Capital Market Summary

After stocks posted a solid third quarter, markets pulled back during the fourth quarter. Volatility, as evidenced by the VIX® Index, spiked from 13.93 at the start of the quarter, hit a high of 36.07 on December 24, and then fell to 24.18 at the conclusion of the year. Over the same timeframe, the S&P 500 Index® declined from 2,913.98 at the beginning of the quarter to end at 2,506.85 at year-end[1,2].

Within domestic equity markets, dispersion between top and bottom performing sectors began to show itself in the third quarter. However, it continued to increase during the fourth quarter as the disparity between the top and bottom sectors in the market reached just over 25%. The top performing sector was Utilities which notched a small gain of 1.36%. Not too far behind were Real Estate and Consumer Staples which lost 3.83% and 5.21%, respectively. The weakest sectors were Energy, Information Technology, Industrials, and Consumer Discretionary which each lost between 16.42% and 23.78% in the fourth quarter.

During the quarter, the widely followed S&P 500 Index® lost 13.52%. Mid-size firms, represented by the S&P 400 Mid Cap Index®, declined 17.28%, and smaller firms, represented by the S&P 600 Small Cap Index®, dropped by 20.20%[1]. This performance was in spite of strong earnings growth, estimated to be around 20.20% year-over-year . Expectations for 2019 earnings have been mildly cut from formerly optimistic projections of 11.2% down to 7.4%[3]. An earnings growth of 7.4% is still a respectable figure for this volatile statistic. Since 2009, earnings growth has been as low as -15.82% (2015) and as high as 20.20% (2018)[4].

Within international markets, the MSCI EAFE Index® (developed international equity) declined 12.54% during the fourth quarter of 2018 after being down by 1.43% going into the quarter. In spite of increasing trade tensions, the MSCI EM Index® (emerging market equity) only fell 7.47% after already being down by approximately the same figure in 2018 as the quarter began. It should also be noted that after falling by 9.9% in 2017, the U.S. dollar rebounded 4.04% in 2018[1]. This increase in the dollar has placed pressure on foreign markets as their returns are then translated back into dollars for American investors. When the dollar rises, this translation results in lower prices of foreign equity. As one would expect, because the dollar's moves were more muted in the fourth quarter than during the prior three, international and emerging market equity outperformed domestic equity for the quarter.

While commodities often perform inversely to the dollar, growth concerns ruled the day when it came to commodity prices during the fourth quarter of 2018. The Bloomberg Commodity Index®, a broad basket of commodities, lost 9.41% during the quarter to finish down 11.25% for the year. Economically sensitive commodities, such as timber and copper, declined by 21.99% and 6.20%, respectively. The agricultural subgroup of commodities gained 0.15% but is still lower by 10.97.% on the year. Finally, precious metals were the standouts among the commodity-linked assets. Gold gained 7.84% during the quarter to finish the year with a negative 1.54% return while silver was up 7.97% to conclude the year at negative 8.76%.

On the trade front, the U.S. is currently in negotiations with China. News outlets are reporting that cabinet-level meetings could come next. If this is true, this could be a positive for markets in general, and specifically emerging market equity. Emerging markets trade at a large valuation discount to U.S. markets (10.4 vs. 14.6 forward price-to-earnings ratio)[5]. Positive news on trade could enable emerging market equity to trade more closely to the valuations of developed markets. Furthermore, with the USMCA (trade deal between the U.S., Canada and Mexico) potentially being ratified in 2019 to go along with deals signed with Japan and South Korea, it appears that trade news has the potential to be more positive going forward than it has been over the past two years.

Finally, looking at fixed income, the Barclays' Aggregate Bond Index® rose 1.64% for the quarter to eke out a positive return of 0.01% for the whole of 2018. The Barclays' Municipal Bond Index®

1 Morningstar.com, 1/8/2019
2 Bloomberg, 1/8/2019
3 Factset, Earnings Insight, 1/4/2019
4 Multpl.com/s-p-500-earnings-growth/table/by-year 1/8/19
5 Yardeni Research, Inc. Global Index Briefing: MSCI Forward P/Es (January 3, 2019)

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gained 1.69% in the fourth quarter to finish the year up 1.28%. Inflation-protected securities (TIPS) lost 0.42% on the quarter as inflation expectations fell along with sentiment during the equity market decline. The Barclays Global Aggregate Bond Index® was up 1.20% for the quarter but down by exactly the same amount on the year as global interest rates are higher than at the end of 2017. Lastly, high yield corporate bonds fell by 4.53% during the fourth quarter to finish the year at-2.08%[1]. Falling interest rates, which materialized as equity markets declined, returned investment grade fixed income to a positive return for 2018 and also helped high yield bonds avert a larger decline in value.

Capital Market Outlook

The market decline that took place in the fourth quarter of 2018 turned a year that was slightly positive for U.S. equities into a year of "lost returns." This phrase was previously used to describe 2015, where most asset classes were slightly down. However, 2018 actually had fewer winners. In 2015, REITs, large cap equity and investment grade bonds posted small gains between 0.5% and 2.8%. In 2018, the only positive returns were in cash (1.8%) and investment grade bonds (0.01%)[6] .

While the market has notably sold off, economic fundamentals remain attractive. Perhaps, even more so than previously. With forward valuations at lower levels than we have seen in some time and below historical averages, equities may have the ability to produce gains without significant earnings growth. The S&P 500 would have to advance 10% just to get to the historical average of the forward price-to-earnings (P/E) multiple of 16[3]. Or, to look at it a different way, earnings could fall 10% and the market would still be at historically average valuations.

As companies prepare to report their fourth quarter earnings, Energy, Industrials and Financials are expected to report the largest earnings growth with estimates of 74.6%, 14.5%, and 13.6% respectively. Of particular note, Industrials would be estimated at greater than 17% if it were not for negative revisions to General Electric's estimates[3]. Revenue growth is also expected to be reasonably robust at 6.1% compered to 9.0%, 7.0%, and 2.1% over the previous three years[3,4].

International equity continues to look attractive when compared to domestic markets. With P/E ratios in the Eurozone, UK and Japan at 11.3, 11.2, and 10.7 respectively, and Emerging Markets at 10.2, it will not take much for these markets to outperform domestic counterparts[5]. We expect this theme to play out for some time into the future as it generally takes a good deal of time for valuation-based theses to come to fruition. However, because we do not know what the timeframe will be, we remain far more domestically focused than global market cap (valuation of all companies in the world) would imply.

Smaller capitalization equity still appears attractive. This is for two primary reasons. First, as mentioned earlier, large cap fell less than its smaller compatriots during the recent selloff. Second, since the prior market peak, small cap blend has returned nearly 20% less than large cap blend[6]. This is relevant because, over long time periods, stocks with smaller capitalizations generally outperform ones with larger capitalizations[7].

Vicus Capital expects that fixed income will provide increased performance in 2019 relative to 2018. The drivers of this thesis are the fact that rates are currently higher than going into 2018 (offering a greater return via coupon or market discount) and due to expectations of fewer rate hikes from the Federal Reserve's Federal Open Market Committee (FOMC). Just six months ago, the market expected three or even four rate hikes in 2019. Currently, the expectation is for one, or potentially zero, for the entire year. Specifically, the market expectation is that at the FOMC's next meeting, in March, there is a 10.8% chance of a rate hike. In June, this probability goes up to 27.5% and remains the same likelihood at the following meeting in September. More interesting is that in December, the expectation for rates to be higher than today is only 24.3%[8]. Therefore, should rates be raised in the interim, this is essentially a market prediction that they will cut rates before the year is over.

To conclude, the fourth quarter was a tough one for equity market investors. However, there are some positives that have come out of the market volatility. The largest is that valuations have been reset to levels not seen in a few years. While forward P/E ratios have been sitting in the low 20's since 2016, now being under 15 makes them quite

6 JPMorgan. Guide to the Markets®. (December 31, 2018)

7 Fama, E.F., French, K.R. The Cross-Section of Expected Stock Returns. The Journal of Finance. 47 (2):427-465

8 CME Group, FedWatch Tool 1/8/19

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attractive. Also, because bond yields are slightly higher, there is more safety in them as a potential fall in price is now offset by a higher yield. Next, GDP growth is still on solid footing as the Atlanta Federal Reserve's GDPNow and "Blue Chip Consensus" forecast 2.8% and 2.6% respectively. While not as robust as the second quarter's 4.2% or even the third quarter's 3.5%, it is significantly higher than many analysts estimated earlier last year when they expected it to fall under 2%[9]. As 2019 progresses, we will be monitoring portfolios with an eye toward taking advantage of market dislocations caused by volatility, and opportunities that arise due to global governments' policymaking. Diversification aided equity-heavy portfolios greatly during the recent period of market volatility as investment grade fixed income rallied and foreign stocks fell markedly less than domestic ones, and we expect that it will continue to provide benefits moving forward.

9 Atlanta Federal Reserve, GDPNow, 1/8/19

Economic Perspectives

Economic Growth & Profits

- Real gross domestic product (GDP) for the third quarter of 2018, according to the third estimate from the Bureau of Economic Analysis (BEA), came in at 3.4%, which is a slight decline from the second revision and the "advance estimate" of 3.5%[1].
- The BEA also noted that, "Personal consumption expenditures and exports were revised down, and private inventory investment was revised up; the general picture of economic growth remains the same[1]."

1 U.S. Department of Commerce: Bureau of Economic Analysis - Gross Domestic Product: Fourth Quarter 2018 (Third Estimate) (December 21, 2018)

Interest Rates

- During its December meeting, the Federal Open Market Committee (FOMC) decided to raise the target range for the federal funds rate from 2.0%- 2.25% to 2.25%- 2.5%[2].
- The FOMC also changed their "dot plot," a graphical view of the FOMC's estimates of future changes to the federal funds rate. The median view is now for two rate hikes in 2019. This view had been as high as four hikes in 2019 as recently as September. The FOMC's prediction of the "longer-term" federal funds rate remains unchanged at 3.0%[3].

Employment

- Total non-farm payroll employment increased by 312,000 in December. In spite of an unexpectedly large gain in employment, the unemployment rate actually rose to 3.9% from 3.7% previously. This change was caused by an increase in the labor force participation rate which hit 63.1% after starting the year at 62.7%[4].
- October and November's non-farm payroll numbers were both adjusted up by 37,000 and 21,000 respectively[4].
- In December, the average hourly earnings rose eleven cents to $27.48, a continuation of the eight cents increase in September. Over the year, average hourly earnings increased by 84 cents, or 3.2%. The average workweek remained unchanged at 34.5 hours[1].
- The broader U-6 measurement of unemployment rose to 7.6% on a seasonally-adjusted basis, from 7.5% in September 2018 but down from 8.0% in December 2017[5].

2 U.S. Federal Reserve - Federal Reserve Issues FOMC Statement (December 19, 2018)
3 Bloomberg.com The Fed's New Dot Plot. Christopher Condon. (January 8, 2019)
4 U.S.Department of Labor: Bureau of Labor Statistics - The Employment Situation, Dec. 2018 (Jan. 4, 2019)

Inflation

- According to the Bureau of Labor Statistics, the Consumer Price Index for All Urban Consumers (CPI-U) held steady in November after an increase of 0.3% in October[5].
- The CPI-U increased by 2.2% over the last 12 months before seasonal adjustment[5].
- The Core-CPI, a popular indicator that looks at all items less food and energy, rose 0.1% in August and 2.2% over the last 12 months[5].

Risks

- Trade tensions remain as one of the largest concerns of financial markets. While concerns regarding Europe, South Korea, Mexico and Canada continue to be on the decline, Chinese relations continue to be tenuous. On the positive side, because an agreement was reached at the end of 2018 to delay tariff increases (from the U.S. on Chinese goods), we may be closer to the end than the beginning of this "trade fight."

5 U.S. Department of Labor: Bureau of Labor Statistics - Consumer Price Index, November 2018 (December 12, 2018)

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However, many questions still need to be answered regarding intellectual property, openness of the Chinese economy, and a large trade imbalance in goods without an offsetting imbalance in services.

- As the United States considers pulling out of Syria, influence in the region could wane to the benefit of adversaries including Syria, Iran and Russia. Since this was just announced, and has not been implemented, we will be actively monitoring the events.
- Global interest rate uncertainty remains. While it had been clear what direction the U.S. FOMC was moving in their interest rate hiking, the market's volatility during the fourth quarter of 2018 appears to be giving them pause. Nevertheless, balance sheet reduction (the Federal Reserve allowing maturing securities that it holds to be redeemed and not reinvested) continues to occur. This will drain liquidity from the bond market. Still, this is a slow process, and given that countries like Japan continue to stimulate their economy, it may or may not be felt by financial markets.
- The reduction in valuation of equities in 2018 actually de-risks the market to some degree. Because stocks are now trading at lower valuations, they have theoretically more room to grow and less to fall. In fact, forward-looking valuations of the S&P 500 are now around 14.5 times earnings, less than the historical average of just under 16[6].

6 Yardeni Research, Inc. Stock Market Briefing: Valuation Models. (January 7, 2019)

Index Returns Table

Index	Total Return (%) 3 Mo (Mo-End) USD	Total Return (%) 1 Yr (Mo-End) USD	Total Return (%) Annualized 3 Yr (Mo-End) USD	Total Return (%) Annualized 5 Yr (Mo-End) USD
DJ Industrial Average TR USD	(11.31)	(3.48)	12.94	9.70
S&P 500 TR USD	(13.52)	(4.38)	9.26	8.49
S&P 400 Mid Cap TR USD	(17.28)	(11.08)	7.66	6.03
S&P 600 Small Cap TR USD	(20.10)	(8.48)	9.46	6.34
MSCI KLD 400 Social GR USD	(12.46)	(3.50)	9.19	8.17
MSCI EAFE NR USD	(12.54)	(13.79)	2.87	0.53
MSCI EM NR USD	(7.47)	(14.58)	9.25	1.65
Barclays U.S. Agg Bond TR USD	1.64	0.01	2.06	2.52
Barclays Global Agg Bond TR USD	1.20	(1.20)	2.70	1.08
S&P GSCI Spot	(23.02)	(15.39)	6.30	(9.95)
S&P Target Risk Cons. TR USD	(3.17)	(2.73)	3.95	2.93
S&P Target Risk Mod. TR USD	(4.63)	(3.72)	4.41	3.31
S&P Target Risk Aggr. TR USD	(10.25)	(7.65)	6.10	4.69

Source: Morningstar® as of December 31, 2018

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI U.S. Broad Market Index is comprised of nearly 100% of the total market capitalization of U.S. stocks traded on the NYSE and the NASDAQ. The S&P 500 Index is a market capitalization free-float adjusted index of the prices of 500 large capitalization common stocks traded in the United States. The S&P 400 Mid Cap Index serves as a barometer for the U.S. mid-cap equities sector and includes stocks with total market capitalization that ranges from roughly $750 million to $3 billion. The S&P 600 Small Cap Index covers a broad range of U.S. small cap stocks and is weighted according to market capitalization covering about 3-4% of the total market for U.S. equities. The MSCI KLD 400 Social Index is a free float-adjusted market capitalization index designed to target U.S. companies that have positive environmental, social, and governance (ESG) characteristics. The MSCI EAFE Index is a market capitalization weighted index and is designed to measure the equity market performance of developed markets (Europe, Australasia, and Far East) excluding the U.S. and Canada. The MSCI EM NR USD Index is a free-float adjusted market capitalization index that is designed to measure the equity market performance in the global emerging markets. The Barclays Aggregate Bond Index is a market-capitalization weighted index that is considered to be representative of U.S. traded investment grade bonds. The Barclays Global Aggregate Bond Index includes government securities, mortgage-backed securities, asset-based securities and corporate securities to simulate the universe of bonds in the market. The S&P GSCI Spot is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures. The S&P Target Risk series of indices comprise multi asset class indices that correspond to a particular risk tolerance with varying levels of exposure to equities and fixed income intended to represent stock and bond allocations across a risk spectrum. The market indices referenced are unmanaged. You cannot invest directly in an index.

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