Tax & Investment Advisors

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Key Economic Statistics

Leading Economic Index 111.70
Recent Trend: decreasing
(Source: The Conference Board)

Consumer Confidence Index 120.20
Recent Trend: decreasing
(Source: The Conference Board)

US Current Annual Inflation Rate (PCE): 1.90%
Overall FED Goal: 2%
Recent Trend: Flat
(Source: Inflationdata.com)

US Unemployment Rate: 3.90%
Recent Trend: historically low
(Source: US Dept of Labor (BLS))

Interest Rates:
Fed Fund Target Rate: 2.25- 2.50%
2-year US Gov't Bond Yield: 2.56%
10-year US Gov't Bond Yield: 2.72%
30-year US Gov't Bond Yield: 3.06%
Recent Trend: Interest rates continue to be low.
(Source: Wall St Journal Market Data)

Total Returns: 2018
US: S&P 500 (SPY): -4.38%
US: Dow Jones Ind. Avg. (DIA): -3.74%
US: NASDAQ Comp (NASDAQ): -3.88%
US: Aggregate Bond Index (AGG) 0.10%
Europe: FTSE Europe (VGK): -14.91%
Canada: I-Shares (EWC): -17.16%
China: Large Cap (FXI): -13.26%
Hong Kong: I-Shares (EWH): -8.73%
Japan: I-Shares (EWJ): -14.09%
Brazil: I-Shares (EWZ): -2.57%
Gold: I-Shares: (IAU): -1.76%
(Source: Morningstar Office)

Quarterly Investment Commentary: Q4 2018

1/09/2019

"The stock market is like a small row boat in rough seas, bouncing around as it drifts. Whereas the macro economy is like a large ocean liner, very ponderous and difficult to maneuver, but without such a rough journey" – Clive Granger

Mr. Granger's quote helps us put the most recent quarter in the stock market into perspective. After one of the worst Decembers in history the S&P 500 closed 2018 negative (-4.38%) on an annual basis for the first time since 2008. After fear from rising interest rates, trade wars, and political instability caused disruption across asset classes, the narrative soon turned to talks of an economic recession.

Even with these headwinds, the U.S. economy is showing strength in multiple areas. Commercial auto sales are up 16% annualized, non-defense capital shipments are up 9%, and retail sales are showing significant strength. MasterCard reported retail sales up 5.1% from November 1st to December 24th, showing the strongest holiday season in 6 years. Monthly payrolls are consistent, wages are up 3.2% year over year, and the unemployment rate is the lowest level since 1969. Consumer spending and investment spending by corporations are at healthy levels. We believe these strengths have been discounted by the market over the past quarter showing a divergence in the fundamentals of the stock market and the pricing of securities.

We recognize there are a number of downside risks to international equity markets. Global monetary tightening by central banks has put pressure on both equity and fixed income pricing. The slowdown in US GDP growth year over year, resulting from fading 2017 fiscal stimulus has stirred up growth fears. And increased government debt and deficits have not aided investor confidence.

The recent market correction was not limited to US equities, rather it spread across countries and asset classes. Emerging markets, developed economies, and commodities all saw significant declines.

After such a dramatic move across equity markets, we believe this correction does not warrant the size of the move we saw over recent months. Trade fears, political instability, and rising interest rates have been risks throughout 2018 and are nothing new to investors. Though the market has dramatically reacted to these events, the result has been largely positive for

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equity valuations. With the S&P 500 currently trading at 14.4x earnings, we are well below the 25-year average of 16.1x. As we look forward to single digit earnings growth for 2019, we expect valuations to continue to improve if prices remain constant.

Tracking historic data shows us that sharp declines can many times be met with sharp snap backs. Looking at 7 negative quarters since 1940 with an average downturn of -20.5%, the average gain one year after has been 23%. This does not necessarily mean that we are due for a significant rally but shows when the market overreacts on the downside there can be positive upside potential.

Looking forward we remain cautious about the rate of tightening by the Federal Reserve as well as the slowdown in global growth. With the exorbitant amount of government and corporate debt resulting from the aftermath of the 2008 recession, the Federal Reserve must be cautious in raising rates too quickly. For borrowers to maintain their debt payments, interest rates must remain at considerable levels. At the same time the Fed must not keep interest rates too low and risk an overheating economy as well as overextended asset prices. Engineering what is known as a soft landing and reducing the massive amount of liquidity injected into the system from quantitative easing is a very delicate process. As the Federal Reserve aims to normalize interest rates and re-establish a healthy risk return relationship, the moves they make over the next year will be heavily weighted by the market.

We recognize there are many risks to investors in this economic environment but remain confident in US equity markets. As we move into a new year, we expect the increase in volatility to remain a characteristic of the stock market. We remain cautious about slowing growth and the impact of the Fed. We believe defensive positioning is warranted this late in the business cycle. We will see if the tone of the Federal Reserve and political risks will continue to disrupt equities as we move into 2019.

By Ed Canty, *Registered Investment Advisor Representative*