

2018 Fourth Quarter Review of the Markets

Index	4th Qtr Return	YTD Return
S&P 500	-13.52%	-4.38%
MSCI ACWI Ex USA IMI	-11.88%	-14.76%
Barclay's Bond Index	1.64%	0.01%

Given the decline in global equity markets during the fourth quarter of 2018, we thought we'd deliver our Review of the Markets a bit early.

Investment Commentary

The fourth quarter of 2018 was negative for global stocks. In the U.S., the S&P 500 sank 13.5% for the quarter, erasing the year's gains. Growth oriented stocks generally fell harder than more value-oriented names; however both were down over 10%. Smaller companies in the U.S. did particularly poorly. The Russell 2000 declined 20.2% and ended the year down 11%.

Non-U.S. stocks also declined with the MSCI ACWI ex USA falling 11.9% to finish the year -14.8%. Emerging market stocks struggled throughout the year but actually outperformed both U.S. stocks and other foreign stocks throughout the fourth quarter as their low valuations provided something of a backstop during a difficult period for global equities.

Bonds did their part to diversify portfolios in the fourth quarter. The Bloomberg Barclays Aggregate was up 1.6% during the quarter as the interest rate on the 10 year Treasury bond fell to 2.69%. Strong returns in the fourth quarter were sufficient to wipe out losses for the year – in fact, the Bloomberg Barclays Aggregate Bond Index was down on a year-to-date basis every day of the year until December 31 when it crossed into positive territory. This happened as The Federal Reserve (“The Fed”) increased its

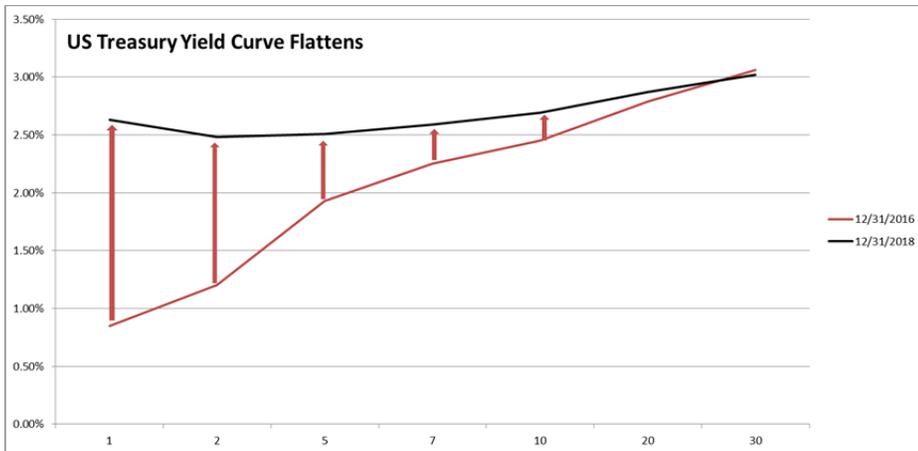
target range for the Federal Funds rate to 2.25%-2.5%. More on the implications of these opposite moves below.

Economic Outlook

The Fed continues to be data dependent as the economic cycle progresses. Low unemployment, increases in household spending, and inflation near target levels were all cited as reasons for their December rate hike. The rate hike was consistent with The Fed's mandate, despite markets being unsettled by the continued tightening of monetary policy. It is worth noting that the bulk of the quarter's declines came before the December rate hike. Perhaps these declines were in anticipation of what the market perceived as a policy misstep, but if that is the case, it appears we have re-entered an era of “good news is bad news”.

The Federal Funds rate is the rate used by banks to lend money to each other overnight, thus the increase in December impacted short term interest rates much more than it impacted long term interest rates. Meanwhile, a “flight to safety” in response to stock market declines bid up the price of intermediate and long term Treasury bonds, pushing their yields down. This results in a smaller difference in yield between short term bonds and long term bonds. This difference, known as the slope of the yield curve, is important to financial markets.

Historically, when that slope turns negative (known as a yield curve inversion), the U.S. enters recession. As of the end of the year, the slope of the yield curve as measured by the difference between the yields of the 10 year Treasury and 2 year Treasury is 0.21%. It is important to note that there is a big difference in the predictive power of a yield curve with a gentle slope versus flat, and bigger still between a flat yield curve and an inverted yield curve. Further, recessions don't tend to follow immediately after a curve inversion. As an example, the yield curve first inverted in 2006 prior to the Global Financial Crisis. The recession and stock market decline didn't begin until more than a year later. We think it is unlikely that the Fed will increase interest rates when doing so would push short term rates above the then-prevailing 10 year Treasury rate. One might reasonably observe that since the 10 year Treasury yield and the 3 month Treasury yield are within 0.24% of each other, The Fed may only be able to hike one more time. It is possible that The Fed is calling attention to the positive economic data with its recent hike and suggesting to markets that longer term interest rates should be pricing in more robust economic growth going forward (i.e. long rates should be higher).



Source: Federal Reserve Bank of St. Louis, 01.04.2019

The dramatic shift in the yield curve over the past 24 months can be observed above (note that the black line represents the current U.S. Treasury Bond Yield curve as of 12/31/2018 and the red line is the U.S. Treasury bond yield

curve as of 12/31/2016). The yield of a 1-year Treasury has moved up in excess of 1.75% since December 31, 2016 while the 10-year Treasury yield has increased by only 0.24% and the 30-year Treasury yield has actually fallen. It is also worth noting that the short end of the yield curve is currently inverted as the yield of a 1-year Treasury bill is currently above the yield of 2-year, 5-year and 7-year Treasury note.

December's rate hike was not the only event of importance for the quarter. Trade protectionism continued, although the U.S. and China entered into a 90-day agreement to try to work things out. It seems unlikely that a conclusive agreement will be reached by the end of this period, but it does signal a willingness on both sides to work towards a solution.

Current economic data does not suggest a recession is imminent, so investors may ask why stocks went through such a significant repricing in the fourth quarter. Towards the end of the third quarter, an increased number of S&P 500 companies issued negative earnings guidance than average over the past several years. In commodity markets, oil's decline of over 40% raised questions as to whether the drop continues to be a result of increased supply, or if a slowdown in economic growth is leading to lower demand. Internationally, a key Brexit vote was postponed. If negotiations are to continue past March 29, 2019 all 29 European Union member nations must agree to the extension. Otherwise, the United Kingdom would leave the European Union with no trade deal in place. These and other considerations increase the range of possible outcomes for global stocks. With greater uncertainty, market participants are less willing to pay above average multiples for stocks, thus the decline.

Investment Strategy

The brief summary of the implications of yield curve shape above is not meant to diminish its importance. It should not be read as "it's different this time". We continue to monitor yields and an inversion of the 10 and 2 year Treasury yields would be one potential catalyst for an allocation change.

We have written recently about small credit spreads in both investment grade and high yield bonds. Recent market volatility did push these spreads wider

(decreasing the value of bonds that have higher levels of credit risk), but at this point we still do not view current valuations as a buying opportunity.

In addition to yields, the employment picture remains a key variable for our assessment of the investment landscape. Like The Fed, we view current conditions as very favorable, but deterioration could also bring about allocation changes.

Within equities, the year-long selloff in emerging markets has created opportunity. The strengthening U.S. dollar certainly played a role in the negative performance. The market has now applied a large and perhaps overdone discount to these companies to reflect this. There is potential for us to increase exposure to emerging market stocks in the near future.

We are aware that volatility in global equity markets has been weighing heavily on investors' minds. The S&P 500 through the course of the quarter flirted with a 20% peak-to-trough decline. As always, we feel it is our responsibility to do everything we can to remind our clients that short term volatility is the price to be paid for the higher long term returns produced by equity markets. While equity market corrections and bear markets are normal, they often create a shaking out period in which investors with weaker resolve typically capitulate and sell at the wrong time. Staying invested during these periods is crucial for long term oriented investors.

We continue to monitor financial conditions and asset prices, and we will make adjustments to client portfolios as we believe they are warranted. Corporate earnings continue to grow and the recent volatility in global equity prices has therefore resulted in significant contraction of valuation multiples (meaning that prices have dropped while the underlying corporate earnings have continued to grow and therefore the multiple paid for those earnings has dropped significantly). For the first time in several years, equity valuations are now at a discount relative to long term average valuations across the board and therefore long term expected returns for global stocks are increasing. This discount ranges from small in U.S. markets to moderate in developed foreign markets to significant in emerging foreign markets.

It is unclear how much longer this economic expansion has to run. We are cognizant of the risks to global markets and are prepared to make changes as opportunities arise. It is important to remember that volatility should be expected by long term investors, and that markets will not only go up forever. Further, volatility is incorporated into the financial plans created for clients. A disciplined approach is crucial for achieving and maintaining financial independence. We wish you and your families a happy and healthy 2019.

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