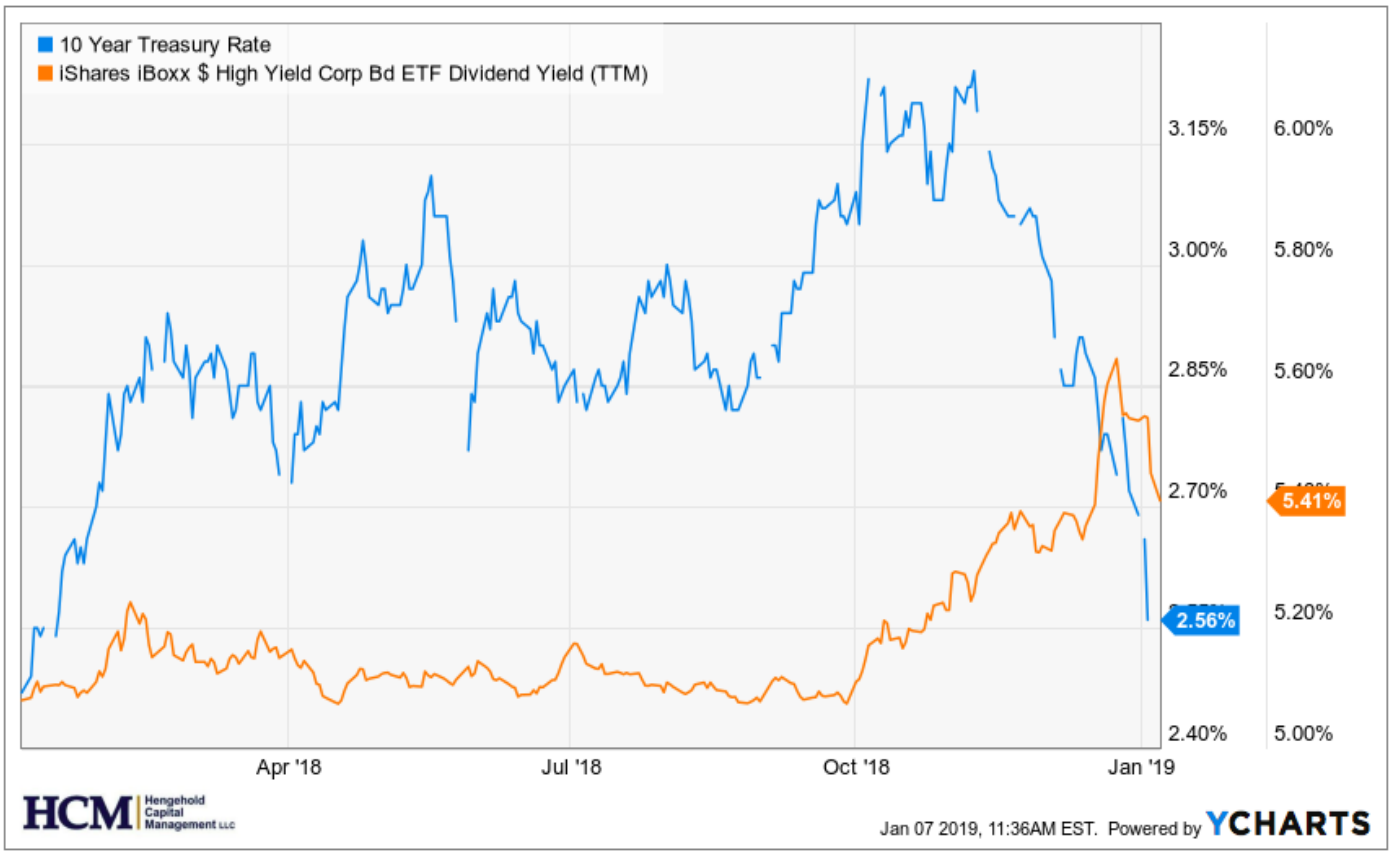
Market Insights for Week Ending Jan 4, 2019

The Year of The Dart, Redux

It isn't often that you get back-to-back years in financial markets that are almost complete opposites. But alas, here we are. For our astute readers, you may notice this title has been recycled from the first *Market Insight* of 2018. For those who need a quick refresher, that piece was about how one could have thrown a dart at a list of major asset classes for 2017 and hit one with positive performance every time. Well, it you get that dart back out and repeat the exercise for 2018, you will find negative returns on every throw. 2018 was the antithesis of 2017, culminating with the worst December since 1928 in terms of returns for the S&P 500.

With 2018 now in the rearview mirror, many are asking, "What's next?" The mystery of what will unfold in 2019 will be revealed over the next 12 months, not sooner. As our role is to manage portfolio risk, not predict the future, we will not entertain a 2019 prediction. What we can say is that 2019, so far, isn't erasing any of the concerns that plagued the final quarter of 2018. While we won't make any predictions of the future, we can look at some of the issues taking center stage in our current risk assessment.



The chart above shows the 10-year Treasury bond rate in blue and the yield on the iShares High Yield corporate bond ETF in orange, both over the past 12 months. We can see a clear inflection point in both lines right around the beginning of October. This was also around the time that we started to see equity prices selling off. While the move in the 10-year bond didn't begin down right away, it certainly

started to move lower as the equity selloff began to pick up steam.

Why Do We Care?

You may be asking why we are focusing on bonds when all the big price action has been in the equity markets. While that is a fair question, HCM believes the bond market is going to give a better indication of where we are headed in 2019.

First, let's give a quick summary of the items that should be front and center in determining how this year will likely play out.

China is probably the one that gets the most attention. The current weakness in China's economy and the ongoing trade and intellectual property negotiations have created uncertainty and risk around global economic forecasts. The ninety-day truce in the trade war between the U.S. and China ends on March 1st. Even if China's recent steps to protect IP and purchase more from the U.S. led to an extension of the truce, structural tensions will exist for an extended time frame stoking investment risk. With earnings season right around the corner, we will get a better gauge of the degree to which these concerns will be affecting corporate earnings forecasts. As of now, a tariff deal (anything more than an extension of the truce) still appears elusive. We believe the related economic risk will feed continued market volatility.

The next major wildcard is the Fed, more specifically, what are they going to do with interest rates and their balance sheet. Guidance has been for higher interest rates in 2019, though the degree of those increases has come into question lately. Regardless, the strong jobs report and the dovish language from Jerome Powell last week generated a perceived risk reduction, resulting in big follow-on gains. If the Fed decides to back off their rate hike plans for 2019, it could provide a significant tailwind for the equity markets, at least in the short term.

This brings us to the chart provided. One thing that has been overlooked in the recent selloff has been the movement in both the treasury and high-yield bond market. Historically, most major bear markets have been accompanied by an economic recession. While few analysts are seeing conditions that warrant concern over a recession, that can change very quickly. Judging by the price movements in the bond market, there is more than a modest level of concern about recession risks. During 2018 the number one investor worry was that the economy would overheat, and inflation would drive interest rates higher. In a surprise move, 10-year yields dropped nearly .65% (that's a big move) in almost 45 days!! In addition, high yield bond yields have moved up almost .30% at the same time. While that might not seem like much, it shows that investors are buying safety in the government bond market and selling risk in the high yield market, which is more sensitive to economic growth. This type of trading shows that investors are protecting capital from the risk of a recession in the next twelve to eighteen months.

One final item that is adding risk to the global equity markets is the UK's exit from the European Union (Brexit) which is scheduled for March 29th. The UK and EU seem to be having some difficulty agreeing on a clean exit plan. Parliament wants nothing to do with the deal Prime Minister Theresa May has offered. Can they do it on schedule? Well, we here in the Colonies know only too well how difficult it can be for politicians to work out compromises acceptable to everyone as this *Market Commentary* is being penned on day 17 of the U.S. government shutdown.

HCM reduced risk in mid-December, based on several factors outlined in our Risk Reduction Webinar. As we evaluate our next moves, we continue to pay close attention to the risks outlined above as well as the interplay between credit spreads to give us indications of potentially deteriorating credit conditions and ultimately, increasing recession risk.

Weekly Focus – Think About It

"Definiteness of purpose is the starting point of all achievement"

-W. Clement Stone

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 1.92%
- Developed Foreign Markets (EFA) – Gain of 2.08%
- Emerging Markets (EEM) – Gain of 1.15%
- Fixed Income (AGG) – Gain of .44%

(Note: performance is based on the change in price plus dividends)

Last Week's Headlines

- A strong US jobs report eased worries about weakening growth in the economy with over 300,000 jobs added in the month of December.
- Global stocks rallied with other risk assets late in the week, reversing earlier declines while Treasury yields rose.
- Global manufacturing data was disappointing with US manufacturing activity falling to a two-year low, China's factory activity shrinking for the first time in two years and Eurozone activity slowing to the lowest since early 2016.

Eye on the Week Ahead

US CPI data will be in focus this week. Consensus estimates point to a December reading of 2.2% year over year. A lower number could further downward pressure on Treasury yields.

If you have questions about the current market piece, please contact a member of HCM's Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

Disclaimer

Any tax or other advice contained in this document, including any attachments, is not intended and cannot be used for the purpose of avoiding penalties under Internal Revenue Code. No action should be taken on any information contained in this message without first consulting with your tax/legal advisors regarding the tax/legal consequences for your particular circumstances.

Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

• • •