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MARKET PERSPECTIVE 4Q 2018

Optimism After a Year of Extremes

CAPITAL MARKETS REVIEW

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MARKET MUSINGS

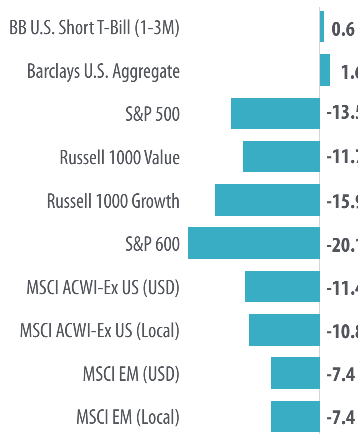
The year 2018 may be remembered as a year of extremes. Moderating forces could help make this year a good one for financial markets.

Last year began on an economic high note, spurred on by newly implemented U.S. policies. That positive momentum continued for months, until investor confidence finally began to waver late in the year. Again, U.S. government actions were a major impetus, along with the controversies and volatility surrounding the current administration. Yet there was plenty of reason for optimism in the U.S. and elsewhere as we entered the new year—one that should provide ample opportunity for disciplined investors focused on economic fundamentals.

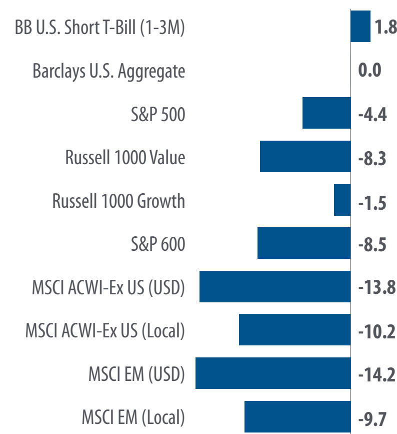
Capital Markets Review

I. GLOBAL OVERVIEW

Market Performance: 3 Month



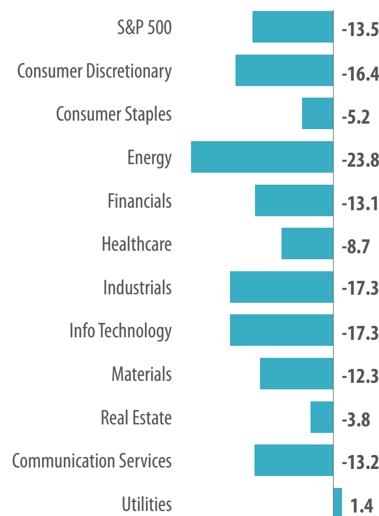
Market Performance: 12 Month



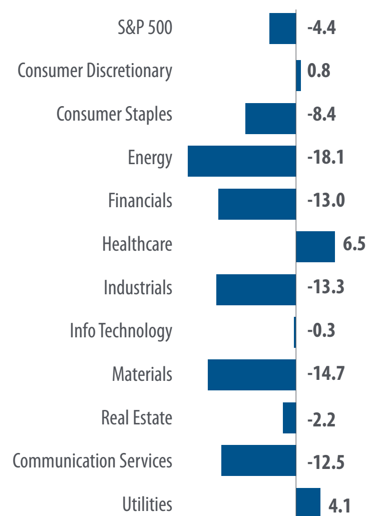
- Fourth quarter returns placed most equity indices in correction territory.
- Despite year-end volatility, the growth sector continued to be a market leader.
- Growth concerns for China and Europe have weighed on non-U.S. equity returns.

II. U.S. EQUITY MARKETS

Market Performance: 3 Month



Market Performance: 12 Month

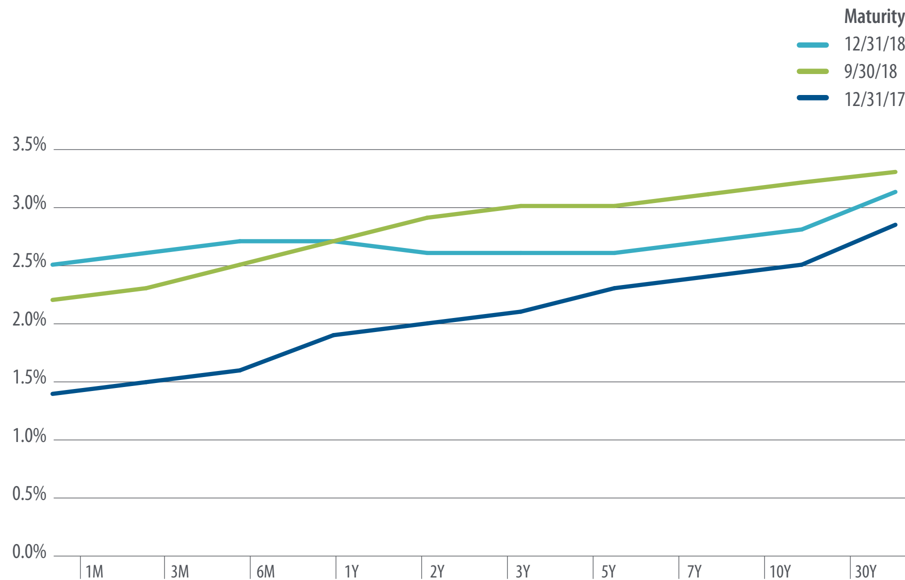


- Oil prices have been highly volatile and the energy sector has followed suit.
- Interest-sensitive sectors were the only areas of the market left unscathed during the quarter.

Healthcare was a standout for the year, reflecting higher earnings and depressed initial valuations.

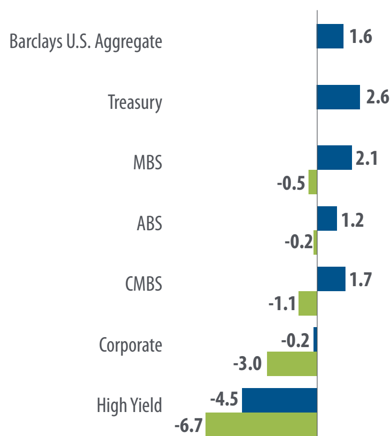
III. FIXED INCOME MARKETS

Treasury Yield Curve

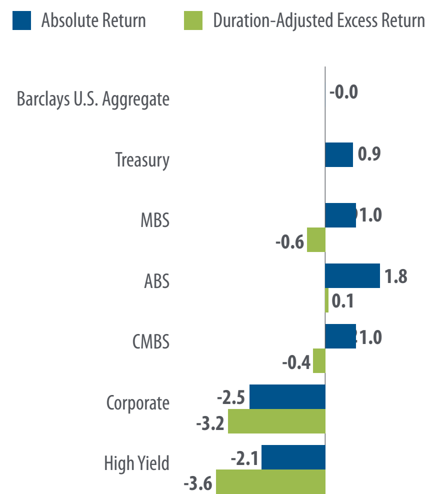


- The short end of the yield curve continued to rise, driven by increases in the Federal Funds rate.
- The yield curve has flattened, reflecting expectations of slower growth and low inflation going forward.

Market Performance: 3 Month

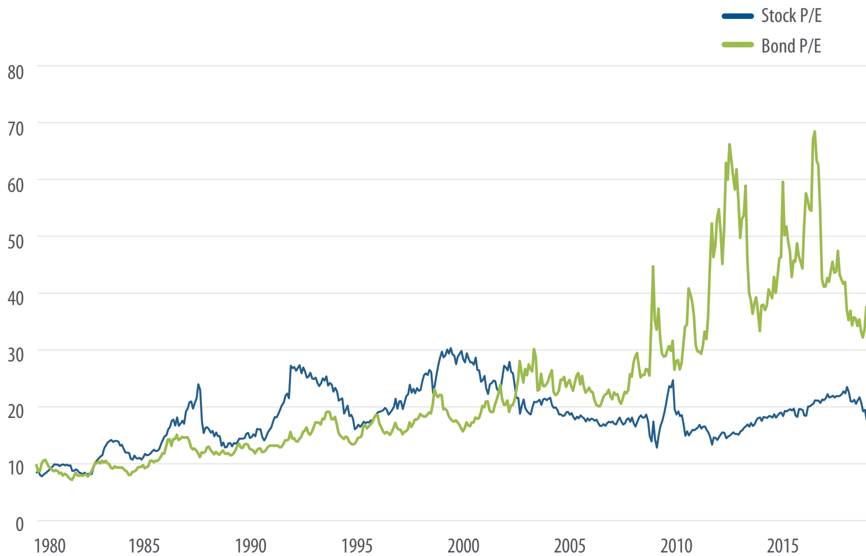


Market Performance: 12 Month

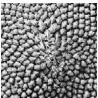


- Reversing the trend of the past several years, non-Treasury securities underperformed due to higher interest rate volatility and recent declines in the equity markets.

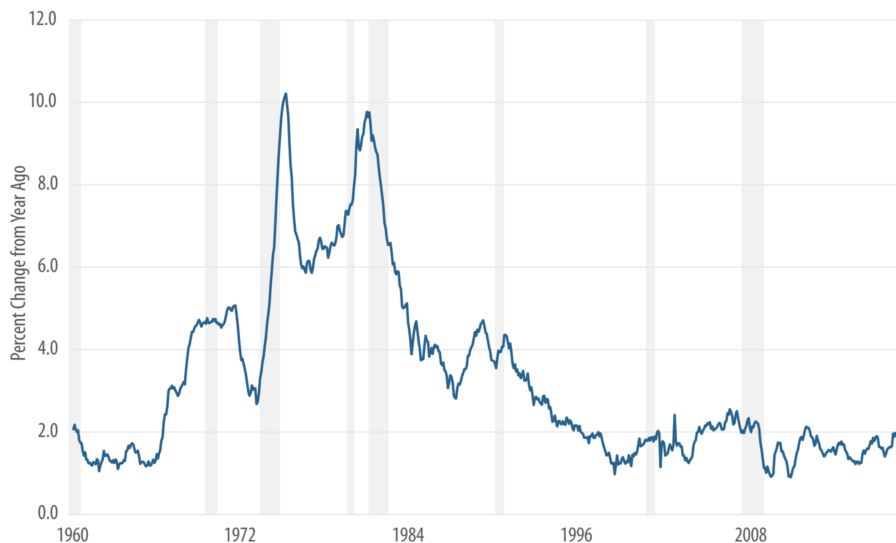
IV. BOND AND EQUITY P/E



- Interest rates have started normalizing, though bond valuations are still high relative to equity valuations.
- There are numerous factors suggesting interest rates can remain lower even longer, though it is risky to think "this time is different."



V. U.S. INFLATION HAS REACHED TARGET

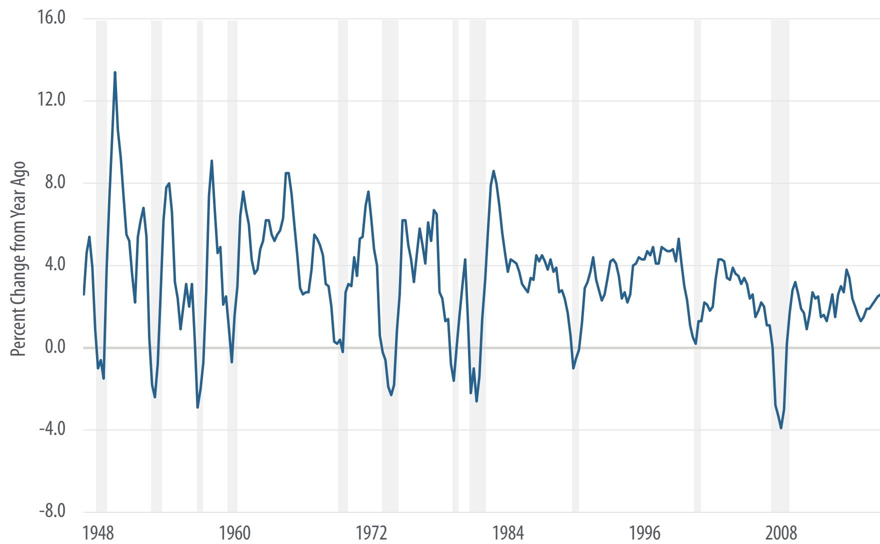


- Despite low unemployment, inflation remains in check.

The Federal Reserve remains focused on "Phillips Curve."

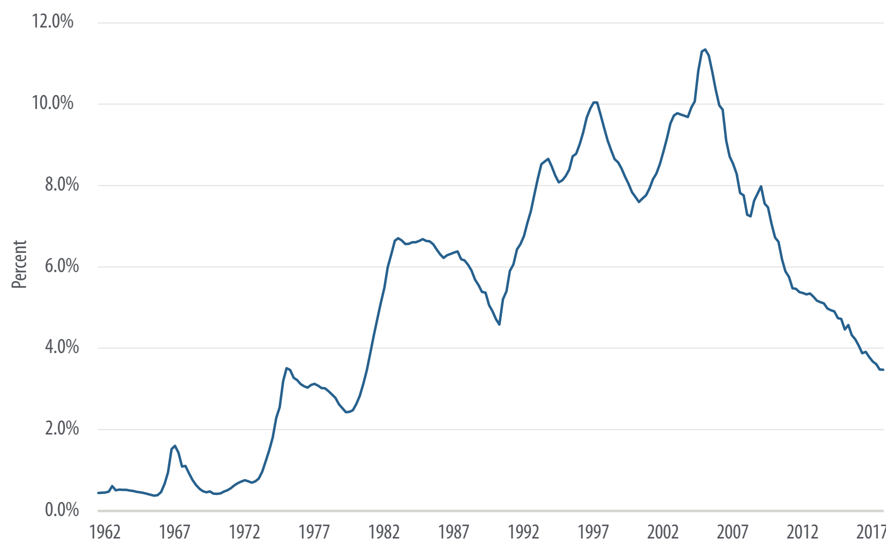
- The Fed has a bias to continue monetary tightening.

VI. U.S. ECONOMY HAS BENEFITTED FROM FISCAL STIMULUS



- Tax cuts have stimulated growth in 2018.
- However, there is some question as to whether momentum will carry into 2019.
- The Federal Reserve has become less aggressive in tightening.

VII. GERMAN UNEMPLOYMENT HAS DECLINED



- Southern Europe has not experienced the same declines.
- Pressure on the eurozone remains.
- The populist political movement continues.

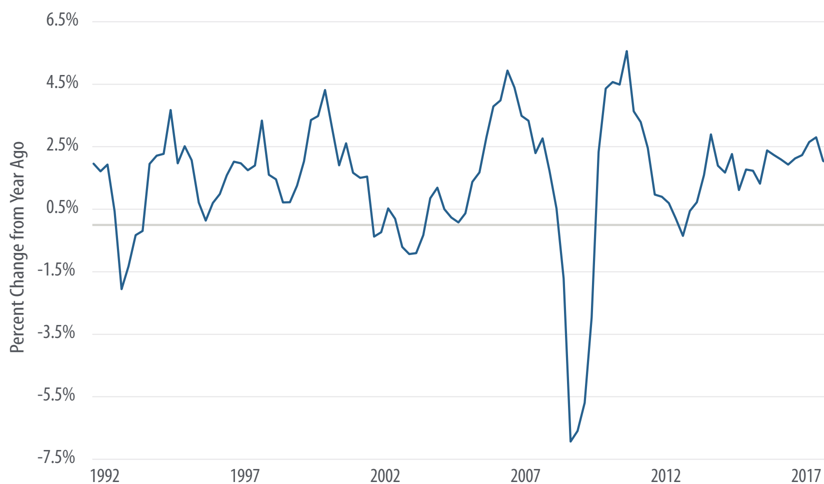
VIII. THE DEFLATIONARY RISK HAS BEEN AVOIDED

Source: Organization for Economic Co-operation and Development

- The eurozone has moved toward inflation targets.

When will the European Central Bank follow the Fed's lead?

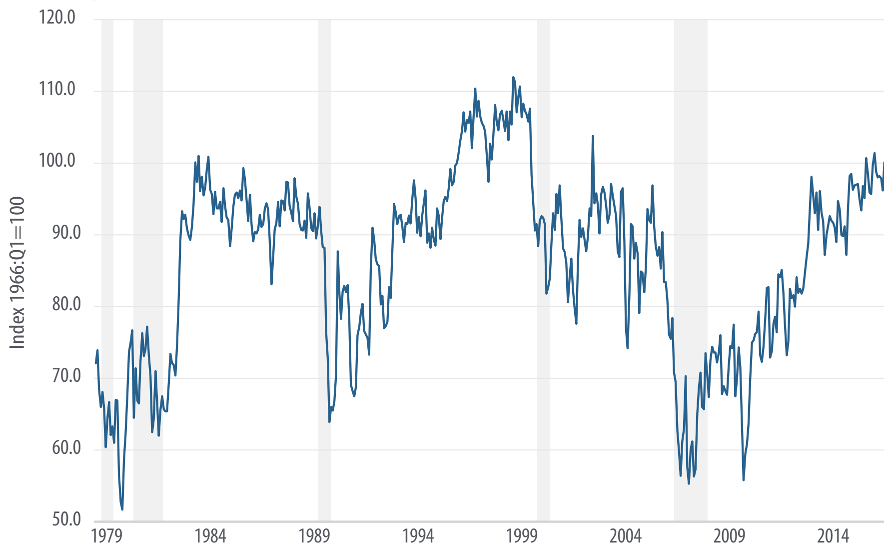
IX. WEAKNESS ON THE HORIZON?



Source: Eurostat

- The eurozone has recovered from the Greek growth scare.
- Recent data suggests the economy may be losing momentum.

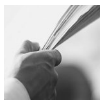
X. RECESSION WATCH: CONFIDENCE REMAINS HIGH



- Consumer confidence has been resilient, suggesting continued economic growth.
- This bears watching in the face of global political uncertainty.

XI. RECESSION WATCH: EXCESS CAPACITY REMAINS

- There is room for non-inflationary growth.



XII. RECESSION WATCH: CORPORATE SPREADS BEAR WATCHING

ICE BofAML US High Yield Master II Option-Adjusted Spread

Source: ICE Benchmark Administration Limited (IBA) *Shaded areas indicate U.S. recessions*

- Is the recent widening of corporate credit spreads a harbinger of future economic and financial stress?

Market Musings

> "It was the best of times, it was the worst of times..."
>
> Charles Dickens, A Tale of Two Cities

The year 2018 may be remembered as a year of extremes. Euphoria reigned as we entered the year, with the U.S. stock market rising more than 5% in the first month as tax cuts and deregulation boosted corporate earnings. The U.S. economy is expected to have posted one of its best annual growth rates since the Financial Crisis. Unemployment in the U.S. reached 3.7% in September, its lowest level in almost 50 years, yet inflation remained low by any historical measure.

However, investors were reminded that the stock market reflects more than actual economic activity. Policy and expectations also play a large role. The U.S. was a hotbed of policy initiatives and controversies in 2018 involving issues including immigration, North Korea and a Federal Reserve on the path toward interest rate normalization. Trade wars were a major concern, with President Trump tweeting he is a "Tariff Man." Tariffs are simply a tax by a different name, though; the stimulative effects of tax cuts were offset by both the threat of tariffs and rising interest rates.

The U.S. was not alone in making policy-related headlines in 2018. Italy has kept the attention of investors through its election cycle, with the new coalition government threatening to increase populist budgetary moves and posing yet another threat to the eurozone. Meanwhile, Britain struggles to find a path toward Brexit.

Through September, economic fundamentals outweighed restrictive policy as the financial markets remained resilient. U.S. fixed income markets were negatively impacted by Federal Reserve interest rate hikes, yet most U.S. stock market indices were up more than 10% year-to-date. Aside from Emerging Markets, most non-U.S. markets were in positive territory in local currency terms.

"…the winter of despair…"

It will be interesting to read the minutes of the Federal Reserve's December meeting. While the Fed had telegraphed a December interest rate hike earlier in the fall—precipitating market declines in October—there was certainly enough contemporaneous information to justify a pause in order to determine the effect of previous rate hikes: slowing growth in China due to tariffs, growth concerns in Europe, declining oil prices, and political uncertainty over Brexit. Did the Federal Reserve contemplate a pause, only to be pushed over the edge by political concerns over Trump's tweets, which were in effect a "double-dog dare" to raise rates?

Unfortunately, the Federal Open Market Committee's decision was not the only policy in play the week of December 17. The investigation into Russian election interference continued to unfold, although this story had been playing out for several months with an expanding focus on former Trump associates. The surprise announcement to withdraw troops from Syria and Afghanistan—followed by the resignation of the well-regarded Secretary of Defense, General Jim Mattis—revealed a dislocation between the White House and Pentagon. Finally, the government shutdown prompted by the dispute over funding for "The Wall" was more than the market's confidence could withstand. Since early

> *"...it may be a good thing for one of the longest-running bull markets to have almost ended."*

December, the S&P 500 has dropped 4.4%, with 3.5% of the decline happening in the last two weeks of the year. What is not captured in these numbers is the extreme volatility experienced at the end of the month.

Technically, the bull market is still intact. However, it may be a good thing for one of the longest-running bull markets to have almost ended. After all, the market decline of October 1987 was followed by strong economic performance the next year. The U.S. economy remains on solid footing. Data on U.S. retail sales point to strong consumer demand

as unemployment remains low and wages have increased. China has signaled significant fiscal and/or monetary stimulus to offset the negative effect of U.S. tariffs. And, as the new year began, China and the U.S. appeared to be making progress on trade.

Even though U.S. corporate earnings expectations have been reduced, they are still pointing to growth. It could be a good year for financial markets: The pace of interest rate tightening is expected to slow, a Democratic-controlled House of Representatives may provide checks and balances on Trump's volatile policy initiatives, and stock valuations should provide ample opportunity for fundamentally based investors.

Adieu, 2018, and good riddance. My New Year's resolution is to focus on economic fundamentals and delete my Twitter account.

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