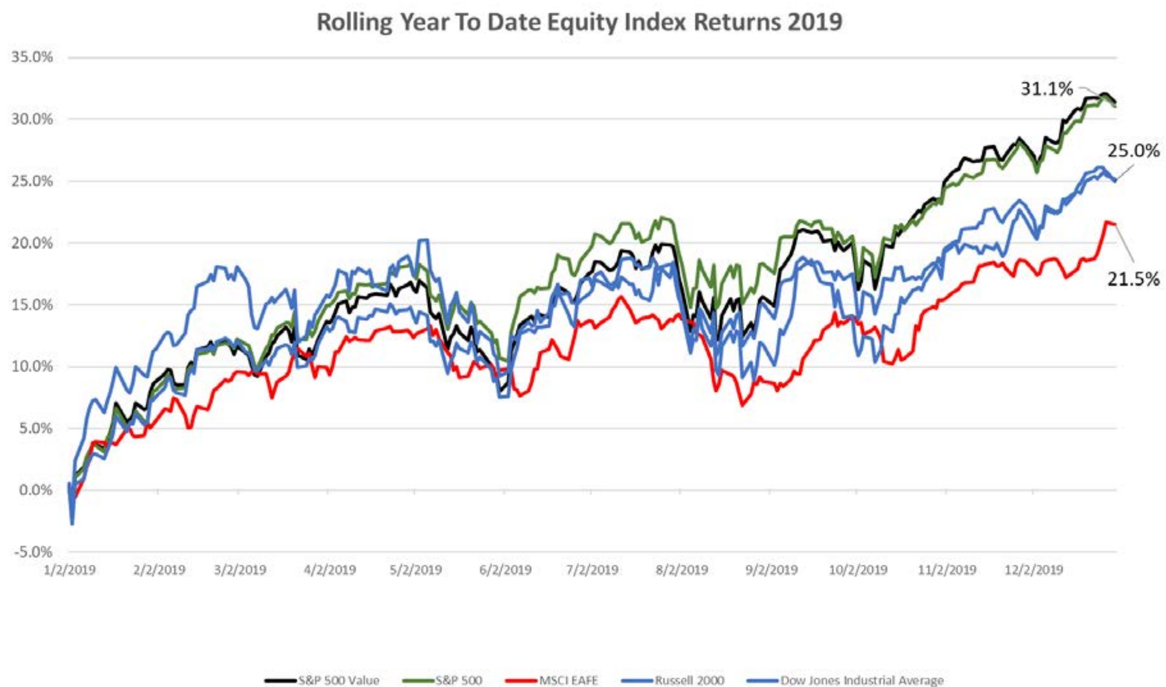
Dear Turtle Creek Client,

Global stock markets rallied significantly through the final months of 2019, capping the best year for equities since 2013. Many economic headwinds and sources of risk dissipated during the year. The U.S. and China agreed to a “Phase 1” trade agreement, hopefully avoiding the worst-case outcome for their ongoing trade dispute. Central Banks around the world provided significant stimulus to help ailing global economies and maintain the record U.S. expansion. Even the seemingly endless BREXIT discussions found forward momentum as British voters gave a clear mandate to Prime Minster Boris Johnson.

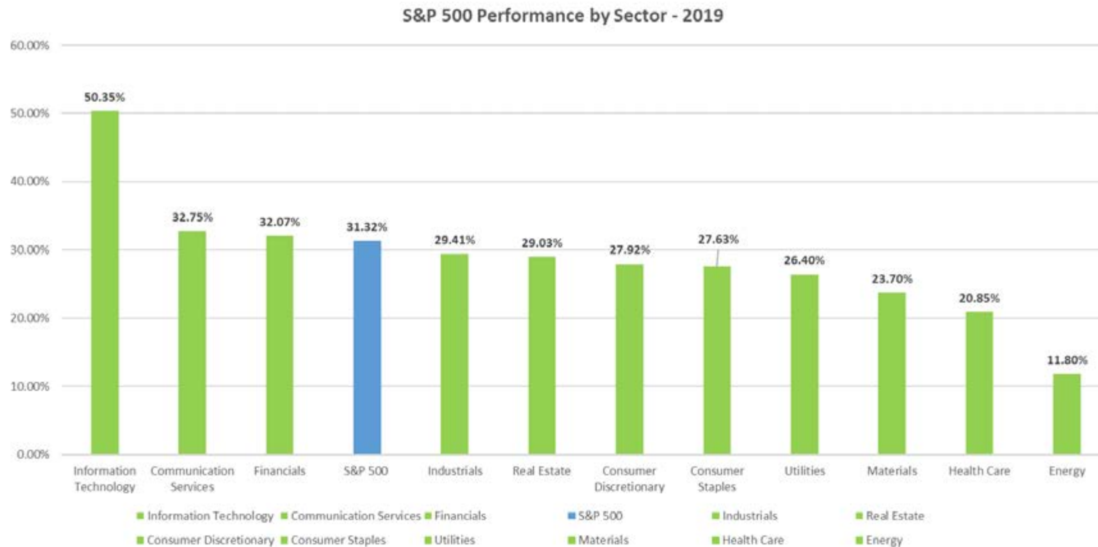


Source: Bloomberg

<u>Stock Market Performance</u>

The U.S. stock market responded to this diminished global uncertainty with a “risk-on” mood. The Technology sector, hit hardest during the late 2018 bear market, posted a remarkable 50% gain during the year. Cyclical and growth-oriented sectors like Financial Services, Industrials, and Communications Services also carried the market higher. Every S&P sector posted gains of 20% or more with the exception of the Energy sector, which continues to struggle with a global supply glut and depressed commodity prices. Consistent with recent history, overall index performance was heavily influenced by the largest companies. Apple Inc., the largest member of the S&P 500 Index, posted an 88% gain during the year. Microsoft, the second largest company in the S&P, delivered a 58% gain.

International stock markets also posted strong gains. European and Asian economies had flirted with recession for most of the year, but stimulus initiatives stabilized economic growth and corporate profits. Key economic indicators in most international markets surpassed expectations in the fourth quarter. As signs of economic recovery accelerated in the final months of the year, international markets rallied noticeably. The MSCI EAFE index finished with a 22% gain on the year. The MSCI Emerging Markets Index finished 2019 with an 19% gain.



Source: Bloomberg

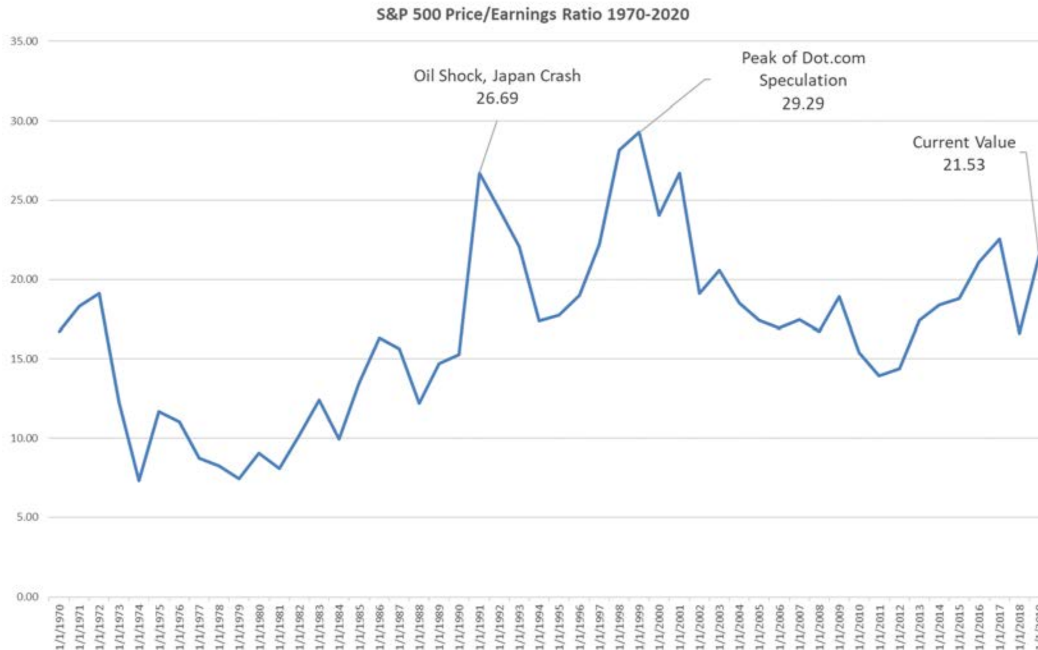
While stock market returns in 2019 were remarkable, a 24-month analysis shows less impressive results. 2018's stock market losses and collapse in bond yields were in hindsight not justified by any fundamental shift in profits or growth. Recessionary signals from 2018 proved false, so markets spent this year making up for lost time.

Market analysts generally agree that three factors explain changes in stock markets values - growth in earnings, dividend yields, and the multiple investors are willing to pay for stocks. Over the last two years, S&P 500 earnings per share have advanced 24% and dividend yields totaled an additional 4%. The market has advanced roughly 26% in this same period. Despite the steep peaks and valleys in market prices, stocks have largely tracked with their fundamentals.

Finding Comfort with Elevated Market Multiples

One well-noted market risk is the premium multiples currently being paid for stocks, prompting concern over unsustainable market valuations or even speculative bubbles akin to the dot.com euphoria of the late 1990s. The S&P 500 finished the year valued at 21x its 2019 earnings per share, a premium to its long-run, 50-year average of 17x. Should this market valuation revert to the long run-average, goes the logic, then your stocks will experience negative returns. While this analysis has been helpful in times of previous market manias, current valuations are well below the speculative peaks of decades past. Also, the current confluence of economic factors influencing today's market multiples are unique and in certain cases unprecedented.

Is this our parent's or grandparent's stock market? Would they have foreseen near-zero or even negative interest rates around the world for prolonged periods? Would they have predicted Central Bankers would battle stubbornly low inflation rather than hyperinflation? The economy of today bears little resemblance to the 1970s and 1980s, a period during which energy shocks and rampant inflation drove much lower market multiples. It is always dangerous to state "this time is different", but the conditions that currently drive premium stock valuations - unattractive yields on competing investments, stubbornly low inflation, accommodative Central Banks, demographic headwinds, excess global savings – seem here to stay for at least the near-term. This makes the current premium market multiple understandable if not attractive. We have included an exhibit with this memo illustrating in more detail several of the key differences between the current market backdrop and the run-up to previous equity bear markets.



Source: Bloomberg

Lessons from 2019

Investors were given another valuable lesson regarding the inherently volatile nature of investment markets. The pessimism that blanketed markets at the outset of the year now appears unfounded. The investors that ran to the sidelines in reaction to market instability missed some or all of the remarkable rebound in asset values. Once again, a disciplined buy-and-hold approach proved superior to attempts at market timing.

We were also reminded of the limited utility or uselessness of many traditional economic forecasting techniques. Wall Street strategists and financial journalist cited a series of age-old economic indicators to illustrate a coming economic slowdown. The Dow Transport Theory, Manufacturing PMIs, and even the usually reliable inverted yield curve all now appear now to have exaggerated the potential for an economic slowdown.

Finally, the importance of market liquidity was once again reinforced. The decision by global Central Banks to inject liquidity into markets served as a powerful fuel for the recent market rally. The Federal Reserve is signaling no change in its accommodative stance for 2020 and the Fed Funds Rate remains well under 2%, a historically low number.

Looking Forward

It will be hard for the stock market to repeat its impressive 2019 performance, but we do see potential for more modest gains in the year ahead. We understand the root causes of today's elevated market valuations but don't expect significant multiple expansion for equities. Profit growth and dividend yields will have to propel the stock market going forward. With a backdrop of robust employment, slow but steady economic expansion, central bank support, and a potential recovery in international economies; U.S. companies should post profit growth over the next 12 months.

In contrast to the current environment for stocks, fixed income investments continue to offer frustratingly low returns and historically thin compensation for credit risk. Bonds will continue to serve as an

important source of portfolio protection, but it is equities that will drive returns on your investment capital over the near-term.

From a valuation standpoint, International markets remain the most interesting longer-term opportunity. Should global economies indeed be turning the corner and entering into the expansion phase of their business cycles, international market returns could outpace U.S. investments.

The usual litany of longer-term risks remains relevant. The U.S. economy remains in a late-cycle mode. and at some point, the business cycle will run its course. With an election imminent, the current business-friendly regulatory and tax environment could shift. The relatively placid geo-political environment could turn more ominous. Despite all this, the outlook for your investments currently remains bright.

As we have in past cycles, we are taking opportunities to rebalance investments and review portfolio allocations to be sure the current strategy is best suited to your longer-term needs and objectives. Given the recent strong run in equities, this is being accomplished through small adjustments to the position size of some of your largest holdings while eliminating smaller investments that have not met our expectations.

As always, we appreciate the trust and faith you place in our firm. Please call or write with any questions.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA

		12/31/2019 Current	12/31/2007 Credit Crisis	5/31/2001 Dot.com Crash	Comment
Market Valuation	Equity Risk Premium	3.5%	2.9%	-0.6%	While stock multiples are above historical trend, other valuation indicators compare favorably to the onset of previous bear markets. Equity dividend yields are currently equal to fixed income alternatives. Bond yields have been much higher historically. Free cash flow yield and Equity Risk Premia also illustrate a more reasonably valued stock market as compared to the peaks prior to the Credit Crisis and Dot.com crash
	S&P Dividend Yield - Treasury Spread	-0.10%	-2.09%	-4.13%	
	S&P 500 Free Cash Flow Yield	3.87%	2.28%	2.07%	
Liquidity	Fed Funds Rate	1.55%	4.24%	4.21%	Financial Conditions remain accomodative. The current Fed Funds rate of 1.55% is stimulative compared to previous Bear Market Onsets. The Financial Conditions Index also shows healthy liquidity. A positive reading indicates illiquidity. This barometer displayed such a reading at the onset of the Credit Crisis
	Chicago Fed National Financial Conditions Index	-0.78	0.26	-0.43	
Household Health	Personal Savings Rate	7.90%	3.60%	4.50%	Households display superior financial health as compared as compared to previous recessions and bear markets. Personal savings as a percentage of income remains elevated and household debt levels are within historical averages. The consumer displayed greater indebtedness at the onset of the Credit Crisis.
	Household Debt/GDP	74.20%	96.53%	70.82%	
Inflation	PCE Deflator	1.58%	2.33%	1.82%	Measures of inflation remain below both historical trend and Federal Reserve Bank targets. Above-trend inflation has previously spurred Central Bank tightening and a slowing of the economy which in turn negatively impacted financial asset values.
	CPI YOY Change	2.30%	4.10%	3.60%	
Growth	GDP Growth - 3 Year Average	2.55%	2.76%	4.00%	GDP growth is currently slow but stable. 3 year average GDP growth is below trend compared to history. Also, GDP growth has yet to decline noticeably. GDP expansion had slowed to a much greater degree at the onset of previous market sell-offs.
	GDP % Change 12 Months	-8.00%	-23.08%	-79.25%	
Leading Indicators	Conference Board Leading Indicators	128.20	90.62	116.10	Leading Indicators such as the Conference Board continue to signal future growth. The current reading is elevated compared to previous market peaks. It also remains stable. This measure had declined noticeably in the run up to previous market sell-offs.
	Leading Indicators - 12 Month % Change	1.3%	-17.6%	-19.8%	