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4th Quarter 2018 – Investment Commentary

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Market and Portfolio Performance:

Summary:

- **Domestic equities pushed through headwinds with relatively low damage.** Markets weathered a "tech wreck" early in the year, four rate hikes, a complex new tax law, trade tariffs, the end of NAFTA and beginning of USMCA, and a government shutdown to name a few! With all of that, the S&P500 is down just -4.4% for the year. International stocks struggled to recover from losses earlier in 2018 and finished more deeply negative.
- **Strong economic backdrop.** U.S. GDP is on track to grow this year at the fastest pace in 13 years, after 3.5% for Q3 and 4.2% in Q2. Strong data propped up markets, with falling unemployment claims, and strong December jobs reports. A strong employment environment supports consumer spending – a huge part of the economy.
- **Fewer rate hikes in 2019?** Although GDP growth is strong, the Fed indicated that the pace of future rate hikes could slow and would continue to be data dependent. This will include consideration of potential risks from trade and tariff issues with China.
- **Volatility returns to more normal levels**. After years of low volatility, in 2018 equities rose and fell depending on investor sentiment about trade tensions, rising interest rates, and the economy.

U.S. Equities:

- **Volatility is often unpleasant, but we were prepared for it.** In our commentary last year, we wrote, **"***2017 was a highly unusual year, with extremely low volatility overall and all asset classes moving together. Remember that volatility is normal and expected for equities. Price-to-earnings, price-to-book value, and consumer sentiment remain very strong for markets. However, do not be surprised if market herd mentality results in larger swings than normal, even for events that have no impact on fundamentals."* This is exactly what we saw in 2018!
    - 2018 brought us many days with swings of several hundred points on the Dow Jones Industrial Average, including three days with over 1000-point moves (1 positive, 2 negative) and 3 separate market corrections.
    - In the final quarter of the year, markets gave us an incredibly mixed bag. We had a terrible October, positive November for almost every single asset class (post-election relief – markets hate uncertainty leading up to an election), and a dreadful December, which stamped its effect on the year-to-date numbers. December started off strong, and it seemed like the attempts at resolution of the tariff disagreements between the U.S. and China were making headway. Then things turned on renewed fears of a potential trade war and possible economic slowdown.
    - However, the Q4 downturn was not in response to changes in fundamentals. Nothing significant changed in the economy or in companies' ability to increase earnings. There was emotion-based selling, and computer-based algorithmic trades amplified the effect of the selling.
- **Returns always represent a "point in time."** Any short-term period, like a single year, can provide sharply negative or positive returns, which can provide a very different picture depending on the timeframe you

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choose. In fact through the end of November, U.S. markets were positive YTD! A longer-term view (measured in multiple years or decades, which is your investment time horizon) is far more impactful to your financial success.

- **A perfect example of market timing's folly.** The market posted its worst Christmas Eve decline in history and then posted the best post-Christmas Day rally in history, when the DJIA rose 1,086 points in a single trading day – a 5% gain in just 1 day! Buying and selling based on short term movements only increases the likelihood of locking in losses and missing the "right" opportunity to buy back in. Long term investors avoid this stress, cost, and increased tax burden—while benefiting from long term compounding.

International Equities:

- **International markets struggled to recover from weakness earlier in the year**, and delivered deep negative returns for the year-to-date, especially compared to U.S. markets. Emerging markets were the laggard. Emerging markets are your highest risk asset class so they nearly always 'lead or lag' in the short term. Sanctions on Venezuela, Turkey and Russia in addition to tariff tit-for-tat with China added to volatility in the class.
- **Strong USD pros and cons.** The U.S. dollar surged as investors fear the European economy could stall during the Brexit fallout. A rising dollar is a sign of a strong economy – but can hurt U.S. companies with business overseas.
- **Eurozone monetary policy beginning to normalize?** The ECB announced the end of crisis-era stimulus, and held interest rates steady. This brings to an end the multi-trillion dollar bond buying program which had been in place to stimulate the economy in the aftermath of the financial crisis, and which likely helped avoid a double-dip recession for the area. We believe this displays some confidence of financial strength for the region, despite worries about slowing growth.

Bonds:

- **Despite 4 rate hikes in a single year, bonds slightly positive almost across the board!**
    - Yields bounced around during the year, allowing for price increases for income investors with well-diversified portfolios.
    - We are happy to see your income instruments adjusting to the higher rate environment. Funds are still adapting to show the value of holding higher yielding instruments.
    - The structure of your bond and income portfolio helped navigate this rising interest rate environment on a relatively smooth path. Institutional share class, low-cost mutual funds provide us with baskets of underlying bonds. These are constantly reshuffling and adapting in an effort to take advantage of rising rates and include higher-yielding bonds in the portfolio.
- **The Fed's comments that they may be close to 'neutral' helped bond markets.** In fact, only longer-term corporate bonds, higher-yielding corporate bonds, and bonds from emerging market countries experienced negative returns of note. Emerging market bonds followed the trend of declining stock markets in those regions, and a stronger dollar relative to those countries' currencies.
- **High Yield*:*** The managers of the funds in your portfolio are keeping a diligent eye on credit qualities. As interest rates raise, it can cause pressure for less financially sound corporations with large debt sheets.

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- **Municipal Bonds** experienced significant inflows and outflows, especially near year-end, as savvy investors took advantage of tax-loss trading (realizing losses for tax purposes, while continuing to collect tax-free income by completing swaps within asset classes).

- **A rising rate environment makes debt more expensive for borrowers and more profitable for lenders (and bondholders like you!)** In Q1 of 2018, U.S. companies held more debt than ever before. For around 10 years, that debt has been essentially free (during a zero and incredibly low rate environment).

Expectations and Perceptions for the Future:

Equities:

- **Economic expansion likely to continue, simply more slowly than before.** It would be difficult to have a recession in this environment: the labor market is strong, wages are increasing, and businesses continue to invest heavily in growth. Being 'late in the cycle' of an economic expansion does not mean a bear market will immediately follow. Global growth may slow as economies stop stimulus programs (in Europe), or begin tightening (as in the U.S.).
- **Opportunities in equities.** After the recent pullback, equity markets actually look cheap (despite the extended bull market leading up to 2018). Financials and value companies may benefit from higher rates, especially compared to their growth counterparts.
- **Emerging markets will continue to provide larger-than-life gains and losses depending on when you start and stop the clock.** Over the longer-term, we are very confident in the small role emerging markets play in your portfolio. Many of these countries have large populations living in poverty, working and aspiring to the middle class – should help spur growth. It's important to take a balanced approach and maintain risk exposure to the U.S. and around the world.
- **Markets will benefit from clarity on tariffs and China.** Equity markets hate uncertainty. Regardless of how the final details of the tariff situation play out, any resolution or agreement will likely be cheered by markets.

Bonds:

- **Everything will be data dependent on the strength of the economy!** Fed President said the Central Bank is open to re-thinking rate hikes for next year, depending on economic data. The inflation rate for 2019 is now expected to remain below the 2% target, further reducing the need for immediate rate hikes.
- **Yield curve likely to stay flat for some time.** It is uncertain whether an inversion will take place, or what the impact would be if so. Currently, the predictions are for perhaps 1-2 more rate hikes in 2019, potentially pausing completely in 2020 – with a target of around 3.25% - 4.3% on the Federal Funds rate.

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