



Fourth Quarter 2018  
Market Review & Outlook



FELTZ WEALTHPLAN  
A REGISTERED INVESTMENT ADVISOR

# Market Summary

## Q4 2018 Highlights

- A Return to Normalized Volatility
- Tariffs Take Their Toll
- Earnings Growth Estimates Moderate
- Valuations Reset Lower

Last year was a reminder that although stocks move with fundamentals over the long run, they are a) forward-looking and b) a voting mechanism for investor sentiment in the short-run. Despite arguably the strongest year for the U.S. economy in over a decade, and a surge in earnings for Corporate America, U.S. stocks suffered two sharp selloffs from record highs, culminating in the worst December since 1931, a year in which the U.S. was collapsing into the Great Depression. For the year, U.S. equity markets posted their first loss since 2008, with the S&P 500 declining 6.2% (4.4% including dividends).

U.S. small caps fared worse, declining 20% in the fourth quarter (as measured by the Russell 2000 index) and 11% for the full year. International and emerging market stocks actually fell less than U.S. stocks in Q4, most likely due to losses already suffered in the summer months. For the year, the MSCI EAFE and MSCI EM indices declined 13.4% and 14.2%, respectively in dollar terms.

After one of the best risk-adjusted years ever for just about every major asset class in 2017, cash was the only major asset class that posted a positive return in 2018. Net of inflation, even cash was negative for the year. Bonds served their purpose in the fourth quarter, advancing ~2% as the 10-year Treasury yield dropped with flight-to-safety bond buying. Still, the Barclays Aggregate Bond Index posted only flat returns including interest in 2018, a lost year even for safety assets.

Concerns around Federal Reserve monetary policy, trade frictions & an overall global economic slowdown led to substantial de-risking in the fourth quarter. Momentum can quickly dissipate, but most of the major leading economic indicators paint a different picture for the U.S. economy than risk assets would suggest. We would expect the U.S. economic growth and corporate profit engine to slow as the near-term tax stimulus fades and the global economy cools, but recent de-risking was starting to reflect more than just a slowdown.

Consumers are still the lifeblood of the economy, contributing ~70% of U.S. G.D.P., and spending/sentiment gauges were still very positive as we closed the year. Even so, we live in an increasingly globalized economy and a slowdown like what we are seeing in Europe as well as the Chinese economy will eventually have spillover effects for U.S. companies. The magnitude of this slowdown is still unknown, but that appears to be what the market is attempting to price in, and also what U.S. multinationals will be guiding towards in the coming weeks.

While moments like the weeks leading up to Christmas can be gut wrenching for equity investors, they do provide “healthy” reminders of individual risk tolerance that would otherwise be hypothetical in nature. As 2018 reminded us, you diversify for what you don’t know, not what you do know. Even though we believe December was an overreaction to heightened uncertainty, exaggerated by end-of-year tax-loss selling and a lack of liquidity, the market is very often right as it is wrong in re-pricing risks. Should the Fed moderate their trajectory (which they seem to be moving towards) or should Chinese-U.S. trade relations improve, stocks would very likely rerate higher. However, if the global economy slows more than anticipated, it will likely be awhile before stocks hit fresh record highs.

Putting aside the unknowable short-run, we do believe the severe de-rating of equity valuations last year has set up for one of the more attractive starting points for stocks for those investing as they should for the long-term. Assuming profit margins do not substantially mean revert, the risk premium investors are now getting paid to own stocks vs. bonds has rarely been much better. With earnings growing ~20% last year and stock prices falling ~5%, that means valuations are nearly 25% cheaper than where we started 2018. Valuations tell you nothing about what will happen next year, but they often have a high correlation to 5 and 10-year returns.

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## A Return to Normalized Volatility

When volatility runs dormant for an extended period of time, it gives rise to complacency and many other behavioral tendencies for investors to grapple with. In 2017, the U.S. stock market only had 8 days in which the S&P 500 advanced +/-1%, the lowest total in over three decades. In 2018, the S&P 500 had 64 such days, 20 of which were +/-2%. After declining only 3% peak-to-trough for the entirety of 2017, the shallowest, lull-you-to-sleep intra-year drawdown in history, the S&P 500 had a max drawdown of 19.8% (on a closing basis) in 2018, which believe it or not is very close to the historical intra-year average of 16.4%<sup>1</sup>.

If you are going to be an investor in stocks over the long-term, you have to be able to withstand periods like what we saw in December. If stocks were stable like bonds, there would be no additional “premium” for owning them. So in that sense, investors should embrace the volatility, which we would not expect to dissipate at this point in the market cycle.

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## Tariffs Take Their Toll

The trade war between the U.S. and China has started to take its toll on economic fundamentals, most directly in China. The problem with China bearing the brunt of this trade skirmish is that the Chinese economy is by far the largest contributor to global GDP **growth**, accounting

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for nearly a 1/3 of overall global GDP growth. Putting aside who has the most to lose, a slowdown in China has far reaching macro and micro tangential ramifications. As an example, Apple blamed the entirety of its Q4 guide down, its first such downward revision in 15 years, on a demand plummet in Greater China. At the macro level, new orders and exports in China have recently started to fall, while manufacturing indices contracted for the first time in two years. Europe and Japan have also fallen into the crosshairs with Eurozone GDP growing at the slowest pace in four years and the Japanese economy contracting in the most recent quarter.

Attributing direct impacts of the recent trade war is difficult, but we continue to see companies commenting on cost inflation as well as uncertainty in outlooks. Global business spending abroad will likely continue to slow until the tensions are resolved so for many reasons we are hopeful that a resolution comes sooner than later to remove this major overhang.

## Earnings Growth Estimates Moderate

Over the past three months, analysts have lowered earnings estimates for the first half of 2019 by 4.5%. That is the largest reduction in the past four years<sup>2</sup>. Even since the end of December, the estimates for 2019 growth have declined from 7.8% to 6.5% in just a few weeks. The biggest downgrades have come from the energy & materials sectors as commodity prices plummeted in the fourth quarter.

The good news is that much of this appears transitory in nature. It also might surprise investors to know that earnings actually declined in 2015/2016 and yet stocks were able to post modest gains after a similar short-lived correction. Coincidentally, earnings are on track to grow ~20% in 2018, which ended up being the worst year for stocks since 2008. What's more important than the actual level of earnings is the trend and right now, the trend down in estimates likely weighed on stock prices as we wrapped up 2018.

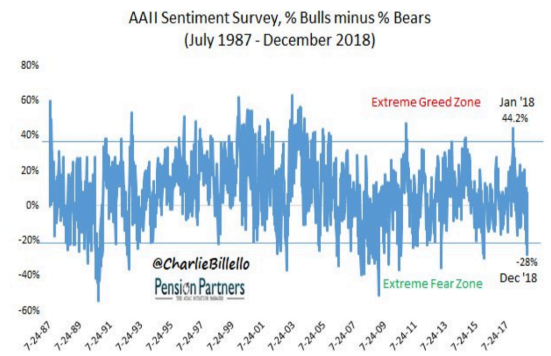
## Valuations Reset Lower

All of this uncertainty amidst a surge in earnings has resulted in a large discounting of stock valuations. At year-end, the S&P 500 was trading at 14.4x 2019 earnings estimates, down from ~19x earnings at the beginning of 2018 and below the 16x average over the past 25 years. This was also the lowest valuation level for the S&P 500 since 2013. As mentioned before, valuations are not a near-term indicator for market returns, but they usually have a high correlation to longer-term expected returns.

More importantly, interest rates have not moved substantially higher to coincide with such a significant discount in the equity risk "premium". For context, if you were to annualize the "earnings" on 10-year bonds based on the current interest rate at the end of 2018, that insinuates around a ~37x multiple. And the earnings of Corporate America actually have potential to grow over that timeframe whereas interest-bearing investments are fixed returns. The one catalyst that could justify such a valuation discount would be a significant mean reversion in margins driven by either rollbacks of recent corporate tax reform or wage/cost inflation and other variables meaningfully pressuring profit margins. As of now, that would be an assumption and not a foregone conclusion.

It is rare to go from such extreme optimism to pessimism twice within the same year, but that is exactly what happened in 2018. Investor optimism hit multi-year highs in January, just before the first selloff. Then in December, pessimism reached multi-year lows. Extreme moments of sentiment, both positive and negative, are often contrarian indicators for returns in stocks. Coincidentally, since pessimism and stock outflows capitulated on Christmas Eve, stocks seemed to have found their footing.

We will know for certain when looking back on this year whether this was the start of something more systemic, but the data as of now does not support that narrative. Outside of higher debt leverage in the system, which will be a headwind when rates normalize, we do not see the major cyclical excesses in the economy that accentuated the past two bear markets. For now, we think this was more emblematic of a garden-variety correction. And yet another reminder on why having a plan for investing, and sticking with it, is the most crucial factor to long-term investor success.



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### Sources:

- <https://pensionpartners.com/2018-the-year-in-charts/>
- <https://insight.factset.com/topic/companies-and-earnings>

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