QUARTERLY REPORT

Vaughan Nelson Investment Perspective

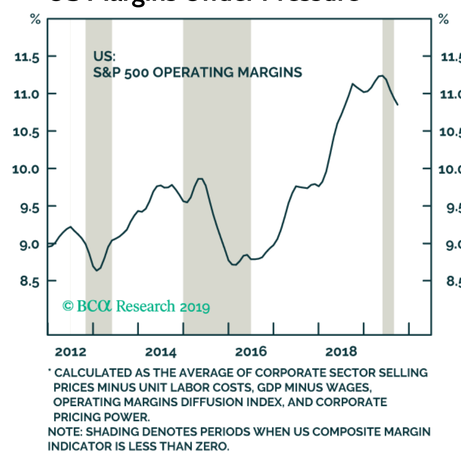
December 31, 2019

During the fourth quarter of 2019, equity markets continued to move higher with the S&P 500 and Russell 2000 advancing 9.07% and 9.94%, respectively. For the year, the S&P 500 returned 31.49% reaching a new all-time high. The Russell 2000 returned 25.53% for the year but has failed to eclipse its all-time highs reached in 2018. The fourth quarter rally was driven by stabilizing economic data overseas and the rapid expansion of the Federal Reserve's balance sheet to support interbank lending markets.

In the prior quarter, we noted the Federal Reserve would likely be forced to provide dollar liquidity on a sustained basis. Our view still stands that the U.S. dollar funding shortage experienced in the third and fourth quarters is not a temporary phenomenon but is the direct result of prior Federal Reserve QE policy and rising federal deficits. With over $11 trillion in U.S Treasuries to refinance in the next twelve months, in addition to rising federal deficits that will require additional U.S. Treasury issuance, the Federal Reserve will continue to provide liquidity support via U.S. Treasury purchases. This support will be necessary until the U.S. dollar declines sufficiently to allow foreign buyers to purchase U.S. Treasuries on a hedged basis, or until global economic activity reaccelerates thus reducing funding stress.

Given stretched valuations and increasing margin pressures **(Chart 1)**, we expect U.S. equity returns to moderate in 2020. While stabilizing economic growth has supported U.S. equity markets, in order to meet 2020 earnings forecasts, there will need to be an acceleration in economic activity.

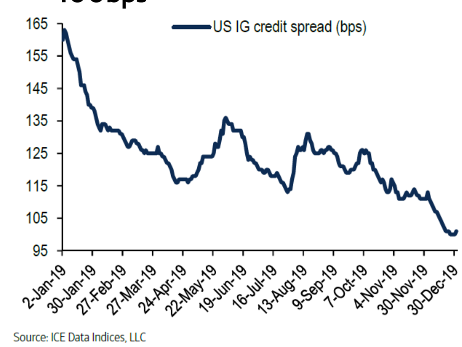
Chart 1
US Margins Under Pressure



The Bloomberg Barclays Aggregate Index returned 8.72% in 2019, its best year since 2002. The best sector within the Index was Credit. The investment grade sector returned 14.23%, while Treasuries rose 6.99%. Credit spreads narrowed 58 basis points ending the year at 100 basis points over comparable Treasury yields **(Chart 2)**.

During the fourth quarter, 10-year Treasury yields drifted 25 basis points higher to 1.92% following more clarity on four key uncertainties. First, news that the U.S. and China made significant progress in trade negotiations, second expectations that the U.S./Mexico/Canada (USMCA) trade deal would be signed, third less Brexit risk, and fourth the Fed made it clear that they are unlikely to hike rates in 2020 but would cut rates, if necessary. Fixed income returns will have a difficult time matching last year, but we continue to see opportunities to generate alpha within spread sectors and opportunistic duration shifts.

Chart 2
US IG Credit Spreads Ended 2019 at 100bps



The municipal markets also recorded solid returns in 2019, with the ICE BofAML AAA-A Municipal Index returning 5.08%, which is 7.43% on a taxable equivalent basis. With demand expected to outpace supply again in 2020, the significant improvement in household net worth, and continuing U.S. economic growth, we expect another solid year for the tax-exempt market.

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