Post Oak Private Wealth Advisors

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Year-End Market & Economic Commentary

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On behalf of all associates at Post Oak Private Wealth Advisors, I extend our best wishes to you and your loved ones at the start of this new year. We thank you for the opportunity to be a part of your lives and to help you meet your financial needs. This past year has been a turbulent one from a political, economic and market perspective. Every day we strive to strengthen the trust we've built with you, our client, and to serve your interests in everything we do.

One of the biggest questions we hear right now from clients, members of the financial community and the press is, has the economy peaked? By the official definition, it hasn't; the U.S. economy is running at the top end of its average growth range and remains firmly in expansion mode. (A recession would start after two consecutive quarterly declines in Gross Domestic Product growth, and we're nowhere near breaching that threshold as of this writing.)

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It is important, however, to recognize the dichotomy between the economy and the stock market. We've just experienced the worst quarter for U.S. stocks since the global financial crisis. Many investors are wondering if the bull market for U.S. stocks peaked. By the most strict definition of bull and bear markets, we can't say so conclusively. (The bull market would end when the S&P 500 falls 20% from its most recent peak.) Robust growth in corporate earnings throughout 2018 has kept the equity bull running strong on a broad basis, but several individual stock sectors of the market officially crossed into bear market territory during the 4th Quarter.

Why have the markets turned so volatile, so suddenly? Why are investors less optimistic about the future than they were at the start of 2018?

Naturally, there are more drivers than one behind this extreme rise in cautiousness and volatility. The outlook for corporate earnings growth over the next year is strong, but it's looking like earnings won't be as strong as they were in 2018. This is mostly due to fading effects of fiscal stimulus; the tax reform package signed at the end of 2017 gave earnings a lift in 2018 and made the year-over-year growth rate look impressive, but it will be hard for firms to match that annual pace of earnings growth going forward. Additionally, the continuing geopolitical saga over trade negotiations may also have adverse effects on earnings—many Fortune 500 executives sent up warning signals along these lines in recent conference calls with Wall Street analysts.

On top of the uncertainty over the economy and the markets, investors must also contend with challenges facing the market-leading technology sector over data privacy and security, the emergence of rising interest rates and the continuation of tightening monetary policy from the Federal Reserve. Then there's a White House that seems to thrive amidst chaos and confusion while keeping both friends and foes on their heels. Taken all together, we have moderate expectations for 2019—volatility will likely carry over and stock returns may be flat-to-modestly-

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positive in the coming year. There's a low probability of a market correction or crash, but a significant outlier event could alter this outlook suddenly.

Politics: The more things change…

Over the last 12 months, much of the hot air in Washington D.C. was spent on the November midterm elections. As far as the financial markets are concerned, the takeover by Democrats of the U.S. House was mostly a non-event; investors by and large anticipated the outcome correctly, and business as usual resumed in D.C. and across the country. A split and gridlocked Congress may in fact be welcomed by the markets—if House Democrats end up focusing so much time and energy on investigating President Trump that they don't bother to write or pass much legislation. From an investor's perspective, a preoccupied Congress is almost as good as a hands-off Congress.

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But not all is quiet and still in the nation's capital—President Trump is largely driving activity on trade policy, without needing or even asking for Congressional input. Trump's trade actions in 2018—from tariffs on imports from China and Europe, to reopening discussions on NAFTA—made waves throughout the business community. Some firms and producers see benefits to their businesses from the higher tariffs and trade restrictions, but others fear for shrinking margins and constricted supply chains. It hasn't gone unnoticed that terms like "tariffs" and "trade wars" came up more frequently on recent manager earnings calls.

The threats to company margins and supply chains from the ongoing trade negotiations largely remain a mystery to corporate management and investors. News about progress and potential deals generates plenty of headlines and tweets, but businesses and markets are mostly in the dark about the direction these discussions are taking. Part of this comes as a result of Trump's deal-making style—everyone by now is well acquainted with his penchant for bluster and his fondness for "winning". As negotiations with China resume in 2019, markets may wonder what is just bluster and what's the real deal. With Trump, the only certainty is uncertainty. This ambiguity will continue to color how earnings are forecast and reported throughout 2019 and what expectations investors set for stock returns.

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The other issue where President Trump stirred the pot in 2018 is with energy policy. Oil prices in general climbed higher through the first three quarters of 2018, with the per-barrel spot price of West Texas Intermediate (WTI) crude rising above $76 in October. The lift in global oil prices came following the U.S. withdrawal from the Iran nuclear agreement and the re-imposition of financial sanctions on the Islamic republic. Then President Trump weighed in on higher gas prices, which over the summer had climbed above $3.00 per gallon on average across the U.S.

Lowering gas prices would be "a middle-class tax cut", he tweeted. He also strong-armed Saudi Arabia to raise their output, in order to counter the loss of Iranian oil on the market. But with the other hand, he loosened some restrictions on Iranian oil exports, allowing certain countries to continue to purchase oil from Iran and keep the supply flowing. As a result, oil prices tumbled in Q4 with WTI crude falling to as low as $45 per barrel, a total decline of 38% for the three-month period. U.S. gas prices fell to a national average of $2.26 per gallon of regular, according to AAA.

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Lower energy prices can act as a boon to the overall economy, but not to the oil and gas industry. Perhaps Trump doesn't recognize the consequences of his statements and tweets on this important constituency to him and these historically stalwart backers of the GOP. The energy sector has mostly been a fan of Trump's administration, in particular for its deregulation efforts. But there's more to energy price movements than one person (no matter how powerful) can affect; the drop in oil prices has also come as the U.S. boosted its domestic output to become the world's largest producer. Also, global energy consumption appears to be slowing along with economic activity, particularly in China. While the global oil supply remains robust, global demand is starting to fall, setting the stage for lower energy prices. As a firm, we view this as an opportunity, providing we don't see a massive slowdown in China's economy in 2019.

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Economy: Contents are fragile

As mentioned earlier in this letter, top-line statistics show the U.S. economy appears to be in excellent shape: the GDP growth rate for Q3 rose at 3.5% year-over-year pace; unemployment is at its lowest rate in nearly 50 years (November's rate was 3.7%); and the annual inflation rate has hovered in a comfortable range of 2.1-2.3% for nearly all of 2018. Now that wages are starting to edge higher, consumers are shopping more and spending again. The data are very clear—there's lot to like in the U.S. economy, even as the stock market makes investors nervous.

Most concerns about the U.S. economy focus on how much longer can these good times last. There are several indications that economic activity may be peaking as 2019 begins or already peaked back in 2018. For instance, forecasts for Q4 GDP growth are much cooler than the torrid pace of growth we saw in Q2 and Q3 of last year. Moreover, unemployment may be at generational lows, but the pace of monthly job growth seems to be slowing down; private sector companies added just 155,000 jobs in November, well off the consensus estimate of 198,000 jobs for the month.

When doubts creep in about the economic outlook, all eyes tend to turn toward the Federal Reserve. There are some investors and market analysts who think the Fed has been too aggressive in hiking rates. Others see a Federal Open Market Committee that has been slower than previous boards in pacing rate increases during the current cycle. Keep in mind the Fed funds target rate is still low relative to other periods of economic expansion.

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Those fearing a more hawkish Fed have good reason for concern—11 of the last 14 U.S. recessions were preceded by aggressive Federal Reserve moves to tighten monetary policy. But have we seen the peak of this cycle of rate hikes? The most recent indications from Fed are for two rate hikes in 2019, but the Fed's tone certainly indicated this projection is a moving target based upon always-evolving economic data. Investors may see or fear something that the Fed doesn't at this point—a fragile economy on the verge of a slowdown, needing more monetary stimulus and less tightening from the central bank.

Market nervousness about the economic outlook is showing up on the yield curve, which represents interest rates for U.S. Treasury securities across the range of maturities from short-term (30 days being the shortest) to long-term (30 years is the longest). Under normal market conditions, the yield curve slopes upward from short-term to long-term rates as investors demand higher yields for taking on the risk of owning longer-term bonds.

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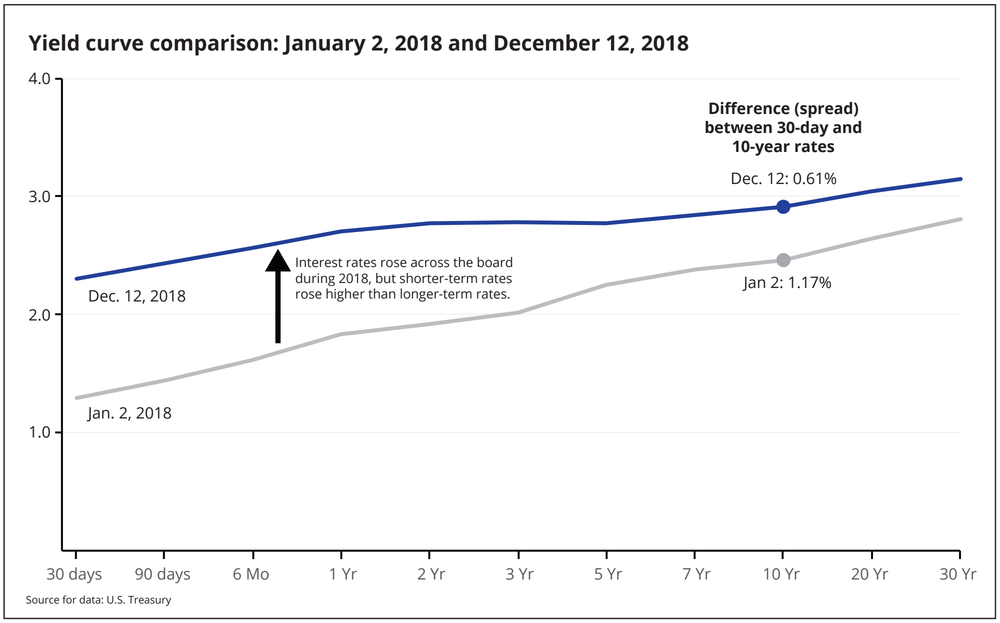
The yield curve received a lot of press in 2018 because the curve has flattened—shorter-term interest rates are closer to longer-term rates, at least for some maturities. That means investors are not as willing as they had been to assume the risk of longer-maturing securities. In 2018, interest rates rose across all maturities but increase in shorter-term rates was greater than the increase in longer-term rates, which caused the yield curve to flatten.



The importance of the yield curve comes when it inverts—meaning, the curve slopes down when short-term rates are higher than long-term rates. In most occurrences over the last 70 years, a yield curve inversion has precipitated an economic recession. As of this writing, the curve has not inverted, but it is as flat as it's been in the last 12 months. If or when it does invert, that doesn't mean the recession has begun; there can be a lag time as much as one year between a yield curve inversion and the start of the recession. Also, an inverted yield curve doesn't cause a recession; you should regard it as a signal that all is not well in the economy. If investors don't have the stomach for taking greater risk in exchange for greater return, it means they're not optimistic about the future prospects for the economy at large.

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Financial markets: Volatility strikes back

All of these worries about the health of the economy, the strength of future earnings and heightened political risk sent tremors through U.S. financial markets in 2018. The volatility that was largely absent for so many years reappeared with a vengeance—bond markets shuddered as rising rates caught investors in longer-dated bonds off-guard, and stock markets wobbled as nervous investors began considering the end of the longest bull market in U.S. history.

Let's look at bond markets first. Many income investors are aware (perhaps painfully so) that interest rates have been on a long, strong downward trend over the last three decades. Rates hit bottom as the world economy emerged from the global financial crisis, but prolonged central bank intervention had kept interest rates in a historically low range for much of the past 10 years.

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These low rates fueled a corporate borrowing binge—corporate debt nearly doubled over a 10-year period from $4.9 trillion in 2007 to $9.1trillion in 2018. Lower borrowing costs for companies was good for business, helping to propel growth and fund stock buybacks, which in turn made equity shareholders happy.

Now that the era of historically low interest rates appears to be over, corporate bond investors are finding good reasons to be anxious. First, many outstanding corporate bonds are due to reach maturity in the next few years, and borrowers who roll over this debt into new bond issues will be doing do so at higher rates. Second, firms aren't holding as much cash on their balance sheets as they once were—the cash-to-debt ratio was at its lowest-ever level in 2018. That may make it difficult for some companies to continue to service existing debt obligations. This is a major concern in the investment-grade bond market; most outstanding debt in this space is rated at the lowest-level of investment grade, or in other words just above junk. If any big borrowers slip below investment grade, it could spell trouble for a large segment of the bond market. General Electric bonds are a good case in point—they were downgraded in Q4 to the lowest tranche in investment grade, and many bondholders worry about the likelihood of a further downgrade to junk status. Not many years ago, GE was a blue-chip company and looked to by the business world as a paragon of exceptional management. It's a good reminder that it doesn't take much time for the mighty to be laid low.

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But for all these concerns, there are also reasons why these worries about the bond market may be overdone. First is the strong economy—GDP growth may cool in the coming year but it is still expected to grow, which is a positive sign. Continuing growth would be good news for businesses. Second, borrowers aren't defaulting on their current debt loads; default rates are relatively low at present. If business activity continues to hum along, even at a moderate pace, many firms should still be able to service their existing debt. Third, companies aren't issuing new bonds at the pace they were when interest rates were lower; that will keep their overall levels of debt in check. Finally, there's still a lot of demand in the marketplace for income-generating investments, particularly from pension funds, insurers and any investors looking to build steady cash flow to fund retirement spending.

There are also reasons why worries about the bond market may be overdone.

What about stocks? The S&P 500 finished 2018 in the red with a total return of -4.3%, but most of this slide happened at the end of the year. The U.S. equity market went through short squalls of volatility in the early months of 2018, but this turbulence was driven more by investor fear and emotion rather than anything concrete. Then, Q4 arrived—the 13% drop in the S&P 500 was its worst quarterly performance since the global financial crisis. Stocks fell broadly in the final three months of the year, led by energy, technology and consumer discretionary shares. Only the defensive utilities sector provided any gains for the quarter.

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The turbulence that hit stocks late in the year shouldn't be all that surprising, given we're at the end of the "easy money" days and loose Federal Reserve monetary policy. The stock market is acting almost like a spoiled adult child upon learning his parents have just cut off the financial support that funded his opulent lifestyle over the last 10 years. For investors who have stayed and participated in the market over the long upward climb, a little pain right now shouldn't be that painful. One quarter

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of poor performance is not enough to establish a trend, much less any projection on where the stock market will go in the year ahead. The six-month period from November to April has historically been strong for stock returns, so it would not be surprising to see the market climb higher at the start of 2019. But we are seeing a lot of worry and fear creep into the market—and there's plenty of reasons behind that worry and fear, perhaps more than there was 12 months ago.

2019 outlook: A climate of concern

We believe stocks will continue to struggle in 2019 as long as this climate of concern persists. Prevailing strength in the U.S. economy and corporate earnings growth should offer some support to the stock market, but increasing worries about a global slowdown now loom large. These worries will likely impact the markets as investors digest what a global slowdown could mean for the U.S. economy. The extreme volatility we saw in Q4 is likely to continue, given the heightened political and global economic uncertainty.

This outlook is why we're firmly on the cautious and defensive side as we head into 2019, with modest expectations for returns in the coming year. In our hedged models, equity exposure is substantially hedged to help our clients manage the heightened risks, as we seek protection of your wealth and opportunities for growth wherever they may appear.