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January 2019

Annual Financial Market Update & Look Ahead

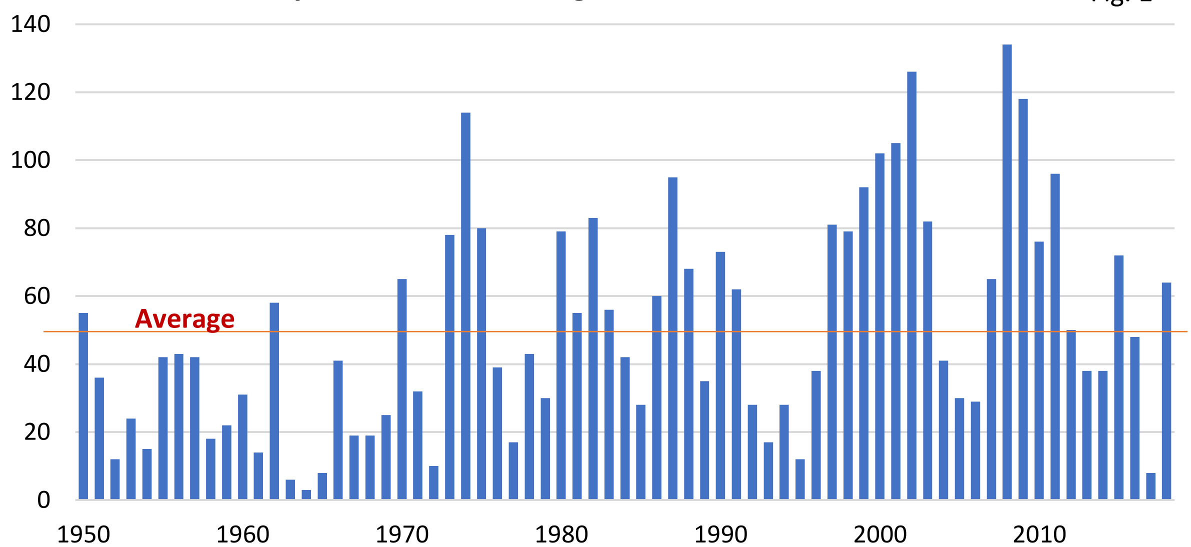
The Year Volatility Returned

The lack of volatility in 2017 was nearly unprecedented. We witnessed 310 trading days without two consecutive daily pullbacks in the S&P 500 Index of at least 0.5%, according to research firm Bespoke Group. The unprecedented streak ended in late January of 2018. History tells us we eventually "revert to the mean (average)." Timing such events, however, is nearly impossible.

In 2018, the broad-based index of 500 major U.S. companies (S&P 500) rose or fell by at least 1% daily sixty-four times versus just eight in 2017. Yet, as Figure 1 highlights, 2018's volatility was not out of the range of what might be considered normal.

S&P 500 Index +/- Daily 1% or Greater Changes/Year

Fig. 1



Data Source: LPL Research, St. Louis Federal Reserve 12.31.18

The modern S&P 500 Index began in 1957; prior data using S&P 90. Both are unmanaged and cannot be invested into directly.

Note in Figure 1 that the years 2007 through 2011, and 2015 produced a greater number of 1% daily changes. Still, the fourth quarter selloff exacerbated concerns (especially in the month of December).

Figure 2 illustrates the late-year downturn, but it also highlights that year-end weakness was not out of the ordinary either.

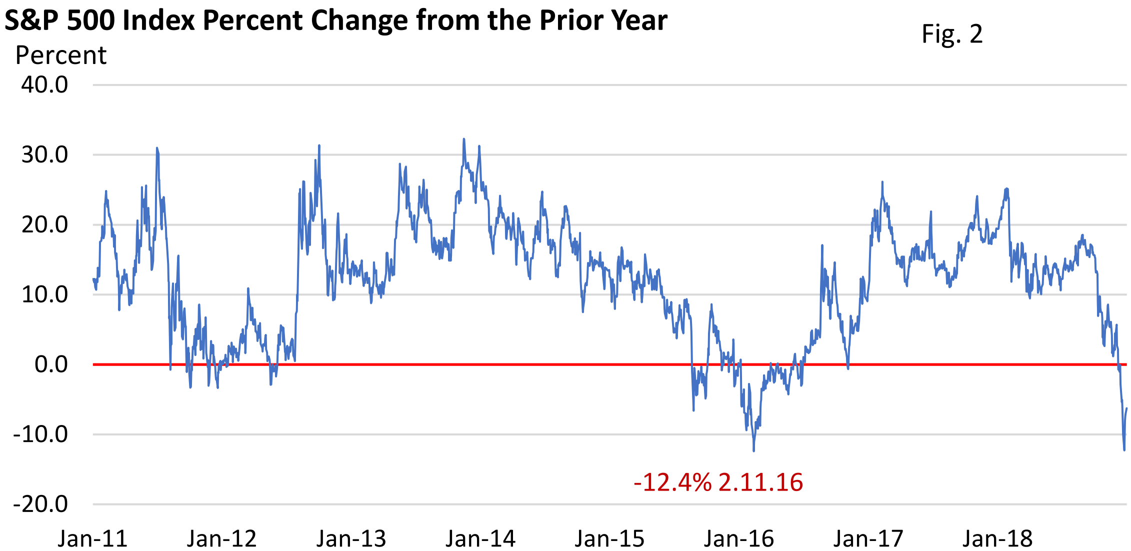


Fig. 2

Data Source: St. Louis Federal Reserve 12.31.18

Longer term, stocks react to the economic fundamentals and earnings. Shorter term, unpredictable events can quickly dampen sentiment, and pricing in uncertainty is difficult; hence, the fourth quarter's decline and volatility.

What Happened?

The global economy has been slowing and the United States economy is showing signs of moderating. As a consequence, analysts have been trimming 2019 profit estimates. Thus, some of the decline has been in reaction to the fundamentals. But was the selloff overdone?

Eight rate increases by the Federal Reserve since the rate-hike cycle began did not hamper bullish sentiment, that is, until October. A communication faux pas by Fed Chief Jerome Powell in early October and late December took a toll on sentiment.

While trade frictions between the U.S. and China added to the souring mood, the issue extends beyond its direct impact on stocks. For starters, there is a bipartisan consensus on Capitol Hill that China does not play fairly. Furthermore, Chinese theft of intellectual property and forced technology transfers are creating national security issues.

While many in the U.S. and around the world share the president's goal of fair and free trade with China, the current path to obtain the desired outcome has generated some of the tensions we have seen in the market. This is not meant to be a political statement, only a reflection of the reality that stocks have traded down on negative trade headlines and a sense of uncertainty.

Stock Indices*	Q4 Return % Oct. 1, 2018 – Dec. 31, 2018	YTD Return % Jan. 1, 2018– Dec. 31, 2018
S&P 500 (large)	-13.52%	-4.38%
S&P 400 (midsize)	-17.28%	-11.08%
Russell 2000 (small)	-20.20%	-11.01%
MSCI EAFE (intl.)	-12.54%	-13.79%
Bond Yields	**12/31/2018 Yield & Annual Change**	**Yield a/o Dec. 31, 2017**
3-month T-bill	2.45% (+1.06%)	1.39%
2-year Treasury	2.48% (+0.59%)	1.89%
10-year Treasury	2.69% (+0.29%)	2.40%
30-year Treasury	3.02% (+0.28%)	2.74%
Commodities	**12/31/2018 Price & Annual Change**	**Price a/o Dec. 31, 2017**
Oil per barrel	$45.41 ($-15.01)	$60.42
Gold per ounce	$1,279.00 (-$17.50)	$1,296.50

**Stock indices include reinvested dividends*

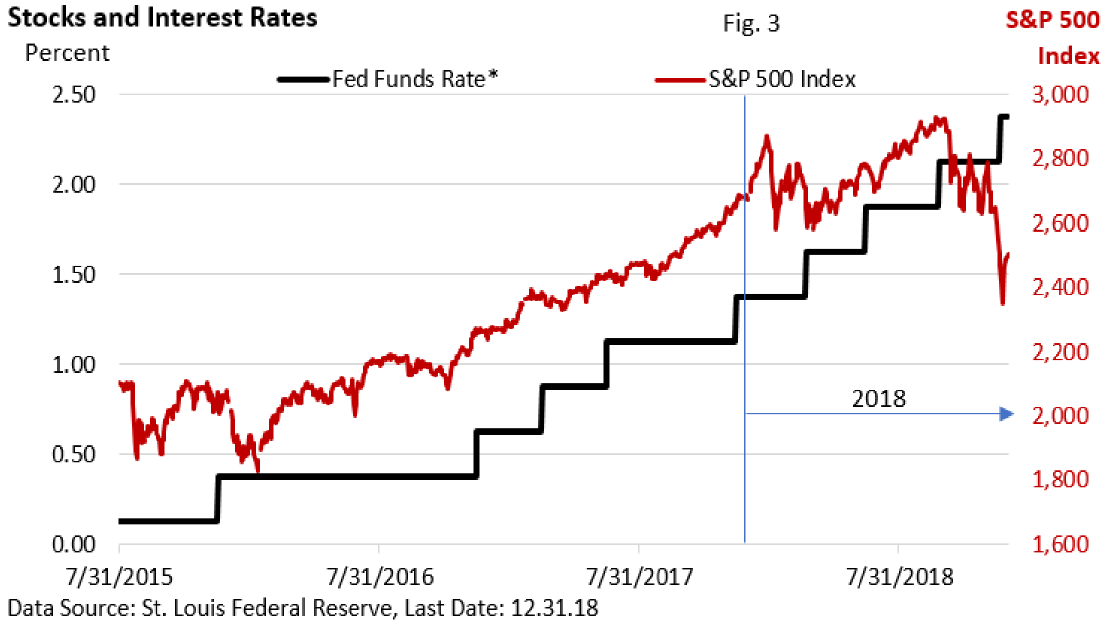
Looking Ahead

1. The economic outlook will likely influence the direction of markets over the next year. A strong holiday shopping season seems to have aided growth. Falling gasoline prices may lend additional support to consumer spending. Manufacturing, however, appears to be slowing and U.S. leading economic indicators suggest growth will moderate in the first half of 2019.

2. Earnings growth likely peaked in 2018 and growth will slow in 2019. Markets have been trying to price in some of the slowdown; hence, some of the late-year decline can be traced to the fundamentals. Importantly, the S&P 500 based on trailing 12-month earnings is at a reasonable 16 times and with modest earnings growth going forward, the P/E is below 15 times expected earnings.

3. What will the Federal Reserve do? Eight rate hikes tied to economic growth did little to discourage investors until early October (Fig. 3) amid concerns that rate increases might stifle economic activity and depress corporate profits.

   Currently, the Fed has projected two 0.25 percentage point rate increases in 2019. The number of increases will likely depend, however, on how the economy performs.



4. The Trump administration delayed an additional hike in tariffs on Chinese imports until March, pending an attempt to forge a trade deal with China. Plenty of ground must be covered over a short period of time, but if a workable framework can be achieved, this would likely aid business confidence.

5. U.S. political instability did little to slow stocks in 2017, as optimism about the economy fueled gains and overshadowed political worries. Today, the change in the House has injected uncertainty into the mix, though it is difficult to quantify its impact. Will Congress and the administration work together or will acrimony continue?

6. Brexit and Italy's financial troubles aren't far from the front burner. Both issues had a minor impact on trading this year. While the European Union has approved a deal for the UK to exit the EU, it's an agreement that likely can't pass Parliament. It has been a difficult split, but it is not in either party's interests for the UK to fall out of the EU without an agreement that establishes parameters going forward.

7. While we don't want to be alarmist, the amount of debt outstanding in both the United States and around the world is troublesome. To make matters worse, little is being done to confront this ticking time bomb.

Just the Facts

The broad market indexes can be unpredictable, and selloffs can and do occur. Whether or not a bear market officially occurred in the fourth quarter (a decline of 20% or more), it was very close. We saw similar drops in 1998 and 2011 without a corresponding recession.

Since WWII, the S&P 500 has averaged a pullback of 31% every 5 years. Since 1980, the annual average decline in the S&P 500 index has been 14%. Yet, the index, including reinvested dividends, has risen nearly 80% of the time.

Despite regular pullbacks, the S&P 500 has produced a compounded annual return of nearly 10% since 1928, all dividends reinvested. That means a $100 investment 90 years ago was worth $382,370 at the end of 2018. The same investment in the three-month T-bill would have turned into $2,052 and $7,366 for the ten-year Treasury bond. While we expect returns to be lower going forward, we do think the long-term difference in returns between different investments will persist.

Selling low and buying high isn't a way to reach your financial goals. It is one reason we recommend an intelligently constructed, highly diversified investment plan. It is not only a roadmap, it reduces volatility and helps separate the emotional component that may encourage decisions based on the sentiment of the day. Remember that euphoria often encourages too much risk taking, and pessimism can often push one to sell in panic. Following a diversified plan tailored to your situation that incorporates factors outside of market sentiment has historically been the best path to reach one's financial goals.

If you have any questions or concerns, feel free to reach out to us. That is what we are here for.

Warmest wishes for a safe, happy, and prosperous New Year!

Thank you for your business.

Hopwood Financial Services, Inc.