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Recap of Q4 2018 Markets and Economy

After a long period of respectable returns, most investors in balanced portfolios during the fourth quarter of 2018 experienced significant losses. The fourth quarter was filled with a great deal of uncertainty, which is the equity market's least favorite scenario. The U.S. Federal Reserve raising rates and a trade war with China caused major concerns. As a result, U.S. equity markets posted their worst numbers since the financial crisis of 2008. Even though November saw equity markets calm down, much of the quarter's losses occurred during a disappointing December. In that month, all major U.S. indexes dropped at least 8.7%. The S&P 500 and the Russell 2000 also recorded their biggest monthly loss since February 2009.

For the quarter, the S&P 500 and Russell 2000 dropped 14% and 20.2% respectively, their worst quarterly performance since the fourth quarter of 2008. As severe as they were, the final numbers do not fully explain how drastic and volatile the decline was for investors in December. Based on the lowest level of the S&P 500 on December 24, the index was down over 20% from its record high on an intraday basis. The stock market then came rising back in the next session by nearly 5% with the DOW posting its largest daily point gain in history of 1086.25 points.

We believe that these declines were primarily driven by concerns of a global economic slowdown and fears that the Federal Reserve made a monetary policy mistake by hiking rates on December 18. Trade negotiations with China also contributed to volatility earlier in the quarter. However, the interim truce on new tariffs that was reached between President Trump and President Xi at the G20 Summit in Buenos Aries was not enough to quell investor concerns.

	Month	**Quarter**
S&P 500	***-9.2%***	***-14.0%***
DOW	***-8.7%***	***-11.8%***
Russell 2000	***-11.9%***	***-20.2%***
Nasdaq	***-9.5%***	***-17.5%***
MSCI EAFE	***-4.9%***	***-12.6%***
MSCI Emerging Markets	***-2.7%***	***-7.6%***
(Source: Morningstar Research 12/31/2018)		

Federal Reserve Induced Volatility

In our opinion, the actions of U.S. Federal Reserve Chair, Jerome Powell, caused much of the December equity market calamity by hiking rates for the fourth time this year. Although the Fed Funds Rate was elevated to a range of just 2.25% - 2.50%, it was the Fed's stance on continuing to unwind its balance sheet of treasuries and mortgage-backed securities that spooked investors. The timing and lack of regard to weaker global financial conditions had markets convinced that the Federal Reserve may have made a policy error by hiking rates too much for capital markets to absorb. Just as the markets were finally starting to look past trade concerns and other geopolitical risks, the hike and concurrent hawkish tone of the Fed Chair had many questioning whether

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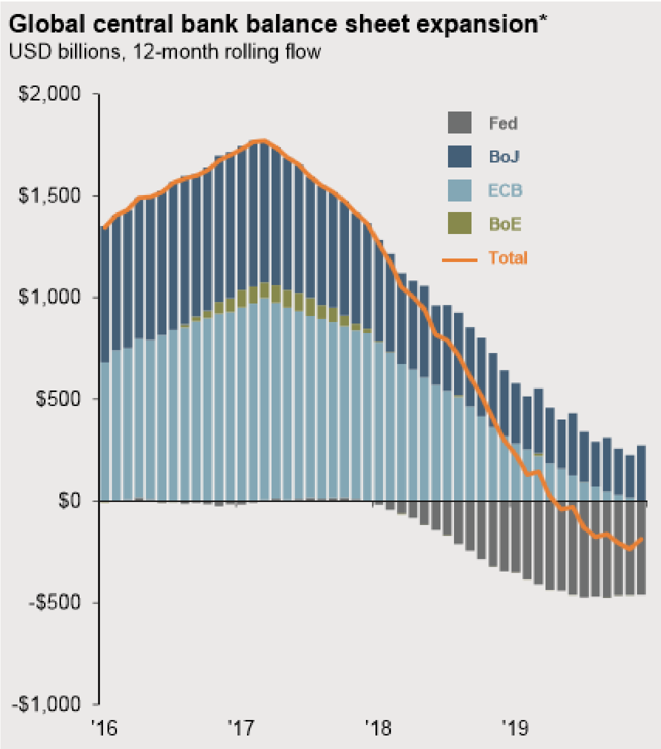

the Fed was deviating from a previous policy of a gradual and data dependent rate path. The fact that the Fed took this stance in the wake of the European Central Bank's and Bank of Japan's decisions to leave rates unchanged until the end of 2019 reignited fears that the disparity in rate policies would lead to tighter credit conditions and an even stronger U.S. dollar. Both of which could put more stress on the global economy and increase the probability of a recession either here or abroad.

Mr. Powell managed to salvage market confidence by walking back his previous comments on the Fed's balance sheet in late December and into early January, returning to the "data dependent" narrative of his predecessor, Janet Yellen. So far this has helped bolster equity markets for the current quarter.

If you recall, the Fed embarked upon "Quantitative Easing" (or QE for short) at the start of the current economic cycle as a supplement to its zero-interest rate policy in 2008. QE was accomplished by the Fed purchasing treasury and mortgage-backed securities to help stabilize the financial system and add liquidity to markets. During all phases of QE, the Fed increased its balance sheet to over $4 trillion. The purchase of these securities was the equivalent of the Fed dropping rates by an additional 3%, effectively making the interest rate environment in the U.S. negative. Therefore, the inverse of this action is in essence a rate hike. The Fed started reducing its exposure to these bonds in 2018 by $500 billion which equated to two 0.25% hikes. So altogether, the U.S. economy endured not four but six rate hikes in 2018. With the Fed originally targeting a balance sheet reduction of an additional $800 billion (or an equivalent 3 additional rate hikes) for 2019, we are paying close attention to see if their future monthly balance sheet reductions are in line with their revised tone.

U.S. Economy

Broad economic conditions did weaken modestly for the quarter. The continued trends of low unemployment increased personal spending and consumer credit were not enough to counter the concerns over softening housing prices, mixed industrial metrics and diminished economic surveys. Of the six main segments of the Bloomberg Economic Surprise Index, the labor market and household segments posted gains while the industrial, retail, housing and business survey segments declined. It is interesting to note that although this economic barometer declined to a reading of -12 alongside the December equity market rout, it reached similar levels in 2017 (-10) and substantially lower levels in 2015 (-40) and 2016 (-20). The U.S. expansion remains on track for a moderate deceleration in fourth quarter GDP growth with the Atlanta Fed forecasting a GDPNow reading of 2.8%,

Mid- to Late-Cycle Phase Transition

Indicator	Typical Late-Cycle Trends	Current Dynamics	
		Mid-Cycle	Late-Cycle
Corporate Profits*	Margins decline	●	●
Inventories	Rise relative to orders	●	
Employment	Tight conditions		●
Wage Growth	Accelerates		●
Monetary Policy	Fed tightens, yield curve flattens		●
Credit	Lending standards tighten	●	

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down from the third quarter's 3.4% rise. Although investor confidence was challenged by the decline in financial conditions for the quarter, we have started to see a reversal in this trend for the start of the year.

The current economic expansion has been running strong for over ten years and we are constantly asked when it will end. At this point, most of the indicators are confirming that we have started to enter the later stages of the business cycle.

International Equity Markets

International stocks outperformed the U.S. during the fourth quarter for the first time all year. Emerging markets which lagged for most of the year outperformed the U.S and developed markets by over 5%. The unresolved tariff dispute, slowing global economy and Fed policy decision put pressure on Chinese, Japanese, German, French and the UK markets.

The international markets fared better than their U.S. counterparts for the month with the MSCI EAFE and MSCI Emerging Market Indexes down by just 4.9% and 2.7%. Even though their returns were less negative for the quarter than U.S. indexes, they still posted low double-digit losses for the year. Most of the annual declines for these markets occurred prior to the U.S. and China trade talks on December 2. However, geopolitical issues and deteriorating economic data abroad added to trade uncertainties. Many other foreign stock markets posted deeper losses than the U.S. For example, China's Shanghai Composite entered a bear market in June and declined nearly 25% for the year.

Fixed Income Markets

The broad U.S. bond market as measured by the Bloomberg Barclays US Aggregate Index was slightly positive for both the quarter and year. The volatility of the equity markets and weakening economic conditions sent U.S.10-year treasury yields to 2.6%, close to where they started the year. The spread between long-term and short-term treasury yields also narrowed to levels that stoked concerns of an impending U.S. yield curve inversion. A yield curve inversion occurs when short-term bond yields (2-year treasury) rise above long-term bond yields (10-year treasury). Even though an actual inversion has not yet occurred investors continue to pay close attention to this barometer as a reliable recession forecasting tool. However, it is important to mention that when viewed in isolation, this metric may not be as reliable in the current interest rate environment.

Two areas in the fixed income universe that have garnered our attention lately are the high yield and investment grade corporate bond segments. With the current economic cycle maturing, we could start to see a deterioration in credit down the road. We have also noticed that many of the bond rating agencies have become a bit lax on their assessment of corporate leverage when assigning an investment grade (BBB) rating to corporate bonds. Some estimates project that approximately 45% of the corporate debt issued this cycle could face a downgrade to high yield status (BB rating or lower) if the rating agencies adhered to their rating standards. This is why we have made an effort to mitigate our exposure to these asset classes in the bond portfolio.

Outlook for 2019

Stocks may be coming off their worst year since the financial crisis of 2008, but for 2019, many analysts feel that equity markets will head higher. International and emerging markets stocks could also begin to show better relative strength to U.S. markets if the U.S. dollar continues its path of weakening. Of course, the major risks to these estimates are U.S. monetary policy, European political risks (namely Brexit) and the ongoing

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trade talks with China. Corporate profit margins are expected to decline this year but moderate lending standards and efficient inventory management are still pointing to an accomodative environment for continued economic growth.

The Fed has two rate hikes slated for 2019. However, we are not too worried of the impact that these increases will have on markets as most of this information has already been priced into stocks and bonds. Our central concern continues to be the Fed's management of the balance sheet and the impact that this will have on global credit.

With the Fed expected to raise rates two more times this year and their continued efforts to reduce their balance sheet (although not as much as previously targeted), we expect bond yields across the maturity spectrum to rise gradually back toward their 2018 highs. Even though current inflationary measures do not pose too much risk to longer dated bonds, the miniscule difference between short- and long-term bond yields still favors shorter maturities in our opinion.

After almost a decade of strong equity returns, 2018 was a confusing and difficult year for investors. Market volatility has certainly caused much concern, but panic is not a plan. Market downturns happen and so do recoveries. This is why reviewing and sticking to your long-term goals and objectives is critical.

Our focus is on helping you meet your personalized goals through customized financial planning and diversified professional investment management. We can discuss your situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial matters.

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Sources for graphs: *JP Morgan Market Insights., DoubleLine Capital Management, Bloomberg L.P, Morningstar Research and Fidelity Investment Research*