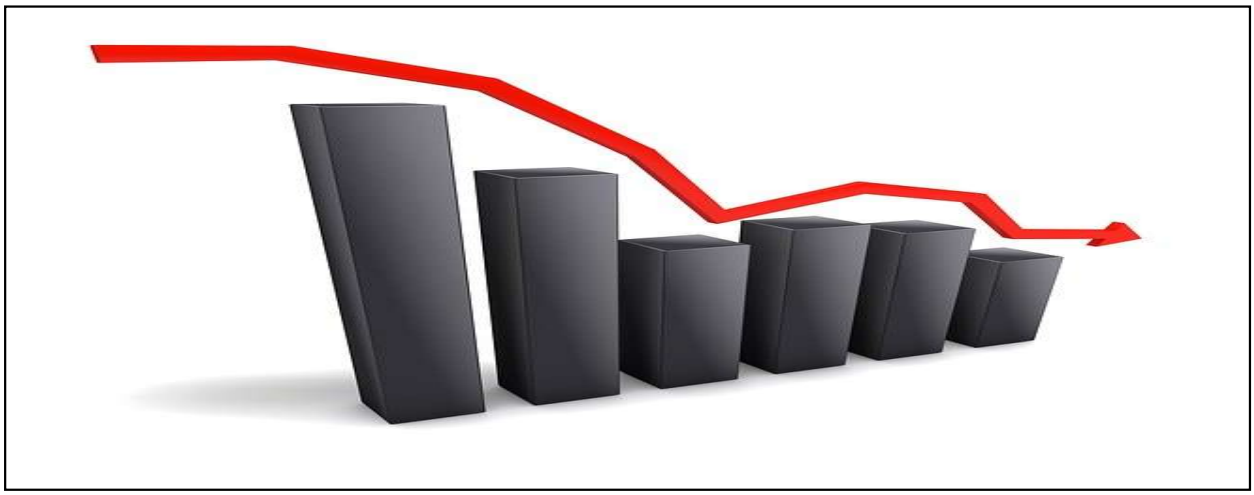
SANITAS
WEALTH MANAGEMENT



A Market Reset

December 2018

Equity markets have blown through a correction and some are approaching bear territory.

THE FEDERAL RESERVE'S NO WIN POLICY ANNOUNCEMENT

Markets have been declining in a volatile trading pattern since late September. While the daily reason may change, the trends point to a concern about a slowing economy and slowing corporate profits. At their December meeting, the Federal Reserve made the decision to raise rates one more time while providing guidance which suggested a slower pace of increases in 2019. The Dow was trading higher on the day until the Fed statement announcing the decision was released. The speed of the reversal was quick, and the Dow declined by roughly 800 points from the intraday high. The day after has not brought any reprieve to selling pressures. Since late September, the S&P 500 has declined over 15%, while the tech heavy NASDAQ is off more than 20%. Hindsight is 20/20, but I'm not sure anything the Fed could have announced would have appeased investors.

Coming into the Fed meeting, many economists and investors were calling for the Fed to pause. President Trump has also been vocal in admonishing the Fed for raising interest rates. If the Fed had followed the policy advocated for by these lobbyists, I'm not sure the market would have reacted any differently as that would have been an indication that the Fed believes the economic outlook is weak enough to take a breather. No change in the guidance probably would have been interpreted as a disconnected Fed in the face of a slowing economy. The decision they did make, which was somewhere in between, was interpreted as an outlook for weakness with still higher rates. In short, I don't think there was a right answer.

HOW BAD IS THE OUTLOOK FOR THE ECONOMY AND CORPORATE EARNINGS?

With markets turning down, it seems the outlook for the economy must be pointing towards a recession, and earnings must be on the cusp of turning to losses. The data does not support that conclusion. The reality is the outlook has slowed, but from an economic perspective, expectations remain for positive growth in 2019 for both GDP and earnings.

The Fed's projection materials (which came out with the statement) suggests the U.S. economy should grow at approximately 2.3% in 2019, followed by 2.0% in 2020. This is relatively strong growth in the context of the expansion since the Great Recession. Other economic indicators support a continuing expansion. For example, for Institute for Supply Management's Manufacturing index stood at 59.3% for November.[1] A level above 50 means the sector is expanding. Levels between 55 and 60 generally mean growth is fairly rapid. Looking at the elements which make up the index, historically there are some key indicators which would suggest slowing. One is customer inventories – when consumers slow their purchases, inventories build up as businesses are slow to reduce production and unsold product builds up. By contrast, since the middle of 2017, the majority of industries have reported inventories as being too low to meet customer demand. In addition, new order growth remains strong and most industries are experiencing a backlog of orders. This is consistent with continued expansion, not contraction. The non-manufacturing index, which refers to the service economy (which today is responsible for the majority of economic output) registered a level of 60.7% in November, also consistent not just with expansion, but relatively strong expansion.[2]

What about corporate earnings? According to FactSet, corporate earnings growth for the S&P 500 should come in slightly above 20% for 2018.[3] This likely represents a bit of an anomaly which results from the tax act passed in late 2017. Earnings growth in 2019 is expected to slow to roughly 8%. This puts the forward valuation on the S&P at 15.1 (as of Friday the 14th of December). With market losses this week, forward valuations should be at or just below the 10-year average.

An important point which I feel has been overlooked by many regards sales growth. For much of the early recovery following the Great Recession, earnings growth resulted from accounting tricks. For example, many companies refinanced their debt loads at historically low interest rates. Declining interest expense resulted in increased earnings without strong sales growth. While CFOs can manipulate earnings, a sale is a sale and is hard to manipulate. Sales growth expectations have come down but remain relatively high, which should be supportive for continuing earnings growth.

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1 ISM Report on Business Manufacturing, November 2018.

2 ISM Report on Business Non-Manufacturing, November 2018

3 FactSet Earnings Insight, December 14th, 2018

IF THE OUTLOOK IS ROSY, WHY ARE MARKETS DECLINING?

In a word, uncertainty. When any investor faces a less certain outcome, the compensation needed to make the investment must rise. That means prices have to come down in order for future expected returns to increase. In part, this hinges on uncertainty created by trade policy, Brexit, a slowing Chinese economy, and more. It also is impacted by expectations for higher interest rates, which changes the discount factor for future valuations. Reasonable investors can argue about the details, and the market mechanism will determine which views win the price fight (right now the sellers are winning). However, some of the market activity may be unrelated to outlook.

With significant declines for the first time in years, taxable investors may be faced with the option to generate tax losses. These losses may be particularly useful in the face of capital gains distributions by many pooled investments like mutual funds. And while tax law doesn't require sitting on the sidelines, with a volatile market, many investors may choose to do exactly that. This likely creates some artificial selling pressure in aggregate which is unrelated to company fundamentals. If a reversal is in the cards, unfortunately there seems to be little reason, from a tax perspective, for a reversal to take hold until the calendar year turns.

In addition to tax loss trades, it seems short term volatility has been amplified in recent years by algorithmic trading. The bad news is that these high-speed traders can swing markets quickly and boost volatility. The good news is that these high-speed traders generally don't look at company fundamentals, and while they can create a sinking feeling for those of us who are not day-trading and are looking at falling account values, markets eventually do reconnect to company fundamentals.

WHAT'S AN INVESTOR TO DO?

For taxable investors, take a look at your accounts and in particular look for any capital gains which may have paid out in the last few weeks (most mutual funds pay capital gains distributions in mid-December). If you have losses in your accounts, consider trading to generate losses to offset these capital gains distributions. In general, you can write off up to $3,000 in excess capital losses each tax year. Any additional excess can be carried forward to future tax years. Note that this is simply a tax strategy, it is not intended to be a directional call on the market.

For non-taxable accounts, consider rebalancing your portfolio, but resist the urge to make wholesale changes to your allocation. Most non-taxable investors have an extended time horizon, and historically, time in the market has trumped timing the market. This advice only applies if you already have an appropriate target asset mix. If you've let your portfolio drift for the last 10 years, you likely have too much equity exposure and should revisit your allocation.