Market Review & Outlook: Investor Concerns Simmer

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Executive Summary

- *The U.S. economy is showing some signs of deceleration; however, the bigger concern seems to be global growth.*
- *Fed rate hike uncertainty and the shape of the yield curve is also causing investor concern.*
- *Good planning and disciplined portfolio rebalancing should maintain appropriate exposure to equities over time. Equity market corrections are part of planning for our financial futures.*

The fourth quarter of 2018 was a disappointing period for global equities. In fact, it was the worst quarter for equities since the global financial crisis of 2008. The S&P 500 declined 13.52% to finish the year down 4.38%. Large-cap, mid-cap, and small-cap indices performed worse for the quarter and international stocks performed worse for the year. Rather than any sudden crisis, simmering concerns flared up. The Federal Reserve raised rates in December as expected, but the language accompanying the announcement raised fears that the Fed would go too far, too fast in its goal of normalizing interest rates. Chinese economic activity showed signs of weakness. Europe continues a gradual slowdown following a period of very strong growth. The U.S. government shut down as Congress and the administration are at loggerheads over funding a border wall. Investors are nervous and nervous investors want certainty.

We buy equities specifically because their returns are not certain. Equity investors forgo more certain returns associated with bonds for the opportunity to share in a company's future earnings. The property rights for equities are sound, but unlike bonds, equities do not offer contractual provisions for the payment of principal and interest. Rather, equities offer the chance that human ingenuity can take scarce financial resources and produce goods and services that are superior to what was previously available in the consumer's mind. Equities give us the opportunity to achieve a return greater than the guaranteed returns on bonds (and the rate of inflation) over time. That is why we own them. We expect to be compensated for the greater risk of equity ownership.

There are better times and worse times to buy (and sell) stocks and these do not necessarily coincide with our cash availability and cash needs. Therefore, good

Equity Market Index Returns

As of December 31, 2018

Asset Class	Index	4Q 2018 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	-13.52	-4.38	9.26	8.50	13.12
	Russell 1000 Large Growth Index	-15.89	-1.51	11.16	10.41	15.29
	Russell 1000 Large Value Index	-11.72	-8.26	6.95	5.94	11.18
	DJ US Select Dividend Index	-9.68	-5.94	9.82	8.49	12.25
Mid Cap U.S.	S&P 400 Mid Cap Index	-17.29	-11.10	7.66	6.03	13.69
Small Cap U.S.	S&P 600 Small Cap Index	-20.10	-8.48	9.46	6.34	13.61
Developed International	MSCI EAFE Index	-12.54	-13.78	2.88	0.53	6.32
Emerging Markets	MSCI Emerging Market Index	-7.48	-14.57	9.26	1.65	8.02
Commodities	Bloomberg Commodity Total Return Index	-9.41	-11.25	0.30	-8.80	-3.78
Real Estate	NAREIT Equity Index	-6.73	-4.64	2.88	7.89	12.11
Global Market Cap Weighted	MSCI World Index*	-13.41	-8.69	6.30	4.55	9.67

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized. Source: Greenhill Market Index Review as of December 31, 2018

planning and disciplined portfolio rebalancing should maintain appropriate exposure to equities over time. The financial press is not helpful to our psychology in this regard. Now that stocks are down considerably from the highs, sensationalized headlines are forecasting a long and painful downturn. Without context, an interview with a bearish hedge fund manager can sound like a call to "sell everything." This is not a constructive approach in our opinion.

First, while always uncomfortable, most equity market corrections are not terribly damaging to long-term performance in the larger scheme of things. According to Crandall, Pierce & Company, during periods when a balanced portfolio (60% equities / 40% bonds) delivered a 1-year loss between 1950 and today, the average loss was negative 6%. Unfortunately, the most extreme sample is a somewhat recent memory: a 24% decline in the 2008 financial crisis. The trade-off between accepting risk for the opportunity to achieve higher returns seems reasonable when you consider that 85% of the annual return samples produced positive returns. Despite some negative years along the way, the portfolio delivered a 9.8% average annual return over the sample set.

Second, risk can take a lot of forms. Losing value is an important consideration, but missing a strong return is another detrimental form of loss. Missing just a few days of the market's strongest performance can dramatically change a portfolio's performance for any given period. This is because recoveries can be as spectacular and as hard to time as declines. People are simply wired wrong for investing. Our tendencies are to be over-confident, near-sighted, and loss averse (rather than risk averse). The scientific evidence of these tendencies is robust and the results are very destructive. It is a shame to remove assets from a portfolio when the risk is lower and potential return greater just because we do not like looking at a loss.

Our job as manager is to prepare for the risks and opportunities that the market presents and prudently calibrate total portfolio risk in a manner consistent with achieving financial goals. The "risk first" blueprint is sound because equities are inherently riskier than bonds. We try to reduce the identifiable risks in a portfolio before they have created damage and use opportunities like the current one to make selective upgrades that we believe can add to portfolio performance over the long-term. Regardless, our portfolios are always diversified and comprised of companies in sound financial condition, with a solid record of profitability and shareholder friendly financial policies. Corrections often present opportunities to buy the strongest companies at improved prices.

The U.S. economy is showing some signs of deceleration; however, the bigger concern seems to be global growth. Global growth is slowing. Eurozone GDP slowed to 1.6% annualized for the September quarter after about two years above 2% growth. Survey results from major European countries suggest that the trend will continue. However, we believe that the depth and duration of the prior European Union downturn leave a solid foundation for future growth. We believe some exposure to international equities offers the potential for outperformance versus an all domestic U.S. portfolio due to lower valuations and potential sustained growth. China is also seeing decelerating GDP growth. Survey data from China is very weak. China has become substantial enough to impact global economic prospects as Apple's recent sales and earnings pre-announcement made clear. The Chinese government will likely act to stimulate the economy because economics and politics go hand in hand in a managed economy. Any resolution on the tariff standoff with the United States could boost growth and alleviate at least one common area of investor angst. However, the level (and obscurity) of consumer and corporate debt in China is a complication worth watching.

The S&P 500 is among the Conference Board's closely watched indices of Leading Economic Indicators and there is some recent data to support the message it sent in the fourth quarter. The December ISM Manufacturing Index declined to 54.1, down from 59.3 in November, a sharp reversal of what has been a stable and encouraging trend. Any reading greater than 50 indicates future growth. The non-manufacturing survey was better, but still indicates deceleration. On the other hand, non-farm payrolls increased 312,000 in the month of December following the 176,000 increase in November. Payrolls are more of a coincident or even lagging indicator of economic trend, but jobs are the engine for consumption which represents nearly 70% of U.S. GDP. Average hourly earnings have accelerated 3.2%, but it took a long time to start moving and seems stable at the slightly higher level. Early reads on holiday shopping from Mastercard estimate a 5.1% increase in sales (excluding automobiles) between November 1 and December 24, 2018. University of Michigan readings on consumer sentiment remain healthy at 98.3, up from 97.5 the prior month. Housing activity

U.S. Existing Home Sales (YoY%)

Source: Factset Research as of November 30, 2018 has not been strong due to increasing mortgage rates and somewhat high prices, but the housing market has been sensitive to these dynamics since the global financial crisis with a general trend that is adequate to support growth.

The Fed went ahead with a 0.25% interest rate increase on December 19, bringing the Fed Funds rate to 2.5%. The accompanying commentary spooked the market. Basically, the December increase pulled one 2019 increase forward to 2018 leaving two increases for 2019 in the forecasts of Fed members. The comments were not necessarily hawkish, they just did not say that they plan to stop. In our opinion, they have room to stop if the economy is showing signs of weakness. While the Fed members have the final say, derivatives markets do not see additional rate increases in 2019. The yield on the 10-year Treasury has fallen to 2.68% as of December 31. The shape of the yield curve is also causing concern. The curve is not inverted across all maturities, but part of it is. The result is a strange (and rare) period of outperformance for cash and equivalents. Commentary from Fed members since the beginning of the year has focused on "data dependence," which suggests more flexibility and the potential for a slower pace to future rate hikes.

We enter 2019 on more uncertain footing than we have seen in many years. The equity market and oil market corrections seem to suggest a pronounced slow-down in the near future. We do not know whether that slow-down is coming at all and, if it does come, how deep it might be. The correction has reduced the price-to-earnings multiple for the S&P 500 to 15x, which is significantly below the 18x multiple at the beginning of 2018. Forecasted earnings growth for 2019 is 7.2%, down from the 10% forecast earlier in the year and well below 2018 growth that will probably wind up around 22%. The primary concerns for earnings are oil prices, interest rates, and global economic growth. We will learn a lot in fourth quarter earnings calls starting in mid-January. The 15% decline in the S&P 500 from September highs already accommodates a significant reduction in expectations for 2019 and 2020 in our opinion.

Equity market corrections are part of planning for our financial futures. Preparation is the best means of making sure we weather them well and that we are able to make moves to improve our portfolios for the future. A portfolio of durable assets that accurately reflects the client's risk tolerance should not require dramatic changes. Investment grade bonds seem to be doing their job of supporting portfolio values during these corrections. We will be dedicated to finding good investments at reasonable valuations.

We wish you a happy and prosperous 2019. ■