FAYEZ SAROFIM & CO.

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Economic Comment and Market Outlook

Having recently experienced a sharp stock market correction at the end of 2018, we wrote to clients at the beginning of last year that we believed there was a "disconnect between the recent market action and the reality of the present situation" and that the market could "climb the 'wall of worry' established in late 2018." Fortunately, 2019 turned out to be a superb year for financial markets and for Fayez Sarofim & Co. portfolios, with the S&P 500 providing a total return of 31.5%, the best result for the index since 2013. While economic growth did decelerate over the past year, the current US economic expansion continues to set records for its duration. Continuing economic growth, strong corporate profitability, and supportive monetary policy still provide a solid foundation for the equity market, especially in an era of extraordinarily low interest rates.

Overcoming concerns surrounding the impact of tariffs and trade negotiations, the path of monetary policy, and domestic and international politics, most financial markets enjoyed a banner year in 2019. The Barclay's US Aggregate Bond Index rose 8.7% as the Federal Reserve shifted course and reduced interest rates three times during 2019. Foreign stock indices generally trailed the US again—in their local currencies and in dollars—but enjoyed solid absolute returns, with the MSCI EAFE and Emerging Markets indices rising 22.7% and 18.9%, respectively, when calculated in dollars. In the middle of the year, investors worried about falling readings of the ISM survey of manufacturing activity and the inversion of the yield curve. However, by the end of the year, developments in trade and monetary policy were assuaging several of the market's greatest areas of concern. The market set fresh record highs as the Trump administration announced a "Phase 1" deal with China and Congress passed the USMCA trade agreement with Canada and Mexico. After lowering short-term interest rates throughout 2019, the Federal Reserve communicated that the Board's expectation was to remain on hold for the foreseeable future; most observers also believe that the Fed will refrain from adjusting interest rates later in 2020 in order to avoid charges of partisan behavior close to the Presidential election. Business confidence and investment should respond favorably to the elimination of these uncertainties, adding support to an economy that has been capably carried by the consumer more recently.

Considering that the consumer is responsible for over 70% of our country's gross domestic product, the US economy remains on a very sound footing. The latest unemployment rate is only 3.5%, and the 4-week average of initial jobless claims of just above 200,000 per week is the lowest since 1969, when the country's population was almost 40% smaller than today. Aided by the recent prevalence of low interest rates and more prudent management of the consumer's debt balances, household debt service is less than 10% of disposable income, near an all-time low. The net worth of American households stands at an estimated $116 trillion, an all-time high. Those households hold over $132 trillion of assets compared to liabilities of approximately $16 trillion, of which 66% are mortgages. Clearly, the US consumer is in a strong position to continue supporting economic growth.

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While we judge the state of the economy to be healthy, investors are currently worrying about a number of items. Most immediately, the coronavirus originating from Wuhan, China is spooking the markets, leading to some recent volatility. Travel restrictions and consumer caution may stunt economic activity in the short run, but it is likely that this disease will run its course and not present a long-lasting impact. While a new disease is disturbing, it is worth noting that the seasonal flu virus is responsible for several hundred thousand deaths worldwide on an annual basis. TV coverage has also been focused on the impeachment trial recently, and it will turn increasingly to the November election as we move through 2020. Many investors have expressed concern about the possibility that a change in control of the executive and/or legislative branches would upset the markets. It is a possibility that uncertainty could cause additional volatility in the marketplace, but we would counsel our clients to remember the dynamism of the American economy and the checks and balances of our system of government. While many views seem to be emanating from the extremes of US political belief, it has proven to be very difficult to pass major pieces of legislation, even when one party controls all branches of the government. Several candidates competing in the primaries may be focused on "structural change" in healthcare, taxes, the energy sector, antitrust policy, and other programs, but most of these policies will be difficult to implement.

With these kinds of worries present, it is hard to say that investors are excessively exuberant. Although the equity markets provided great returns in 2019, both institutional and individual investors demonstrated signs of skepticism and risk aversion that are healthy for the market. In contrast to the venture capital firms that invested giant sums into unprofitable "unicorn" companies, IPO investors and the stock market found a distaste for companies such as Uber, Lyft, Slack, and the aborted offering of WeWork. Investors also pulled a record $156 billion out of US stock mutual funds and ETFs during 2019, allocating more money to bonds and money market funds. The hedge fund community experienced almost $100 billion of net outflows during 2019, but large endowments and foundations still remain focused on alternative assets. Using data provided by NACUBO and TIAA, endowments have approximately one-third of their assets in stocks, and only 14% is invested in US stocks, which have handily outperformed their international counterparts. Most of these educational or charitable institutions have trailed the traditional 60/40 index of stocks and bonds for the past 1, 3, 5, and 10-year periods as a result.

Within our Sarofim portfolios, we continue to focus on industry-leading companies that we believe can grow earnings, cash flows, and dividends at superior rates over the long-term. The S&P's P/E multiple moved up in 2019, and earnings growth will be essential to drive stock returns going forward. We believe a typical Sarofim portfolio will experience faster growth of approximately 11% in 2020 earnings per share versus an estimated gain of 6% for the S&P, and we expect our companies to maintain a growth advantage in future periods as well. In a period of time when fixed income securities are offering paltry yields, the dividend stream of our equity securities remains attractive as well. Using figures from Bank of America, the total sum of

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interest paid to holders of global government and investment grade corporate bonds is approximately $523 billion. That interest figure is probably overstated since roughly $11 trillion of foreign government bonds are actually priced to yield a negative return; what the investor earns in coupon payments is more than offset by principal losses when held to maturity. Compared to these total interest payments, the companies in the S&P 500 paid almost $485 billion in dividends during 2019, and we expect those payments to grow by approximately 5% in 2020. On top of the dividend payments, those companies are also deploying significant sums into share repurchase, which accounted for $770 billion during the twelve months ended September 2019.

Our firm has historically emphasized equity investments as the engine of superior long-term wealth accumulation, and we remain convinced in the validity of this approach. Our forecast for growth in the economy and the level of corporate profits provides a solid foundation for confidence in the long-term outlook for the equity market and our portfolio companies. At the same time, we also build our portfolios to endure the inevitable periods of time when conditions are not favorable. In those periods we rely on the strength of our portfolio companies' balance sheets and cash flows, which provide staying power and flexibility to weather the volatile periods and emerge stronger when the recovery arrives. We encourage you to contact us if you have any questions, and we thank you for your continued trust and confidence in Fayez Sarofim & Co.

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