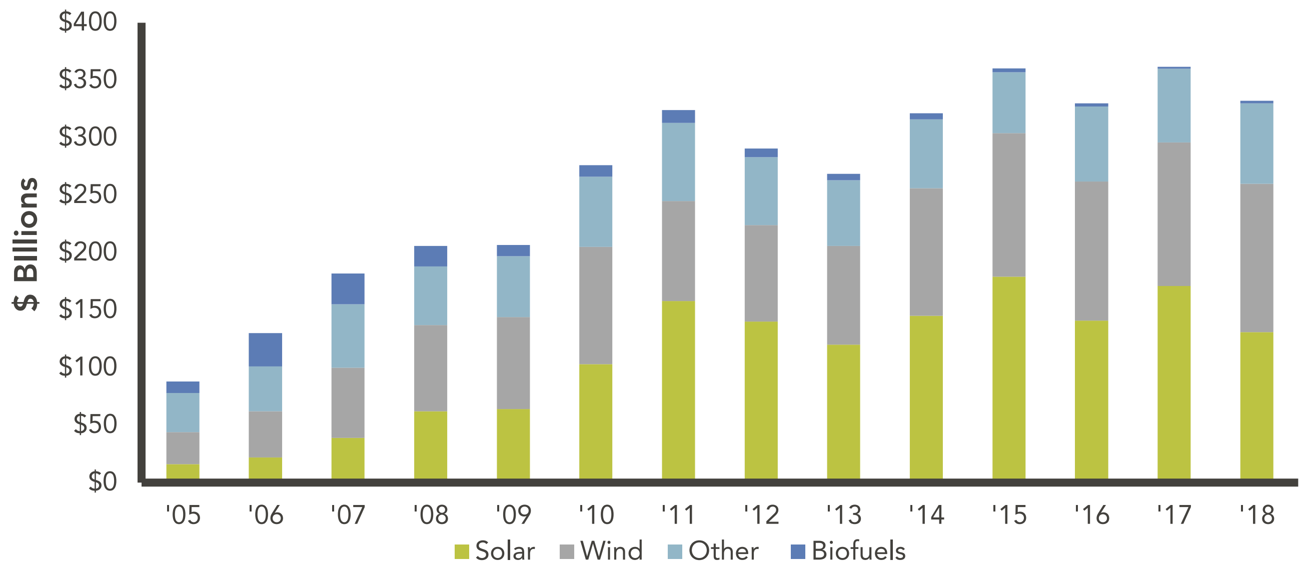
Disruptive trends such as the digitalization and electrification of many aspects of life have played a major role in the overall infrastructure space and will continue to do so in the years to come. These trends are quickly eroding the traditional methods in which infrastructure is utilized and putting some legacy core systems under pressure, which should support the high levels of dry powder in the years to come. As more investors gravitate toward sectors benefitting from these trends such as cold storage, data centers, and renewable energy, competition will inherently increase and could potentially cause returns to drag slightly in the future. However, in the near term, managers with a proven edge should deliver above-average returns and help investors meet their investment objectives.

Many fund managers are also taking advantage of the opportunities that arise from the financial constraints many public institutions are facing through public-private partnerships (PPPs), in which capital is provided to these public institutions over long time periods (20–30 years) for the construction and/or improvement of infrastructure assets. We anticipate PPP demand to increase and emerge as a source of new investment opportunities in the years to come.

ENERGY REVOLUTION

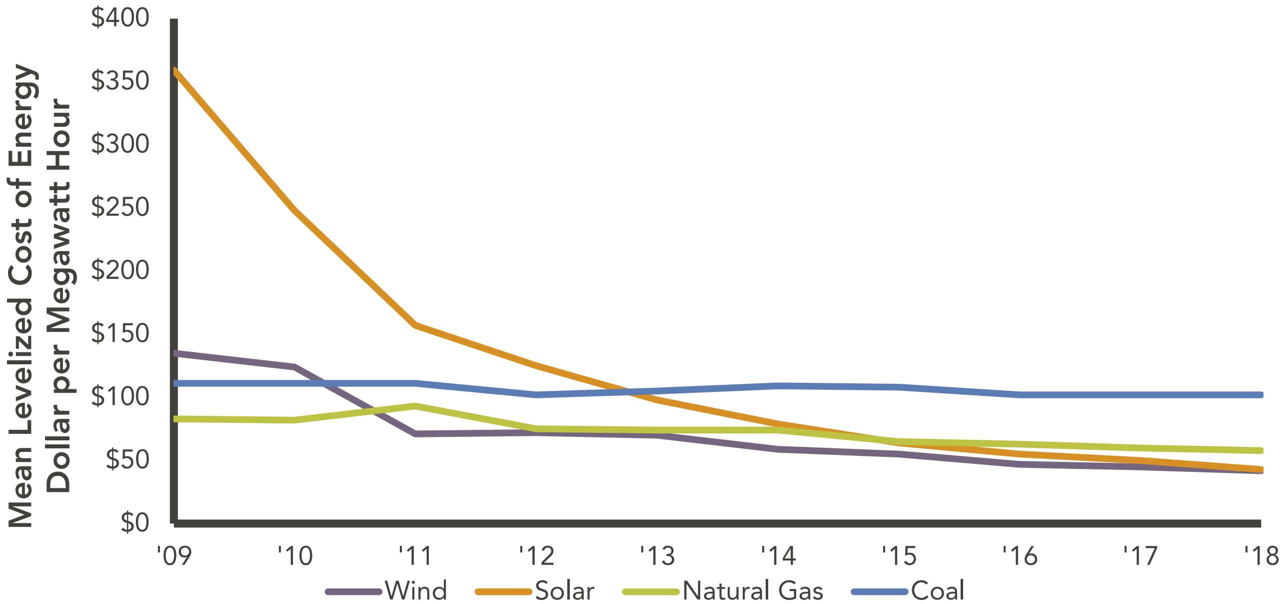
As the shift from traditional energy sources to renewables becomes more prominent — illustrated in Exhibits 3 and 4 — we are seeing an increase in private equity energy firms raising infrastructure-like vehicles to invest in renewables (wind and solar). Solar is typically used as an energy source for the daytime whereas wind is used at night; but for both to become the dominant sources of energy over fossil fuels, advances in battery storage are critical. Currently, battery storage for renewables is limited to the short-term. The reason for this is because lithium-ion batteries have been prone to overheating and catching fire and are only good for storing energy for short periods of time. The good news is that many companies are investing time and money into more efficient and longer-lasting forms of battery storage. Advances in U.S. large-scale battery storage look set to provide a major boost to the U.S. renewables industry, offering a significant new opportunity for investors. While the industry is in its infancy globally, the U.S. is an early leader as a result of various technologies, backed by falling battery and storage prices. Battery storage deals may also offer compelling returns, especially for early investors in the space.

Exhibit 3: Global New Investment in Clean Energy



Sources: Lazard, Bloomberg, JPMorgan. Data is based on availability as of November 30, 2019.

Exhibit 4: Cost of Wind, Solar, Natural Gas, and Coal



Sources: Lazard, Bloomberg, JPMorgan. Data is based on availability as of November 30, 2019.

Although the heightened levels of dry powder and capital raised can be somewhat concerning, the demand for infrastructure assets is expected to remain robust as investors seek favorable risk-adjusted returns in an uncertain economic environment. With global accommodative policies potentially coming to an end, investors may be wondering how infrastructure investments will react in a contractionary market environment. The historically high levels of dry powder, new entrants into the market, and contractionary market environment generally present significant risk for infrastructure investments. However, it is not all doom and gloom for the asset class. Infrastructure assets vary by revenue type and contract, each of which has varying degrees of sensitivity to rising interest rates and inflation. We expect investment managers will take advantage of opportunities in sectors and regions in need of upgrades and revitalization, in spite of slowing growth and geopolitical risks. The disruption by key secular trends should continue to alter the future of the infrastructure space and open an array of potentially attractive investment opportunities in new niche sectors.

2020 Market Preview

Private Equity

AS ASSET CLASS GROWS, CONTINUES TO DELIVER FOR INVESTORS

Derek Schmidt, CFA, CAIA
Director of Private Equity

Private equity thus far through 2019 has continued to deliver the returns investors have come to anticipate out of the asset class, with U.S. private equity funds up 10.6% YTD[1] and international private equity funds up 9.7%.[2] U.S. venture capital funds were up 13.8% YTD,[3] as they provided the strongest returns led by significant IPOs and elevated valuations, as investors continued to seek out growth investments.

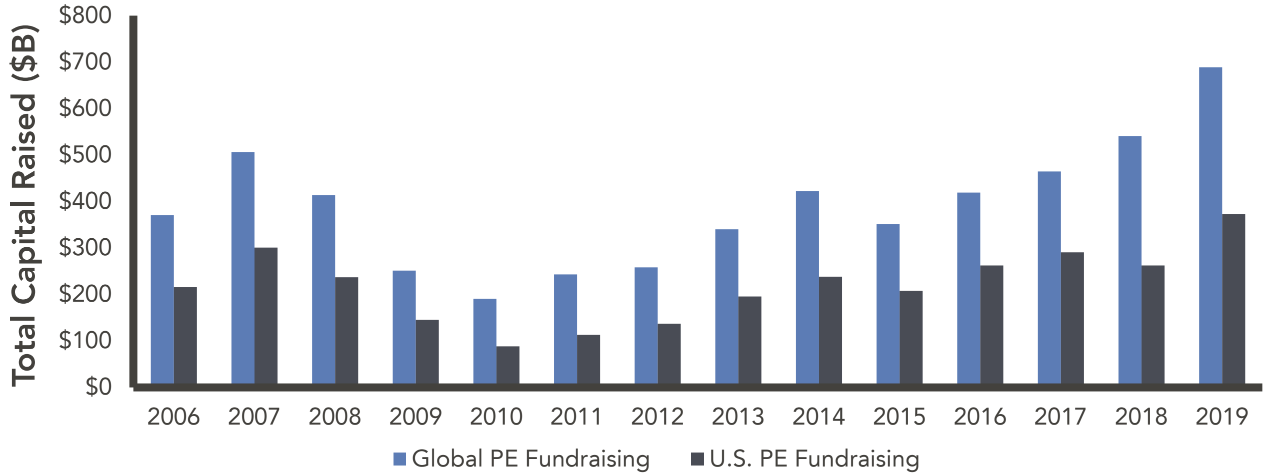
Relative performance remains challenged due to the timing of public market volatility as a market pullback in 4Q2018 contributed to private equity's significant outperformance in 2018, and the subsequent public market snap back in 1Q2019 presented a tough year for the industry on a relative basis vs. public equities. However, looking at the last twelve months from June, which accounts for both volatile public market periods, U.S. private equity funds have outperformed the Russell 3000 by 4.8% (13.8%[4] vs. 9.0%[5]).

Private equity has proven to be an essential component of the U.S. economy, as it provides liquidity within the private market to entrepreneurs as well as capital and expertise to businesses that strive to grow faster and become more efficient. While private equity continues to mature as an asset class, an increasing amount of investors and managers are attracted to the growing number of private market opportunities. These investment interests are further supported by the sustained long-term outperformance over public markets and the current low interest rate environment. Existing and new investors continue to commit incremental capital as they seek to enhance portfolio returns.

DEMAND FOR PRIVATE EQUITY WILL REMAIN STRONG BUT FUNDRAISING LIKELY TO FALL BELOW 2019 LEVEL

The U.S. and global private equity industry raised a record amount of capital in 2019, collecting $373 billion from the U.S.[6] and $688 billion globally.[7] Private equity managers have responded to this strong demand by raising increasingly larger funds, including a growing number of mega-funds that have been raised by leading private equity managers. The top five funds raised each of the last three years (2017–2019) have averaged $15 billion,[8] a sizeable increase from the previous three years (2014–2016) when the top five funds averaged $9 billion by many of the same managers.[9]

Exhibit 1: A Record Year for Fundraising



Source: Pitchbook as of December 31, 2019

However, we believe fundraising is likely to take a step back in 2020, which will be healthy for the industry as dry powder continues to accumulate. Many leading private equity managers just came back to market the last three years, creating an expected void at the ~$15 billion fund size, which may prove difficult for the fundraising market to make up in order to top 2019 totals. We also believe many of these leading private equity managers (Blackstone, Carlyle, Leonard Green, Thoma Bravo, Vista) see a limitation on ultimate fund size and are increasingly looking to expand their platforms with the launch of incremental strategies targeting other areas of the market. We see these incremental strategies as a increasing trend in 2019, but at a collectively smaller size than subsequent fund increases their flagships have been able to obtain.

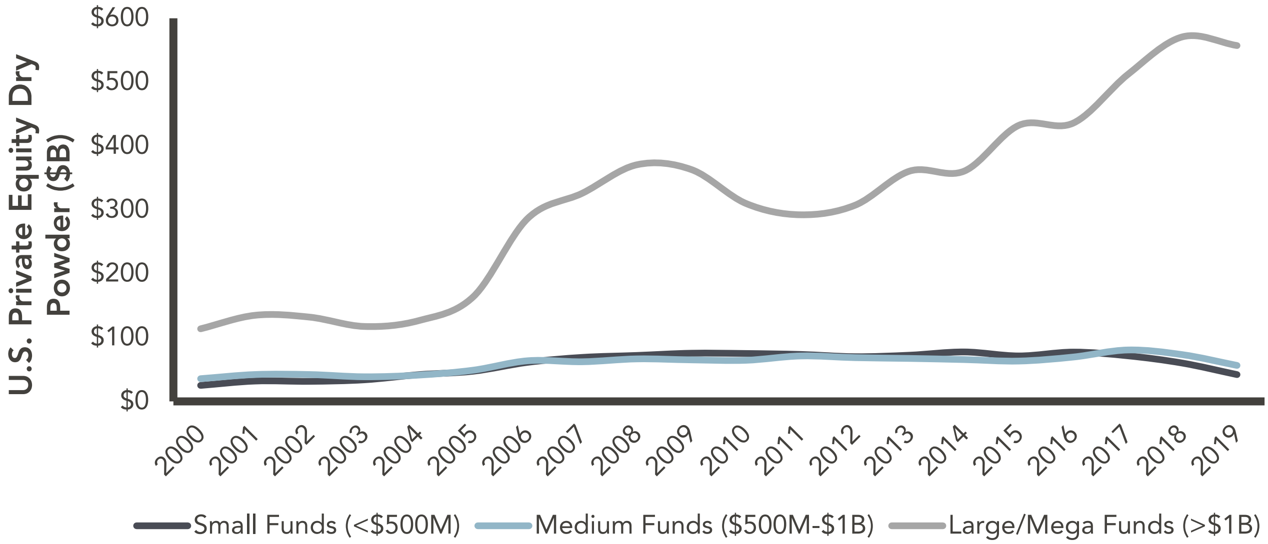
Furthermore, another less obvious but growing headwind for fundraising is the increasing amount of capital being directly allocated by investors. As private equity allocations have increased over the last decade, investors have continued to look for ways to reduce the overall fees paid for their private equity programs. These efforts have resulted in considerable demand for co-investments and direct investments, which often do not come with commitments to a fund or fees. These investments are mostly unaccounted for within reported fundraising data making it increasingly less reflective of overall investor demand. In 2019, a survey from BDO found that 43% of private equity funds offered co-investment opportunities to their investors.[10] This collective sum of capital is difficult to measure but will surely increase in 2020 as investors continue to get comfortable with negotiating and underwriting co-investments in an effort to reduce overall private equity program costs.

DRY POWDER WILL REMAIN AT NEAR RECORD HIGHS IN 2020

The challenge for the industry hasn't been raising capital but instead putting it to work. Robust fundraising, market expansion, and cautious deployment has resulted in a growing level of dry powder awaiting deployment. Preliminary global private equity dry-powder reached $1.43 trillion in 2019.[11]

This level of dry powder is a mounting risk which requires keen monitoring. However, looking deeper we can see much of it has been raised by large funds and/or focused on expanding private equity markets (mega buyouts/take-privates, international, growth equity, and late stage venture).

Exhibit 2: Dry Powder Continues to Accumulate in Large and Mega Funds



Source: Pitchbook as of December 31, 2019

Private equity managers faced many challenges deploying capital in 2019 with numerous uncertainties around geopolitical tensions, a U.S. vs. China trade war, Brexit, and the regulatory challenges provided by the Tax Cuts & Jobs Act which limits interest expense deductions, carried interest treatment, and business income deductions. Many of these challenges remain in 2020 and investors must remain cautious with increasing geopolitical tensions and the upcoming U.S. presidential election.

The private equity industry remains highly competitive, but managers appear to have maintained financial discipline and restraint in 2019. Managers appear to have been hesitant to deploy capital at elevated valuations ahead of a potential market pullback that continues to be expected. This financial discipline wasn't nearly as present ahead of the last market correction when a record amount of capital was deployed at similar elevated multiples. Additionally, the industry's focus has shifted into more defensive and durable opportunities with more conservative bids and underwriting that accounts for downside scenarios that are possible over the next 3–5 years.

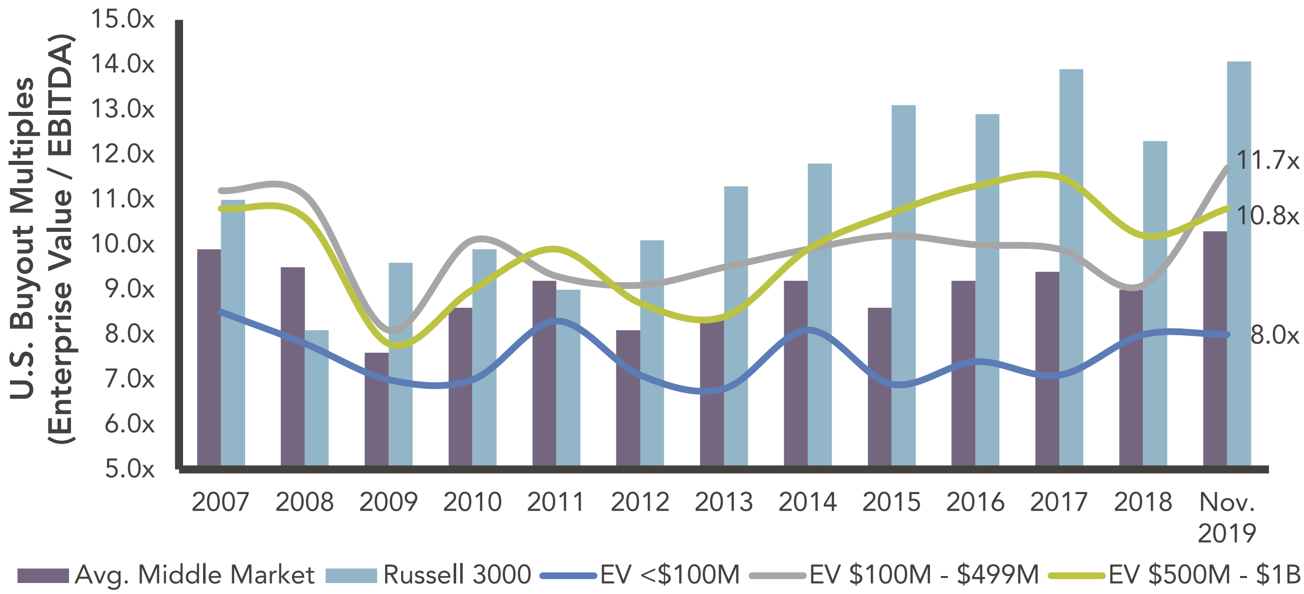
We continue to believe that private equity manager selection is likely to be increasingly important to investors in 2020. There remains intense market competition for the best opportunities allowing business owners/management to either quickly eliminate low quality managers or require them to pay exceedingly high valuations to win, which has forced many new or lower quality managers to compete for more speculative "boom or bust" opportunities where competition is lower.

An economic slowdown could reduce valuations and increase buying opportunities across the industry, which would likely be purchased quickly as managers remain ready to deploy dry powder. This is particularly true within large and mega funds where corporate carveouts and take-private transactions are likely to increase as large funds seek to deploy significant capital at lower valuations in order to take advantage of companies that have failed to be accepted by public markets and where capital can be infused and strategies reshaped under private equity ownership. If this comes to fruition, this could significantly reduce industry dry powder.

PRIVATE EQUITY VALUES ARE LIKELY TO REMAIN HIGH IN 2020

Private equity managers can't afford to overpay for assets, nor can they afford to sit on committed capital due to their fee structures, as both bring down investor returns. This makes the current market fundamentals challenging for investors. However, the significant level of dry powder and elevated public equity valuations are likely to allow elevated private equity multiples to persist in 2020. Investors continue to take advantage of the relative value opportunity as they shift capital into private equity where companies continue to transact at a 27% discount. Additionally, we believe there remains opportunity in small and mid-cap companies where prices are a bit more rational. While U.S. average middle-market buyout multiples reached peak levels in 2019, 10.3x EV/EBITDA YTD,[12] there continues to be opportunities at smaller scale businesses under $100 million in enterprise value that remain at a more normalized level of 8.0x EV/EBITDA.[13]

Exhibit 3: Private Equity Continues to Transact at a 27% Discount to Public Equity Valuations

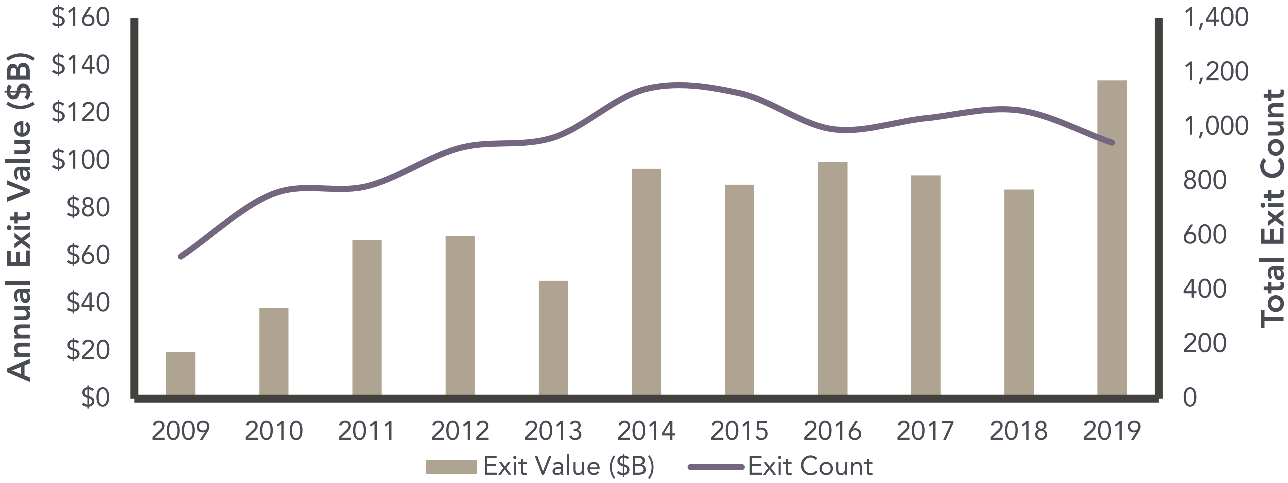


Sources: Bloomberg, Robert W. Baird Global M&A Monthly Report as of November 30, 2019

VENTURE CAPITAL EXITS MAY INCREASE IN 2020 BUT LIKELY TO SEE LESS LIQUIDITY

Venture capital investors had been anxiously awaiting the opportunity to exit many large-scale companies they had invested in over the last decade. As of September 2019, over 67 companies went public through an IPO, including mega exits from Uber and Lyft, which generated a record liquidity year for the venture market exceeding $120 billion for the first time, despite an exit count well below recent years. Despite some of the larger names underperforming, IPOs overall performed fairly well, with an average first day increase of 17% and an average increase of 25% for the year.[14]

Exhibit 4: Large Venture Capital Exits Produced a Record Year for Liquidity



Source: Pitchbook-NVCA Venture Monitor as of December 31, 2019

While 2020 is unlikely to produce the same level of liquidity as 2019, a number of exits are likely to occur in the first half of 2020 as valuations have dropped and can provide a more reasonable price for an IPO or strategic acquisition. Corporate acquirors may be more aggressive in 2020 as economic growth slows and as sales forecasts come down. These innovative and rapidly growing venture-backed companies remain attractive acquisition targets to public companies looking for innovation and to re-accelerate growth. Corporate acquirers, therefore, may drive a higher total number of exits in 2020 as they have been building up cash unwilling to pay the high valuation multiples previously accepted by the public market through IPOs.

There remains a strong pipeline of late-stage venture capital backed businesses (Airbnb, Robinhood, Postmates, Casper, Doordash, Instacart, Poshmark) some of which will either go public through an IPO in the first half of 2020 or be acquired as strategic acquisitions as they look to exit ahead of a U.S. presidential election and before the next market recession. Much of this liquidity generated from venture capital exits is likely to be recycled back into early-mid stage venture opportunities where innovation is constant, and the next set of emerging opportunities is materializing.

VENTURE CAPITAL LESSONS FROM 2019 WILL HELP TO EXPAND MARKET AND IMPROVE FUTURE INVESTMENTS

The late-stage venture capital market has emerged over the past few years as increasing private capital became more broadly available to rapidly growing companies, which allowed them to remain private for longer and grow larger than typical for late-stage venture-backed companies. The past few years numerous companies saw their valuations grow to greater than $10 billion, creating a new category of successful venture-backed companies nicknamed "Decacorns" with Uber leading the way with a valuation of over $70 billion. These companies were able to raise large capital rounds at "sky high" valuations as investors could not resist their robust growth profiles.

However, cautionary signals were visible to many as these companies were raising rounds faster and larger than historical pacing would have suggested they required. Many venture capital managers were anxious to get into desirable growth companies with the belief they were likely to IPO soon or see their valuation increase with the next round of capital. Given this, managers were willing to look past concerns with business models, corporate governance, and questionable founder behavior.

While many venture capital managers have proven to be incredibly skilled at identifying trends, aiding entrepreneurs, building business models, and growing a company, their experience proved less transferable and often lacking at this scale. These mega companies presented new organizational and operational challenges and with less governance and oversight. Additionally, many of these larger businesses proved to be different than traditional "asset lite" venture companies and rather capital-intensive. This ultimately requires larger amounts of capital to fuel growth.

Investor skepticism increased considerably during the second half of 2019 led by public market struggles of both Uber and Lyft, along with WeWork's failure to IPO. WeWork became the poster-child for late-stage venture struggles as the company's valuation fell from $47 billion to $8 billion requiring SoftBank, the largest investor, to rescue the company with an additional capital infusion and removal of the founder Adam Neumann. WeWork was one of many portfolio companies who struggled within SoftBank's $100 billion Vision Fund that provided investors cautionary lessons in 2019.

While the late stage venture capital market remains an area we recommend being underweight, large investor demand is likely to continue into 2020 as growth opportunities are chased by investors and it remains an area capable of accepting large sums of capital. Many late-stage venture-backed companies will continue to accept this capital as they endeavor to remain private for longer, but investors are already asking a lot more questions and being more critical of these investment decisions. Valuations for large and/or capital-intensive companies continue to come down with the understanding private markets will not be able to fund these companies, and valuations need to be more in-line with what the public market or strategic acquirers are willing to accept. Venture capital managers are exhibiting a greater focus on capital efficiency, corporate governance, management oversight, and corporate culture which is a positive shift away from the recent "revenue growth at all costs" mentality that allowed for flexible terms and limited oversight in order to win deals. While 2020 may produce a weaker year for venture capital returns, with less large scale exits and fewer unrealistic valuations, over the next few years the market should become a more reliable market for investors allowing for continued expansion as venture managers learn to manage high growth companies at increasingly larger scales.

A LOOK TOWARDS 2020

Investors continued to shift capital into private equity in 2019 and managers responded as they continued to raise both the size of their funds along with introducing new products to the market. We believe investor demand will continue in 2020 but fundraising is likely to fall as large funds recently raised need to be deployed. Dry powder is likely to remain near peak levels as managers remain disciplined with many of 2019's challenges persisting into 2020 along with the inclusion of a U.S. presidential election. Private equity valuations are expected to remain elevated as they are supported by tremendous levels of dry powder awaiting deployment and higher public equity valuations. Venture capital exits in 2020 may increase given the strong pending backlog of potential opportunities but are likely to produce less liquidity than the record levels investors experienced in 2019. The lessons learned from 2019 within venture capital will continue to be applied to future investments, which will help to grow the venture capital market in the years to come.

We continue to like the private equity market as a growing asset class for institutional investors who can handle portfolio illiquidity. We expect investors to allocate an increasing amount of capital to the market in 2020 as private equity programs are further built out and investors are willing to accept more illiquidity in exchange for access to higher return opportunities.

NOTES

[1] Based on preliminary performance of the Cambridge Associates LLC U.S. Private Equity Index through June 30, 2019
[2] Based on preliminary performance of the Cambridge Associates LLC Ex-U.S. Developed PE and VC Index through June 30, 2019
[3] Based on preliminary performance of the Cambridge Associates LLC U.S. VC Index through June 30, 2019
[4] Based on preliminary performance of the Cambridge Associates LLC U.S. Private Equity Index as of June 30, 20190
[5] Based on performance of the Russell 3000 from Bloomberg as of June 30, 2019
[6] Data from Pitchbook as of December 31, 2019
[7] Data from Pitchbook as of December 31, 2019
[8] Data from Pitchbook as of December 31, 2019
[9] Data from Pitchbook as of December 31, 2019
[10] BDO U.S. Private Capital Outlook 2020
[11] Data from Preqin as of December 31, 2019
[12] Robert W. Baird Global M&A Monthly Report as of November 31, 2019
[13] Robert W. Baird Global M&A Monthly Report as of November 31, 2019
[14] Bloomberg as of November 30, 2019

Private Credit

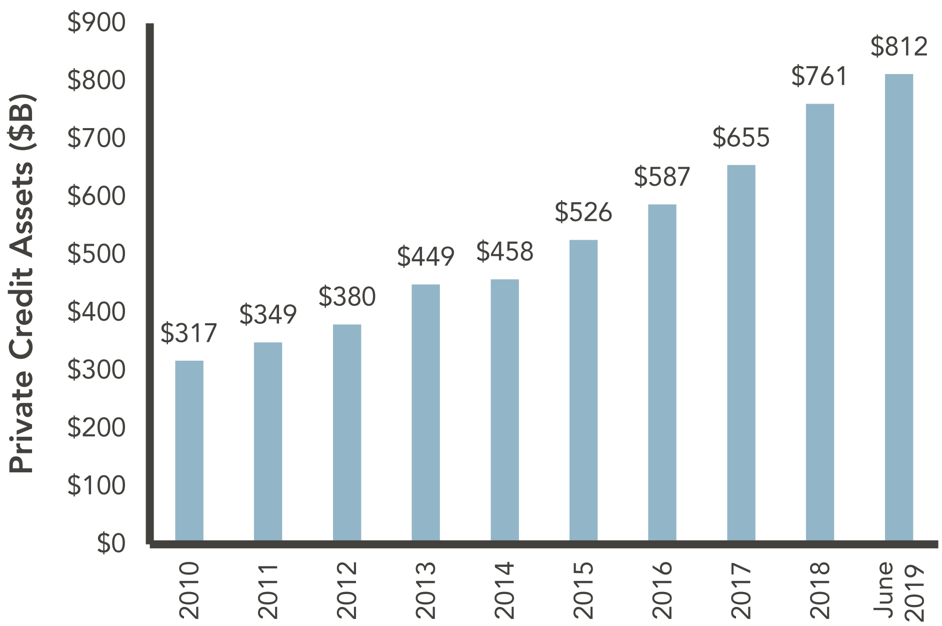
AN ASSET CLASS COMING INTO ITS OWN

At the beginning of the decade, private credit was a respectable but nascent asset class with nearly $300 million in assets managed by a few dozen focused managers. Ten years later, private credit is on the precipice of becoming the 3rd largest private market asset class fueled by a decade of strong M&A activity and investors seeking yield.

Brett Graffy, CAIA
Research Analyst

Private credit is now an $800 billion asset class rivaling the $1.2 trillion U.S. high yield bond market and the $1.1 trillion U.S. leveraged loan market. While the growth in private credit has coincided with strong performance, questions linger regarding how the asset class will perform in future markets.

Exhibit 1: The U.S. Non-Investment Grade Credit Market



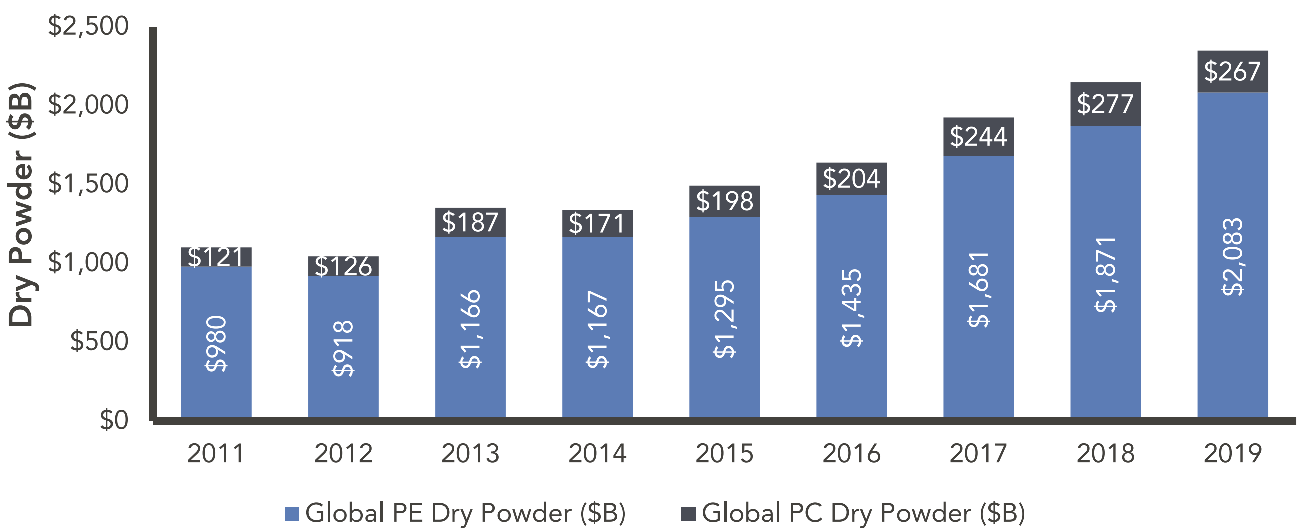
Sources: Preqin, Goldman Sachs Investment Research

Private credit investors have benefited from a strong year with the Credit Suisse Leveraged Loan Index and the ICE BofAML U.S. High Yield Master Index, proxy benchmarks for the private credit market, returning 8.1% and 14.1%, respectively in 2019 against the backdrop of declining U.S. interest rates. Additionally, the Cliffwater Direct Lending Index, which tracks U.S. middle market loans held by business development companies, returned 6.95% through September.[1] While private credit has experienced solid and consistent performance relative to historical standards, fundraising is showing signs of divergence.

Fundraising was mixed in 2019 as pacing cooled compared to 2017–2018 highs. Through November, there were 73 global private credit fund closures, down substantially from 107 in 2018 and 149 in 2017.[2] While fund closures slowed, the total value raised in private credit has remained robust but is showing signs of weakness. Roughly $88 billion was allocated to private credit funds in 2019, slightly below the 2018 total of $109 billion. Investors allocated only $22 billion to private credit during the 3rd quarter of 2019, the lowest quarterly total raised since 2014. In 2019, the average fund size increased to $1.2 billion, up from $1 billion in 2018. While fundraising has slowed, a recent survey conducted by Preqin indicated that 39% of limited partners plan on increasing their allocation to private credit over the next 12 months, up from 31% in 2018.[3] According to Preqin, the number of U.S. public pensions invested in private credit increased by 51% during the years 2015 to 2019.[4] Limited partner appetite for private credit continues to persist as investors build separate allocations to the asset class within their portfolios.

The amount of private credit dry powder has increased, thus leading to a supply and demand imbalance. Leveraged buyout transactions, on average, require approximately 40–50% debt financing. As a result, the strong private equity demand has allowed for an accumulation of private equity dry powder requiring private credit capital. Since 2011, private credit dry powder had increased 220% to over $260 billion in 2019. Interestingly, the ratio of private credit dry powder to private equity dry powder has stayed in a tight range between 12% to 16%, averaging 14% since 2011. Private equity sponsors have chosen private credit managers as their lender of choice over Wall Street banks thanks to the certainty and flexibility of terms they provide. Historically, Wall Street banks syndicated loans, keeping a portion of the loan and selling off the remainder to institutional investors. This strategy diverges from private credit managers who underwrite with the intention of holding the loan until maturity. Today, banks hold less than 10% of U.S. leveraged loans, a 50% decrease from the start of the decade. As an alternative to bank originated debt, private credit has become an attractive channel for private equity managers and limited partners.

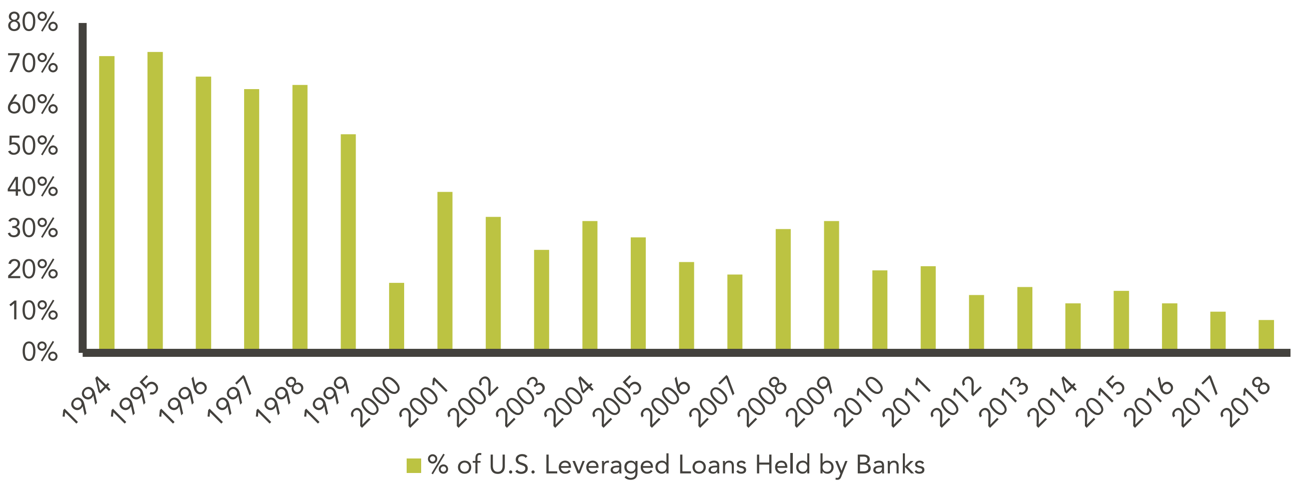
Exhibit 2: Private Credit and Private Equity Dry Powder



Source: Preqin

Manager proliferation has coincided with the amount of capital raised in the private credit asset class. A decade ago, there were nearly 50 managers who specialized in private credit. Today, there are over 200 managers in the U.S. and the number continues to expand as teams spin-out of existing platforms. A small number of early private credit-focused funds have become leviathan platforms managing over $100 billion in private market assets across private credit and private equity. In August, Apollo Global Management supplied $1.8 billion of debt to fund New Media Investment Group Inc.'s purchase of Gannett Co. This deal became one of the largest private credit deals in U.S. history and showcased the private credit market's ability to finance leveraged buyouts traditionally reserved for Wall Street banks. The growth of the private credit market has propelled the expansion of private markets focused investment managers and made them some of the largest asset managers in the world.

Exhibit 3: Demand for Direct Lending Has Increased as U.S. Banks Have Withdrawn from the Market



Source: S&P Global Market Intelligence

2020 OUTLOOK

Looking ahead to 2020, we believe the private credit market will continue to track the same trendline it has for the previous 10 years driven by a low-interest rate environment, a business-friendly regulatory environment, and a healthy M&A market. While the private credit market continues to show signs of growth and strong performance, risks are apparent at the market and deal level.

Widely reported market risks such as increasing EBITDA multiples on leveraged buyouts and the proliferation of "covenant-lite" loans underwritten by managers should be recognized by investors making allocations to private credit. The specter of a spike in interest rates would force companies to refinance their debts at higher borrowing rates, putting added pressure to their bottom lines and possibly leading to an increase in bankruptcies. Additionally, fund-level leverage and the breadth of portfolio manager experience is imperative in this current late-cycle market environment. As seen during the Great Financial Crisis, leverage at the portfolio level will exacerbate losses and potentially force managers to sell assets to meet capital requirements. As a result of the asset class expansion, many managers remain untested by various market cycles and operate lean, resource-constrained staff.

At Marquette Associates, we believe that managers who have long-tenured experience through various market cycles and those who have scope from sourcing to workout situations allow investors the greatest opportunity to navigate this expanding asset class successfully. We believe that a private credit allocation is a valuable return enhancer and diversifier for a client's portfolio, and is poised to become more prevalent across investment portfolios.

NOTES

[1] Index performance is reported on a one-quarter lag from the end of the previous quarter
[2] Lykken, Alex. "Against expectations, private debt fundraising saw a decline in 2019." PitchBook, 27 Nov 2019. https://pitchbook.com/news/articles/against-expectations-private-debt-fundraising-saw-a-decline-in-2019
[3] Preqin Investor Update: Alternative Assets H2 2019
[4] Chappatta, Brian. "Public pension funds shun hedge funds for private credit market." The National. 7 Jan 2020. https://www.thenational.ae/business/banking/public-pension-funds-shun-hedge-funds-for-private-credit-market-1.961030

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About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions.
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