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2018
4th QUARTER

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The Equity Market

Happy New Year!

By Sarah Swan
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And good riddance to what turned out to be a very difficult year for the markets and investors. There was essentially *nowhere* to hide. Of the 15 major asset classes (everything from US large caps to emerging market stocks to high yield bonds to gold), US cash equivalents was the only one to finish the year with positive returns. Likewise, the 25 largest equity ETFs were all down for the year, with almost half of the funds down double digits. Only 3 of 48 country ETFs posted positive returns for the year! And for the S&P 500 index in particular, the last quarter of 2018 was one of the ten worst fourth quarters since 1929.

There has been a clear shift over the past few months in which investor confidence has been shaken by several key environmental factors including our own government leadership, trade relations with China, actions by the Federal Reserve, and more. While many such factors are legitimate causes for concern, something like a polarizing Tweet by President Trump is a non-event for the market long-term, but with enough fear and instability, investors tend to react to any such uncertainty by caving in and selling on the news. This is what we witnessed in the fourth quarter when equity market capitulation was marked by stocks being sold across the board without a material distinction between good/bad/neutral prospects. This is the kind of behavior we see at or near the bottom of a correction, especially in the context of a decade-long bull run.

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John Trentacoste,
Director of Fixed Income

The Bond Market

4th Quarter Overview

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What a way to end a year. As the third quarter was ending, it seemed everyone was expecting yields to continue the slow ascent for the final three months of 2018. The Federal Reserve had just raised the overnight fed funds rate for the third time in September and a rate hike at their final meeting in December was all but a certainty. Bond investors were also thinking about and planning for further rate increases in 2019. That lasted for a few weeks into the fourth quarter, but as it turned out, many were unprepared for the bond market's quick about-face and the ensuing rally that lasted until year-end. While the shortest and longest Treasury note maturities were volatile, by year-end the largest moves were seen in the intermediate range, with 5 to 10-year maturities dropping over 50 basis points from the 2018 highs of early November. December alone was the impetus for many of the investment grade intermediate bond indexes to finish the year in positive territory.

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The Same Headwinds Remain

As long as loose-end concerns stick around, volatility probably isn't going anywhere in 2019.

We know that the strain on trade relations with China, which ramped up with tariff levying by the US in early 2018, isn't over. The initial tariffs on aluminum and steel were put in place to both punish China for its intellectual property theft and combat our own trade deficit with the country. But the trade war that has ensued has impacted the rest of the world negatively, and not just as trade partners but as global and political powers, too. We are still worried about how this situation plays out in months and years to come, especially at a time when global growth is slowing almost everywhere (including China) and the days of Synchronized Global Expansion are also the days of yesteryear.

In mid-December, the Federal Reserve Bank raised rates again, citing soft inflation and continued robust employment numbers as signs of our economy's strength. While the Fed tempered its guidance on further interest rate hikes, it continued on its path of "some further gradual increases." The median projection for the number of rate hikes in 2019 declined from three to two, and the median projection for the long-run neutral rate also came down to 2.75%. Still, the overall impression is of a Fed that is softening but not yet to the degree many investors are hoping for. But Fed Chairman Jerome Powell remains seemingly confident that the central bank will be able to keep a handle on things by managing expectations and staying vigilant. Remember that recessions have occurred 80% of the time in the wake of Fed tightening. So only one thing is certain—for as long as the Fed continues to tighten and rates continue to rise, both the stock and bond markets will not be strangers to instability. And speaking of bonds, risk-off sentiment has consistently driven yields lower while the curve has grown flatter and threatened to invert (meaning that investors demand more yield for the risk they've taken in the shorter term as opposed to longer term, typically suggesting that trouble is on the horizon).

In addition to these continued themes, there are several other factors investors are keeping a pulse on. Geopolitical issues remain a concerning headwind (Brexit, France, our own political turmoil), corporate balance sheets across the globe have been taking advantage of cheap borrowing over the past several years and accumulating debt (and rising interest rates could pose a serious threat to corporate growth), and oil prices have collapsed from their highs.

Remember: Volatility is Normal

And, it creates opportunity. This year, particularly in the last quarter, we all became unbearably familiar with what intra- and inter-day volatility feels like. And from such a perspective, the stock market can feel like an emotional rollercoaster. However, over longer periods, that volatility is much, much less noticeable and, in fact, stocks just generally move higher. As long-term investors, it is important not to miss the forest for the trees, although it can be exhausting being tested on a daily basis, and we recognize that.

I know we have talked about market timing before, but we'd be remiss to not discuss it again. In times like these, it is very difficult to not be driven by fear, and we are all seemingly wired to fear the unknown. But predicting when the market is turning is not only extremely difficult, but as it turns out, historically speaking, it's not even very fruitful to do so. This is because the worst days in the market tend to be surrounded by the best days in the market, so even if you were perfectly accurate at missing the worst performing days, you probably would have missed the best performing days that year, too. This can be a challenging mental exercise to do with your own portfolio, but historical research from JP Morgan shows us that between 1997 and 2016, a fully invested portfolio would have returned nearly double one that missed the 10 best days in the market.[1] Missing those days is likely if you are selling on fear or to prevent loss. To illustrate the point further, every S&P 500 decline of 15% or greater from 1928 through 2017 was followed by a recovery whereby the average return in the first year after each decline was nearly 55%![2] Being a long-term investor is generally worth it in the end. It is far too difficult and pricey to not only time getting out, but getting back in as well.

Our Outlook

We still believe that much of the sentiment volatility we're experiencing has been self-inflicted as opposed to the direct result of a business/economic cycle. And interestingly, we are not seeing a material increase in short positions (betting on a stock going down) across equities, which suggests that short investors don't believe this general decline of late will last or become a recession imminently. This means the environment can be monitored, and even used to our advantage, as we reposition our portfolios and deploy better risk management tactics within them. This isn't to say we are out of the woods—we know the end of the market cycle is coming at some point soon, but we are simply trying to avoid any big surprises and position ourselves accordingly.

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Inflation expectations plummeted in the fourth quarter as oil and gasoline prices fell. The yield curve of 2-year to 10-year Treasury securities finished the year at 19 basis points, down from 24 basis points at the end of the third quarter and keeping the potential for a recession on everyone's mind. And the Federal Reserve did raise short rates for the fourth time at its December meeting, which at the time had lost some if its "as expected" and felt more like "as required." That put the fed funds rate at 2.25%-2.5% to finish 2018. While the market is pricing in a small chance for further rate increases, the Fed is anticipating two rate hikes this year. We believe it will wait until at least its June meeting while assessing further economic data on inflation and unemployment.

For the quarter, the Bloomberg Barclays U.S. Aggregate Index, the broadest bond market index, advanced 1.64%, putting the index flat for the entire year. Of that fourth quarter performance, 1.84% was December alone. This was a remarkable turn from an almost entirely negative year and something repeated in most of the other indexes.

The Bloomberg Barclays Intermediate U.S. Government/Credit Index, our benchmark, returned 1.65% for the fourth quarter, helped by 1.34% in December. For the year, the index returned 88 basis points. That positive performance in the index was due to the over-weight to Treasury securities. The risk-off trade in the bond market overwhelmed demand for Treasuries but took a toll on corporate debt. The Bloomberg Barclays Intermediate Corporate Index finished the year negative 23 basis points even though it was positive in the fourth quarter. Long maturity bonds dragged down performance for the year in the broad corporate index even further.

The Bloomberg Barclays U.S. Corporate Index returned -.18% for the fourth quarter and finished 2018 -2.5%. Not to be outdone was the Bloomberg Barclays U.S. Corporate High Yield Index which lost 4.5% in the fourth quarter – almost half of that in the month of December. The High Yield Index, which was positive entering the final quarter, ended 2018 -2.08%.

In our Q2 *Investment Strategies* newsletter, I wrote how high yield was "bucking the trend' with positive returns but we were "cautious" longer term. High yield bonds (AKA junk bonds) are very susceptible to large price swings. Equity selling, lower commodity prices, and reduced liquidity were just the ingredients of a recipe for disaster. For that reason, throughout the quarter we have been increasing the overall quality of our clients' fixed income portfolios by reducing non-investment grade bonds.

But what about investment grade corporate debt? Reducing lower rated debt and adding to our government bond allocation began a re-positioning of our clients' portfolios as we move through the late cycle domestic economy. The fourth quarter was a return to a more normal risk/reward environment when it paid to hold higher quality corporate securities and we believe that theme will continue throughout 2019. Rest assured we are not giving up on the corporate bond market. Our strategic fixed income allocation for total return portfolios has 50% allotted to corporate bonds and that is a slight over-weight to our benchmark. We value the incremental income of non-Treasury securities as a powerful influence for long-term performance. At the same time, we want to be defensive against credit downgrades if the global economy slows more than anticipated.

Bloomberg Barclays Indexes as of 12/31/18			
	4th Quarter 2018	Full Year 2018	December 2018
Intermediate U.S. Govt/Credit Index	1.65%	0.88%	1.34%
Quality Intermediate Municipal Index	1.72%	1.51%	1.08%
U.S. Aggregate Index	1.64%	0.01%	1.84%
U.S. Intermediate Treasury Index	2.24%	1.41%	1.50%
Intermediate Corporate Index	0.58%	-0.23%	1.05%
U.S. Corporate Index	-0.18%	-2.51%	1.47%
U.S. Corporate High Yield Index	-4.54%	-2.08%	-2.14%

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The Equity Market *continued from page 2*

Further, we believe the market is experiencing some growing pains as many of its investors adapt, for the first time, to a world without excess monetary/fiscal stimulus supporting stock prices. The only way to get through this is to have the stock market finally accept this new reality and re-rate to a lower (more sustainable) level. This is affected through price/earnings contraction, which we saw all year and expect to continue to see in 2019. Many economists anticipate a "growth recession" for 2019, or growth, but at a slower than expected rate (with the distinct possibility that economic growth has peaked). We don't disagree – our expectations are not for a gangbusters year ahead, and we won't be surprised if the market continues to attempt to price-in a full-fledged recession with lower trajectories for earnings and growth.

In other words, the silver lining to this downtrodden, volatile stock market is the opportunity it provides for upgrading our portfolios through obtaining better growth prospects at cheaper valuations. The excess optimism that we saw for much of 2018 held the market uncharacteristically high, making purchasing difficult. We feel that the last month or so has given us several compelling entry points into names we've wanted to own for a while but whose valuations felt unjustifiably inflated. While it's impossible to predict the market, we know that good companies bought at lower prices will reward us over the long game.

End

[1] *https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/navigating-volatility*

[2] *https://rpseawright.wordpress.com/2018/12/16/fear-not/*

The Bond Market *continued from page 3*

Switching gears to the tax-exempt bond market, the Bloomberg Barclays Quality Intermediate Municipal Index returned 1.72% for the fourth quarter and 1.51% for all of 2018. A rough start to 2018 due to tax law changes going into effect put the municipal bond market in quite a hole to start the year. Throughout the year though, the influences of lower new issue supply, high taxable equivalent yields (especially for states like NY, NJ and CA) and improving credit fundamentals brought retail demand back into the market. And like most other high-quality fixed income sectors, the November/December rally provided the strong finish and positive return across all maturities. Revenue bonds outperformed general obligation bonds in 2018 due to the incremental income as well as being a smaller portion of new issue supply during the year.

As we look to the new year in the municipal bond market, net supply is always a focus for the first few months as maturities and calls outweigh new issuance. With the lack of any tax reform scheduled to begin 2019, a healthy start to the year is expected. We anticipate issuance in 2019 to be similar in size to 2018, roughly $350 billion, while seeing more new money deals and less refunding. A bipartisan bill to fund infrastructure to boost spending on roads and bridges may add some much-needed supply to that sector, though compromise in Congress seems a distant possibility. Nonetheless, we continue to look for opportunities in A-rated revenue bonds and AA-rated general obligation bonds.

End

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