Fourth Quarter 2018
Courtesy of Miles Capital

NEW ROADS AHEAD
MANAGING THE CURVES

U.S. fundamentals have remained strong, as evidenced by solid third quarter 2018 Gross Domestic Product (GDP) growth of 3.4 percent. Several leading economic indicators suggest we should continue to see solid growth over the coming quarters. These measures include continued low unemployment at 3.7 percent and moderately strong housing. We also see some pressures that could lead to wage growth.

A few potential longer term challenges do include the housing market, as pricing is increasing at a reduced level due to rising mortgage rates and declining home affordability. The consumer represents approximately two-thirds of U.S. GDP, so we are watching these trends carefully. There are also potentially longer term pressures on earnings growth after experiencing over 25% percent overall earnings growth for the members of the S&P index for the last three quarters. The tax cut bump we experienced in early 2018 may be winding down.

Volatility in the financial markets has risen considerably since September. A key factor contributing to the selloff was a high level of uncertainty
surrounding political policy and more specifically policy around trade and tariffs. In addition, worry that the US Federal Reserve (Fed) policy of raising rates has gone too far has begun to create some anxiety with investors.

The Fed has raised rates nine times since December 2015, after maintaining rates effectively at zero for several years due to the 2008 financial crisis. The rate hikes include four increases during 2018. They have indicated they will be raising rates 2 times in 2019 (previously they indicated three raises during 2019) and potentially one raise in 2020. The Fed is keeping close tabs on inflation which is running on the lower side of their 2% range, as well as watching for economic changes as the result of recent market volatility.

The risks to the economy include tariffs, inflation and global uncertainties.

MARKETS TAKE CENTER STAGE
INVESTORS SHAKEN

Just as 2018 started with a roar, it ended with a whimper as markets across the globe experienced significant volatility and sold off over the last few quarters. While much of the volatility was concentrated in the equity markets, the fixed income markets did not escape the risk reduction trades. The "risk-off" positioning of investors caused a fairly dramatic divergence in returns across the different fixed income market sectors. The trade and policy uncertainty caused many investors to pull back from the market segments that could be impacted the most such as the credit sectors. Defensive sectors such as U.S. Treasuries performed much better than credit sectors.

Changes in the overall level of interest rates drove fixed income returns for the quarter and the year. Interest rates, as measured by the 10 year U.S Treasury note, declined significantly for the quarter and ended the year at 2.69 percent which was 0.38 percent lower than where it started the quarter. For the year, interest rates actually rose modestly for longer maturities and rose more dramatically for short term bonds due to the four Federal Reserve increases during 2018. The difference between the 10 year and 2 year yields has shrunk to levels not seen in over a decade, resulting in a very flat interest rate curve. A partial inversion of the interest rate curve (between the two-year and fiveyear) and the prospect for a full inversion, defined as the environment when long term interest rates have lower yields than short term interest rates, added to investors' worries as historically that condition has preceded many U.S. recessions.

The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. bond market, ended higher by 1.64 percent for the quarter largely due to falling interest rates but returns for the full year were essentially flat as rising rates in the first half of 2018 and increasing risk premiums during the second half eroded total returns. Most major credit sectors including corporate, municipal, mortgage backed, and agency bonds significantly underperformed similar duration U.S. Treasury securities for the quarter and overwhelmed any gains realized during the first three quarters of the year. Within the investment grade corporate sectors, lower quality assets underperformed higher quality and longer duration underperformed shorter duration securities.

The recent market turmoil has understandably created some anxiety. We believe it's important to step back and assess the longer term fundamental and economic trends, which remain solid, especially in the U.S. We expect 2019 will bring additional volatility while the markets contend with more political turmoil and further rate increases. While we are constantly monitoring the markets and the economy for new opportunities and risks, it is these longer term themes and trends which drive our major investment decisions. Clearly the markets have entered a new level of volatility but those investors who stick with their long term investment plan will likely be better served.

EQUITY THE BULL TAKES A BEATING

U.S. stocks had a rough fourth quarter to cap off the first calendar year with a negative return since 2008. Long standing “buy the dip” trades burned out, as the particularly crowded FAANG (Facebook, Amazon, Apple, Netflix, and Google) trade fell hard during the quarter. Corporate buybacks were announced to be a record of $1 Trillion for the year, exceeding the prior record of $781 Billion in 2015. Earnings growth for the third (most recently reported) quarter was 26 percent growth yearover-year. That is the highest growth since Q3-2010 and exceeds the prior two quarters’ 25 percent growth. For Q4-2018, earnings are expected to grow at nearly 12.5 percent, which would be the fifth consecutive quarter of double digit earnings growth. Earnings growth in 2019 is estimated to be in the mid to high single digits; valuations (12-month forwardP/E ratio) now look particularly attractive, as they have dipped below the 10-year average (15.78x).

For most of 2018, the markets largely ignored the drama surrounding the President and focused on the tailwinds of tax cuts and deregulation. This sentiment seemed to change in the fourth quarter with the publicity around “Tariff Man,” the Cohen guilty plea, Mattis resigning on the Syria troop decision, continued criticism of the Fed and Chairman Powell, and the partial government shutdown over the border wall.

Despite the December Trump-Xi truce on trade, the U.S. has imposed tariffs on $250B of Chinese imports, and there are still further structural changes that China is resisting. Tensions beyond trade also exist, with the administration accusing China of meddling in U.S. democracy, using “debt diplomacy” to broaden influence, and engaging in currency manipulation and IP theft. While the ending net impact of a trade dispute is not detrimental to the U.S., it has shaken investor confidence.

We continue to watch for all emerging and developing risks and opportunities, keeping our focus on long term investing for clients.