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FOURTH QUARTER 2018 MARKET RECAP & 2019 OUTLOOK

Global Stocks Get Hammered By Positive Fed Comments And A Reprieve In Trade Tensions. Wait, What??

What Happened? Why did Stocks Take a Beating When They Were Expected to do well in 2018?

The S&P 500 Total Return Index ("S&P 500"), a market-weighted index of the 500 largest U.S. stocks, posted a negative return in 2018 for the first time in three years. As discussed below, a novice Federal Reserve Chairman and a perceived worsening of the trade dispute between the U.S. and China caused the S&P 500 to plunge almost 20% (from peak to trough) during the fourth quarter. 2018 also marked the first time ever the S&P 500 posted a decline after rising in the first three quarters of the year. Foreign stocks, both international developed markets and emerging markets, were also down for the year due to global trade tensions, a stronger dollar, and a preference for U.S. stocks. High quality bonds, which were down for most of 2018, squeaked out a nominally positive return for 2018 driven by a flight to safety at the end of last year.

We expect both U.S. and foreign stocks to post positive returns for 2019, however, we are becoming more "defensive" with our positioning in U.S. stocks as we get closer the end of the current business cycle. International developed markets and emerging markets stocks continue to provide the best intermediate-to-long term opportunities within equities in addition to tactical investments in Consumer Staples, Healthcare, and Technology sectors and within the Asia-Pacific ex-Japan region. Investments in real assets and alternative assets remain viable portfolio diversifiers, helping to stabilize returns, while holding a diversified mix of predominately high quality investment grade bonds serve as a shock absorber during periods of extreme volatility like what occurred during 4Q 2018.

Communication Breakdown

The U.S. stock market was humming along at an average annualized rate of +15.6% until early October when Federal Reserve ("Fed") Chairman Jerome Powell commented that the Fed was "a long way" from stopping its interest rate hikes. Investors worldwide were taken by surprise by this comment considering global inflationary pressures remain subdued and mounting trade tensions threaten a further slowdown in global economic growth. Forget that just days before at his last press conference of 2018, Chairman Powell said that the U.S. economy was "strong" and growing at a "healthy clip." Powell's comment set off a global stock market correction and a near bear market in U.S. stocks due to fear that the Fed may inadvertently hasten the end of the current U.S. economic cycle by raising rates too high and too fast.

Around the same time at the November G-20 meeting in Buenos Aires, President Trump and Premier Xi Jinping announced a deal to temporarily halt the escalation in tariffs that were to take effect in January to give both countries more time to negotiate over trade concerns. Unfortunately, there was no joint statement issued from this meeting and some contradictory comments made by the White House and Chinese state media caused investors to dismiss this event as more "hot air" rather than as a tangible step towards resolving the U.S.-China trade dispute. In the past, investors would rely on their leaders to be effective communicators of political and economic policy. Due to our current President's lack of understanding of both political and economic policy compounded by his inability to formulate and communicate well thought out consistent messages, poses yet another risk investors must contend with going forward.

These events also illustrate why it is important to maintain a well-diversified, "defensively" positioned investment portfolio versus attempting to time the market by going all-in on any one asset class and risk getting whipsawed by the next ineffectively communicated statement causing national headlines.

2018 U.S. Stock Market Recap

The S&P 500 declined 13.5% during fourth quarter 2018 and was down 4.4% for 2018. After reaching a peak all-time high price on 9/21/18, the S&P 500 declined 19.4% to its lowest subsequent price on 12/26/18. This "correction" in stock prices was just shy of a technical "bear" market. A bear market occurs when an index declines 20% or more after reaching a peak price.

Concern over U.S. Federal Reserve ("Fed") monetary policy tightening was the key driver of this decline as well uncertainty related to the U.S.-China trade dispute and the partial government shutdown. Within the S&P 500, Utilities (+1.4%), Real Estate (-3.8%), and Consumer Staples (-5.2%) led all sectors over the fourth quarter while Energy (-23.8%), Technology (-17.3%), and Industrials (-17.3%) delivered the worst results. For the year, Healthcare (+6.5%), Utilities (4.1%), and Consumer Discretionary (+0.8%) were the top sectors while Energy (-18.1%), Materials (-14.7%), and Industrials (-13.3%) were the worst. Growth-oriented stocks, which tend to represent shares of more economically-sensitive companies, trailed the market, posting a loss of -14.7% for 4Q 2018 but outperformed for the year, with 0.0% return. Defensively-oriented, value stocks that typically pay a dividend declined 12.0% in 4Q 2018 and were down 9.0% for 2018.

Foreign Stocks Recap

The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures the U.S. dollar-denominated return of large company stocks in developed, foreign markets outside of the U.S. and Canada, was down 12.8% during the fourth quarter and down 13.8% for the year. Investor sentiment towards developed international stocks remained subdued during the quarter due to continued dollar strength, moderating economic and corporate earnings growth trends, and uncertainty over the Italian-European Union ("EU") budget negotiations and the upcoming Brexit (the United Kingdom's {"UK"} exit from the EU).

The MSCI Emerging Markets Index declined 7.5% on a U.S. dollar basis in the fourth quarter and was down 14.6% in 2018. Chinese stocks, which account for roughly 33% of the index, continued to weigh on results, declining 11.2% during the quarter and -26.7% for the year. The trade dispute between the U.S. and China has been more impactful to Chinese stocks since exports represent 19% of China's gross domestic product ("GDP") versus 8% for the U.S. (GDP is the value of economic activity within a country or the sum of the market values of all goods and services produced in an economy.) While declining oil prices (-35.0% in 4Q 2018 and -19.6% in 2018) have benefited key Emerging Market economies such as China, India, and Turkey, they negatively impacted net exporters, which are predominately emerging markets countries. Weak currency trends as a result of rising U.S. interest rates (rising demand for higher yielding U.S. fixed income assets increases demand for dollars to buy these assets) and moderating economic growth trends have also negatively impacted investor sentiment towards these stocks.

Expectation for U.S. Equities Going Forward

As we have consistently highlighted over the course of 2018, most of our client portfolios have generally had their allocation to U.S. stocks reduced by 50% of what we typically recommend owning. We advocated lower exposure to U.S. stocks given our expectation for a correction, or a decline of 10% or more, in the value of U.S. stocks. After correcting more than 19%, U.S. stock valuations are much more reasonable with the S&P 500 price-to-next 12 month expected earnings ratio ("P/E ratio") currently trading at 14.4x or an 11% discount to historical levels. A number of trading indicators suggest U.S. stocks are either at or near "oversold" levels. Key contrarian indicators, namely the Bank of America Merrill Lynch Sell Side Indicator and the

Goldman Sachs Sentiment Indicator, reflect an overly pessimistic view of U.S. stocks among investors. Historically, these signals bode well for stock returns over the subsequent 12 months. According to a Bank of America Merrill Lynch Global Research report, when their indicator has reached current levels or lower, U.S. stock returns over the following 12 months have been positive 93% of the time with a median return of 19%.

We expect U.S. stocks to generate a high single digit-to-low double-digit return for 2019 driven by a combination of corporate earnings growth and an expansion in P/E multiple to at or near historical levels. The expected deceleration in gross domestic product ("GDP") growth over the next 12 months is largely a function of a waning benefit from the corporate tax cuts implemented last year. Current macroeconomic data remain healthy led by the pace of job growth, wage growth, consumer confidence, manufacturing surveys, small business optimism, robust financial sector loan growth, and strong household balance sheets following a decade of deleveraging. There is also a unanimous view among the strategists we talk to that the U.S. economy is unlikely to fall into a recession during 2019, which is important because recessions typically occur just prior to or during structural bear markets (i.e. bear markets lasting 12 months or longer). Beyond 2019, however, views among these strategists are polarized, with some strategists sharing the prevailing market view that the next recession will likely occur during 2020 while others expect the current economic expansion to continue for several more years (albeit at a decelerating pace).

While we have stopped reducing weightings to U.S. stocks for most clients, we remain defensively positioned by continuing to utilize investment managers that focus on owning "quality" stocks or shares of companies with stable growth profiles, low earnings variability, strong balance sheets, durable cash flows, and higher returns on equity. "Quality" stocks generally experience less volatility as compared to the broader market due to less "idiosyncratic" risk or a lower propensity for these companies to decline in value as a result of an unexpected deterioration in company-specific fundamentals.

Other means by which we are defensively orienting our client U.S. stock holdings include holding a balanced exposure to both growth and value stocks and tactically emphasizing industry sectors that are less reliant upon the pace of economic growth, such as Healthcare and Technology. Financial Sector stocks may not do as well as we originally expected. While underlying financial sector fundamentals remain positive, we expect the Fed to become more "dovish" as we progress through 2019. This means the breadth and pace of interest rate hikes will be more subdued than we previously anticipated. A more modest "glide path" forward for interest rates means lower sector revenues and earnings growth versus prior expectations. Consumer Staples stocks, on the other hand, typically outperform towards the end of a business cycle and during a recession. Although the U.S. economy is in the early innings of the late-phase of its business cycle, the recent market correction has provided an attractive entry point for Consumer Staples stocks. The sell-off has also provided an opportunity to further reduce systematic risk (i.e. general market risk that affects all stocks) by adjusting the Technology sector holdings to include strategies that can also invest in the Telecommunications Sector. Like the Consumer Staples, Telecommunications sector stocks tend to outperform the broader market at the end of the business cycle and during recessions.

Lowering portfolio “beta” or exposure to systematic market risk by owning balanced exposure to “quality” stocks with a tactical emphasis on lower economically sensitive industry sectors is especially important given our expectation for continued stock volatility going forward. It is not uncommon for market prices to become more volatile towards the end of an economic expansion, as fears of a potential recession increase, but the chaos in Washington and the Administration’s lack of consistent economic and political policy creates additional investor uncertainties. Programmatic trading among passively managed funds will also likely contribute to higher market volatility in the form of more severe daily price swings and “intra-year” declines. The impact from programmatic trading will likely be less pronounced after a positive inflection in underlying momentum trends (i.e. when investor trading patterns portend an increasing penchant among investors to own U.S. stocks).

Foreign Equities are Primed to Take Over Market Leadership

2018 was a rough year for foreign stocks both international developed markets and emerging markets. Investors clearly had a preference for U.S. stocks over foreign equities because of the U.S. tax cuts and expectations that U.S. stocks would do better in the near term. After a stellar year in 2017, foreign stock results were also hampered in 2018 by rising trade tensions (particularly between the U.S. and China), rising U.S. interest rates, and continued dollar strength. These factors coalesced to temper economic growth in key markets such as the EU, Japan, and China, and further enhanced the perceived growth disparity between the U.S. and foreign markets. International developed markets stock sentiment was negatively impacted by the lingering Italian-EU budget impasse and fears over a “hard” Brexit (i.e. the UK leaving the EU’s Single Market and Customs Union without any free trade deal in place). While it feels like the sky is falling for foreign equities, we continue to see opportunity for these securities to consistently outperform U.S. stocks over the next 3 to 5 years.

International developed markets stocks represent a particularly attractive opportunity over the mid-term as the European Central Bank (“ECB”) and Bank of Japan (“BoJ”) monetary policy remains high accommodative. This translates into a more supportive environment for international developed stock prices as compared to U.S. stocks, which will continue to be hampered by more restrictive monetary policy. International developed markets stock valuations are also cheap compared to their historical levels and to U.S. stocks. The prevailing discount to international developed stock valuations does not reflect the potential for an improvement in any of the above headwinds.

The budget agreement between Italy and the EU at the end of December not only removed a major overhang, but fears of a “hard” Brexit may be overblown. If a “hard” Brexit did occur, the UK would still be able to trade with EU members under World Trade Organization (“WTO”) rules. The negative impact from a “hard” Brexit would be largely contained to the UK as its weaker trading position with the EU and the likelihood of a deteriorating currency will ultimately hasten a UK recession. The UK economy is not large enough to represent systemic risk to the global markets, but we would not be surprised to see a short-term “knee-jerk” pullback in global stock valuations in response to this event. The underlying fund managers we use to gain exposure to international developed markets continue to avoid sizeable exposures to UK stocks relative to global market indices.

We see the prospect for greater visibility into some if not all of the major global trade disputes occurring during the first half of 2019. In early 2019, the EU and Japan are expected to begin negotiations with the U.S. to reconcile their respective trade issues. President Trump has an incentive to strike “new” trade deals with both partners sooner rather than later given a limited ability to push any meaningful economic policy through a gridlocked congress and to bolster his profile ahead of the 2020 presidential elections. For these reasons, we continue to expect the U.S. and China to ultimately strike a trade deal or, at the very least, agree not to escalate the current tariff regime for an extended period of time as both countries work to address deeper structural issues related to intellectual property (“IP”) enforcement and barriers to market entry. Recent developments within China support this view, including the removal of tariffs on American made cars and harsher punishments for IP violations. This would be an especially positive development for the EU and Japan considering China is the second largest trading partner for both countries after the U.S. In addition, a portion of the slowdown in economic growth in these markets has been attributed to the delay in corporate capital expenditures due to the uncertainty of how these various trade disputes will progress.

U.S. policy has acted as a break on the global economy, with rising U.S. interest rates, a strong dollar, and growing trade tariffs all slowing things down, but trends in manufacturing data show that most international developed and emerging markets economies are still firmly in expansion mode. Emerging markets stocks further benefit from robust long-term growth tailwinds as a result of positive demographic trends (i.e. younger populations) and the wealth effect (expanding middle class increasing consumption patterns and demand for modernized infrastructure and related services). The underlying health of emerging markets economies, as measured by current account balances and foreign currency debt as a percentage of GDP, have also meaningfully improved over the past 10 years. These improvements have helped to ensure a more sustainable foundation for long-term growth in economic activity and ultimately corporate earnings growth.

The substantial sell-off of Chinese and Asia-Pacific region (excluding Japan) equities during 2018, in particular, provides an attractive tactical opportunity as China has become much more serious about “reflating” its economy, both from a fiscal and monetary standpoint, to offset the impact U.S. tariffs have had on manufacturing activity and consumption. Recent actions to stimulate the Chinese economy that have focused on lowering bank reserve requirements and relaxing loan standards are beginning to filter through to the economy. Current initiatives, such as lowering interest rates, cutting consumer taxes, increasing credit growth, and providing additional liquidity to financial institutions, will provide even more economic support over the course of this year. The central government has even more potent “levers” to pull, such as initiating new infrastructure projects, to stabilize economic growth if needed. All of these “stimulative” measures bode well for the underlying earnings growth support for both Chinese stocks and the shares of companies within regional countries that are major exporters into China including South Korea, Vietnam, India, Singapore, and Taiwan.

Favorable secular growth trends combined with lower and more favorable valuations relative to U.S. stocks continue to make emerging markets equities an attractive long-term investment opportunity. The stabilization in emerging markets debt and currency valuations during the second half of 2018 means investor sentiment toward these assets is improving, but we expect only pockets of outperformance over the near term until there are more meaningful signs of progress towards resolving the U.S.-China trade war or if the trend in the value of the U.S. dollar strength begins to weaken. Either of these events have the potential to trigger a broader rally in emerging markets stocks.

A weaker dollar is still widely perceived as being positive for emerging markets even though local market debt dominates new issuances. Nonetheless, as local currencies strengthen relative to the dollar, it makes it easier for heavily indebted emerging markets countries to service their dollar-denominated debt. A weaker dollar also attracts foreign (U.S.) investment as rising currency values enhance returns generated by emerging markets assets. As the U.S. economy slows from 2018's strong levels and the global inflation backdrop remains benign, we expect the Fed to become more "dovish" with monetary tightening over the course of 2019, which could also serve as a trigger to broader emerging markets rally. The expectation of lower future interest rates in the U.S. (as the Fed intends to reduce interest rates when the recession occurs) provides the impetus for a U.S. dollar weakness as investor cash flows leave the U.S. in search of higher yielding opportunities abroad.

Playing Defense With Real Assets and Alternative Strategies

Our clients' exposure to real assets include global real estate, global infrastructure, and U.S. midstream energy companies (e.g. oil/gas pipeline/storage master limited partnerships). Real assets, or physical assets that have tangible value, reduce overall portfolio volatility due to their relatively lower correlations to "paper assets" (i.e. stocks and bonds) as compared to other traditional investments. Their relatively stable income streams also allows these investments to serve as viable proxies to owing more bonds. Diverting a portion client capital from bonds to real assets reduces the sensitivity of client portfolios to changes in the overall credit environment and to changes in interest rates. (The credit environment is comprised of both the availability of credit and the potential for borrowers to fail to meet their loan obligations.) An additional benefit of real assets is that they provide protection against an unanticipated rise in inflation expectation thus would serve as "hedge" to higher prices due to rising tariffs between the U.S. and its trading partners.

We maintain our favorable view of U.S. midstream energy companies. The U.S. has become the world's largest producer of oil and natural gas, and demand for more efficient storage facilities and pipelines is projected to lead to over $106 billion of additional infrastructure spending through 2021. The buildout of the U.S. energy infrastructure will continue to support the double-digit growth in distributable cash flows we have been accustomed to seeing. Unfortunately, the sector has been negatively impacted by the volatility in energy prices, even though 88% of sector cash flows are derived from long-term, fee-based contracts that are based on the volumes (not prices) of oil and natural gas being transported or stored. We attribute this dynamic to an investor base that has been dominated by retail investors. Retail investors are individuals who purchase securities for his or her own personal account while institutional investors are organizations or financial intermediaries with large pools of investment capital (e.g. investment advisors, mutual funds, pension funds, endowments, and private investment firms). In addition to the sector's steep 29% discount to historical valuations, midstream energy companies have attracted more institutional investors due to the recent fundamentally positive changes to ownership structures and corporate governance that have taken place over the past year. We anticipate volatility as a result of commodity price fluctuations to decline over time as institutional investors absorb a greater share of overall ownership since these investors tend to have much longer investment horizons and a greater ability to diversify risk as compared to retail investors.

Alternative assets/strategies continue to perform in line with our expectation for delivering differentiated returns streams relative to traditional stocks with volatility patterns similar to investment grade bonds. (These alternative assets include funds that own stocks but have the ability to take defensive positions and “short” the market.) The average decline in value of our client’s alternative investments during 4Q 2018 was only a fraction of the decline in the value of the S&P 500 over the same period. We will considering adding more alternative assets and strategies to client portfolios as we get closer to the end of the current business cycle or if we begin to anticipate a greater likelihood of a U.S. recession occurring over the next 12-18 months.

Fixed Income Results

U.S. fixed income or bond markets generated positive returns during 4Q 2018 as the near bear market in U.S. stocks triggered a flight to perceived “safe” assets. U.S. government bonds, as measured by the Bloomberg Barclays U.S. Aggregate Treasury Bond Index, rose 2.6% in fourth quarter 2018, resulting in a full year gain of 0.9% for these securities. The yield on the 30-year Treasury bond ended 4Q 2018 at 3.02%, or 17 “basis points” (100 basis points equals 1.00%) lower than the prevailing yield at the end of 3Q 2018 and 28 basis points higher than the yield on 12/31/17. Since 12/16/15, the Fed has raised its target for the federal funds rate (the overnight rate at which banks and other depository institutions lend reserve balances to each other) by 225 basis points while the yield on the 30-year Treasury has remained flat. This disparity between rising “front end” rates and flat “long end” rates has caused the U.S. Treasury yield curve to “flatten.” The yield curve is a line that plots the interest rate for all Treasury bond maturities up to 30 years, and an “inverted” yield curve, or a plot of U.S. Treasury yields that has higher front end (short-term) rates as compared to long end rates, has preceded all but one post World War II recession by an average of 12-24 months (24 months is the modern era average).

The Bloomberg Barclays U.S. Aggregate Bond Index, a composite of investment grade bonds of all types, increased 1.6% during 4Q 2018, resulting in a slightly higher than 0.0% return for the full year (actually one basis point positive). U.S. investment grade corporate bond performance weighed on aggregate U.S. investment grade bond returns for the fourth quarter (-0.1%) and for the full year (-2.3%) while investment grade mortgage backed securities (“MBS”) drove positive returns. U.S. MBS was up 2.0% for the latest quarter and rose 1.0% for 2018. At this point in the economic cycle, we have not allocated any assets to high yield bonds. Since the risk in this sector grows late in the business cycle, we do not think it advisable to own high yield bonds, which were down 4.7% in 4Q 2018 and -2.3% in 2018.

The Bloomberg Barclays Global Aggregate ex-U.S. Bond Index, which measures the U.S. dollar denominated results of international (non-U.S.) investment grade bonds of all types, increased 0.9% during the quarter but declined 2.2% for the year. International investment grade corporate bonds were the primary driver of weak international investment grade bond returns during the quarter (-2.5%) and for the year (-7.0%). The weakness in demand for these bonds was primarily due to more attractive U.S. interest rates and a stronger U.S. dollar, which was up 4.4% in 2018 versus a weighted average basket of key trading currencies.

Emerging markets bonds, as measured by the U.S. dollar denominated Bloomberg Barclays ex-US Emerging Markets Bond Index, declined 0.7% in 4Q 2018 and were down 4.4% for 2018. All of the losses in these assets for 2018 occurred during the first half of the year as these bonds were up 1.1% during the second half of 2018. The relatively strong results in the face of rising U.S. interest rates and China's trade issues continues to signal moderating "contagion" fears or the perceived risk that specific challenges in a few emerging markets economies will spark a broader crisis within emerging markets.

Our Plan for Bonds Going Forward

We continue to advocate holding a diversified mix of predominately high quality investment grade bonds with the primary goal of stabilizing portfolio values during periods of extreme volatility. The benefit of this strategy was evident in 4Q 2018 given the divergence in returns between the MSCI All Country World Index (-12.8%), an index that measures the performance global large cap stocks, and the average return for the funds we use to gain exposure to high quality bonds (+0.8%). We maintain our emphasis on investment grade structured notes (e.g. agency/non-agency MBS, commercial mortgages, asset backed securities) since these bonds typically reduce both portfolio duration (i.e. sensitivity to changes in interest rates) and exposure to the overall credit environment. We have further reduced both interest rate and credit risk by avoiding direct investments in corporate bonds as these securities tend to have longer durations and a higher level of credit risk, which we want to avoid as the U.S. gets closer to the end of its current business cycle.

The tradeoff with owning a globally diversified portfolio of mostly high quality bonds is stability in exchange for lower overall returns. Going forward, we anticipate our clients' high quality bond holdings to generate an annualized return commiserate with the current yield on the Bloomberg Barclays US Aggregate Index of +3.0% to 4.0%. With that said, we do see an opportunity to enhance expected returns through exposure to emerging markets bonds where appropriate. As mentioned above, emerging markets bonds were down 4.4% in 2018 when historically these assets have generated an average annualized return of 8-10%. While we anticipate emerging markets bonds to outperform the Bloomberg Barclays US Aggregate Bond index, we do not expect these assets to revert back to historical return patterns until there is sustainable weakness in U.S. dollar trends or signs of resolution to the U.S.-China trade dispute.

The Importance of Diversification and Staying Fully Invested

At this time, we do not foresee a U.S. or global recession over the next 12-18 months. This provides a favorable backdrop for continued corporate earnings and ultimately stock appreciation. However, it is even more imperative now as compared to the past to hold a diversified mix of defensively positioned assets and tactical exposures to withstand the numerous sources of volatility investors and the markets face. It is also important to remind clients that people are living longer during their retirement years, which means it is important to stay fully invested to better ensure retirement assets not only keep pace with inflation but will last throughout the course of retirement.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

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