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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A Three-Month Year

The fourth quarter of 2018 brought to the fore many of the concerns that have been building over the last year: trade tensions between the U.S. and China increased amid drawn out negotiations, the real and perceived impact of tariffs began to be felt in the broader economy, economic reports from China and Europe showed continued signs of slowing and global monetary conditions continued to tighten. The coup de grace occurred in December when the Federal Reserve announced an increase in the federal funds rate to 2.5%. While the rate increase was widely expected, the Fed also communicated that additional rate increases would be contemplated in 2019. The Fed action occurred against a backdrop of slowing economic growth both at home and abroad. The stock market, acting in its role as a short-term voting mechanism, took notice, and the broad market averages sold off between 6-7% in the last two weeks of the year. For the full quarter, stocks returned -13.5% as measured by the S&P 500 Index. There were few places to seek shelter during the quarter: the Citigroup Value Index returned -12% and the MSCI All Country World Index had a return of -12.7%. In the U.S., traditionally defensive sectors such as consumer staples and health care declined less than the broad market. Short-term U.S. Treasury securities provided a positive return for the quarter and the full year.

In many respects, the fourth quarter felt like a year compressed into three months.

From its peak level in September to the trough in late December, the U.S. stock market registered a decline of slightly more than 20% before rebounding at year-end. A stock market correction is defined as a decline of 10% or more with a bear market defined as a decline of 20% or greater. Market corrections are part and parcel of investing and they occur with some regularity. According to Yardeni Research, stock market corrections have occurred once every 18 months over the last 50 years. What made this correction different was the period of low volatility that preceded the decline; prior to September, the stock market had not experienced a 20% decline since 2011.

Thinking Ahead

At its low point in late December, the S&P 500 was trading at a price/earnings (P/E) multiple of approximately 13.7 times estimated 2019 earnings. Over the last 20 years, the forward P/E multiple on the S&P has averaged 16.3 times earnings. The recent sell-off in stocks has brought valuations for the broad stock market to more reasonable levels. As we have written in recent letters, one of our ongoing concerns was the valuation level of stock prices; the recent correction has mitigated, although not fully alleviated, that concern.

Given the recent stock market volatility, mixed economic news and generally unsettled geopolitical environment, it is worth taking stock of the broader economic picture. In the U.S., the economy continues to operate at full employment and 2019 GDP is expected to grow 2.4%, according to Strategas Research Partners. Inflation, as measured by the Consumer Price Index, has shown an uptick in recent months (2.2% in November 2018), but is still low by historical standards. Inflation trends are expected to moderate in coming months due to a 30% decline in the price of crude oil since September 2018. In addition to the constructive inflation trends, lending costs have also been reduced: the St. Louis Fed reports that the nationwide average rate for a 30-year fixed mortgage has declined from 4.9% in November 2018 to 4.4% in early January. The lower borrowing costs are a function of subdued inflation trends, moderating economic activity and, more recently, a less hawkish tone on the pace of future interest rate increases from members of the Federal Reserve Open Markets Committee.

Outside the U.S., economic trends are less consistent. In Europe and China, growth continues to slow. European growth has been tepid in recent years and GDP moderated in the second half of 2018 due to a confluence of factors including trade tensions, tighter budget conditions and drawn out Brexit negotiations. In China, the industrial and real estate sectors of the economy continue to slow, in part due to government regulatory and fiscal policies aimed at curbing lending activity in these sectors. Additional pressure on the Chinese economy resulted from trade tensions and the initial round of U.S. tariffs which took effect during the quarter. A common concern in both Europe and China is the ratio of overall debt to GDP. In Europe, debt to GDP peaked earlier this decade and has declined over the last several years but is still elevated compared to modern history. In China, debt ratios are still well below the levels of more mature economies, but have been rising steadily.

Japan is the world's third largest economy after the U.S. and China. Japanese growth in 2018 was hampered by several natural disasters including torrential rains, an earthquake and a typhoon, and these factors resulted in negative GDP growth for the third quarter and muted growth for the full year. Looking towards 2019, the Japanese economy is expected to expand between 1-2% due to the impact of corporate reforms, improving productivity and increased private and public investment.

In the first half of 2018, emerging economies in Asia, Europe, Latin America and Africa saw growth negatively impacted by higher energy prices and a stronger U.S. Dollar. These trends reversed in the second half of the year and we are beginning to see signs of a rebound in growth in Asia and South America in particular.

The global economic picture for 2019 is a change from the "synchronized global growth" of recent years. Europe and China have shown notable deceleration. In addition, the ongoing trade negotiations between the U.S. and China, along with the protracted Brexit negotiations, have had a dampening effect on corporate planning. Another change has been the impact of tighter central bank policies and the move away from ultra-low interest rates.

While estimates for global economic growth have been lowered in recent months, there are reasons for guarded optimism about the year ahead. The Chinese central bank recently eased monetary conditions by lowering the reserve requirement for member banks. In the U.S., the Federal Reserve has indicated that there may be a pause in additional monetary tightening, depending on the strength of incoming economic data. Another encouraging development has been the decline in energy prices and moderation in borrowing costs discussed above. While U.S./China trade negotiations, and accompanying tariffs, have exacerbated tensions and inhibited the flow of economic activity, it is worth keeping in mind that much of what we are witnessing is a high stakes negotiation taking place in public (proverbial "sausage making"). While the outcome is uncertain, and the potential for a drawn-out stalemate remains, there is reason to believe that the world's two largest economies will reach an agreement in the coming months. The outcome of the Brexit negotiations, which have a March 2019 deadline, remain uncertain, but some form of resolution is expected before summer and this should remove another uncertainty.

While there are reasons to be constructive about the economic outlook for the year ahead, there are two ongoing areas of concern that act as counter-weights to that optimism. Elevated debt levels, particularly in Europe and the U.S., where the Federal deficit rose to near $1 trillion in fiscal 2018, are an important consideration and may restrain global stock valuations in the year ahead. In addition, beyond the frictions around trade agreements, strategic rivalries between the U.S., China and Russia continue to play out in Europe, the Middle East and Asia. Aggressive cyber espionage, the use of proxy military forces (Syria, Yemen) and the growing military presence in the South China Sea and Ukraine are concerning developments that influence our thinking on asset allocation for the year ahead.

Searching for Opportunity

The investment picture is rarely clear and there are always sound reasons for concern, even when investment opportunities may appear abundant. The picture today is perhaps a bit more cloudy than usual. The major questions revolve around the rate of global economic growth, the challenge of elevated debt levels (both private and public) and a high level of geopolitical tension. Our investment positioning for clients is guided by the following:

- Owing to more attractive valuations, we have modestly increased our equity weightings in balanced accounts, within the context of an overall conservative equity allocation.
- In the current environment, financial strength is paramount. Our equity holdings emphasize companies with low debt levels and above-average free cash flow generation. Similarly, our fixed income holdings are investment grade with most rated "A" or better by the rating agencies; fixed income duration remains below the benchmark.
- Innovation continues at a rapid rate and this is an important trend in the overall growth of the economy. Innovation is a theme in our holdings across industry sectors and extends beyond traditional innovation sectors such as technology and health care.
- We have modestly increased our international holdings with an emphasis on faster growing emerging market economies where valuations have reached more attractive levels in recent months.
- Given the economic uncertainties and heightened geopolitical risks, we are maintaining a position in the gold iShares in our portfolios.

As always, we welcome your comments and questions.