Investment Perspective

The calm and profitable period of the last two years ended with stock market turbulence in late 2018 not justified by the fundamentals. The S&P 500 had its worst December since 1931 losing 9%, putting the fourth quarter down 14%. The Russell 2000 declined 12% for its worst December in history. Additionally, the September–December peak-to-trough decline of 20% was the largest correction since the 2008 financial crisis. Historically, December is the second-best month of the year with the highest probability of a positive return, so the late holiday swoon was clearly disappointing and unexpected. Investors worried about China's economic slowdown, moderating earnings growth, the pace of Fed tightening, U.S.-China trade negotiations, political dysfunction in Washington and the Turkey/ Saudi Arabia Khashoggi conflict.

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Severe corrections occur periodically as investors focus on the negatives rather than the positives. Typically, these are excellent buying opportunities as they cleanse the market of excesses and increase the potential for capital appreciation. For example, in the summer of 2011, the S&P 500 corrected 19% and subsequently rallied 37% in the next 12 months. It is difficult to predict changes in sentiment and there are reasons for caution, but we do not advise "timing the market" in response to increased volatility. In general, the long-term outlook favors equities due to a combination of sustainable earnings growth, low interest rates and moderate inflation. Today, the investment outlook is better than popular opinion suggests. The stock market gained approximately 300% in the last 10 years – one of the most impressive advances in history – yet this is often called the "most hated bull market." Because of this skepticism, we do not suffer from excessive exuberance as many investors were underinvested during this period. The odds favor further advances ahead. A summary of last year's index returns through December 31, 2018 is as follows:

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Dow Jones Industrials	-3.5%	Russell 2500	-10.0%
MSCI EAFE	-13.8%	S&P 500	-4.4%
NASDAQ Composite	-2.8%	Wilshire 5000	-5.3%

GLOBAL ECONOMY

Global economic growth (ex. U.S.) is moderating to 3.5% in 2019 after two consecutive years of 4%-plus growth. This has been the broadest and strongest period of global growth since the mid 1990's. On balance, the economic tone is constructive, but various headwinds are surfacing and we are experiencing a synchronized global slowdown. China and the U.S. are engaged in a simmering trade war that is impeding both regions.

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China is expected to grow 6%, but estimates suggest that the China-U.S. tariff war might clip growth another 1% if retaliations spiral. There was also an unexpected decline last month in exports and imports and Chinese domestic auto sales fell for the first time in 28 years. In response, China plans to stimulate again with a combination of easier credit, incentives and tax cuts. The Euro area is expected to grow 1.1% this year after 1.8% in 2018 and Japan is likely to muddle along at a 1.1% pace. Economic performance in the emerging markets remains uneven and, as a result, those stock markets were among the worst performing equity benchmarks last year. The global decoupling of monetary policies is generating increasing tension and volatility. In Europe and Japan, accommodative monetary policies continue to support those economies. For example, in Germany, industrial production dropped unexpectedly in November. Meanwhile, the U.S. is operating closer to its long-term growth rate and has begun monetary policy normalization. These differences will exacerbate movements of capital, exchange rates, interest rates and the relative value of goods between trading partners.

The global decoupling of monetary policies is generating increasing tension and volatility

The U.S. economy is expected to grow 2.4% this year following 2.9% in 2018. This downshift in growth is indicative of an aging economic cycle, although a gentle slowdown remains plausible. First, employment growth has been strong which is expanding the labor force by drawing in the unemployed from the sidelines. This movement increases wages and payroll taxes. Second, consumer spending remains solid as household balance sheets are healthy and cash flows have improved. Third, growth in business investment spending continues to outpace the general economy reflecting years of under-investment, demand for newer technologies and favorable tax reform changes. The capex cycle appears to have a long runway for sustainable growth and may increase structurally over the next several years.

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Housing is an economic soft spot and may pose some growth risks. For the second consecutive year, residential investment will not be a strong contributor to growth. The softness stems from a slowdown in the sales of existing homes due to affordability, higher mortgage rates, real estate tax law changes and low supply in some regions. Existing home sales plateaued earlier this year at a 5.5 million annual rate and declined 10% in December to the 4.9 million level. The rate of increase in national home prices is slowing as demand is softening — the S&P/Case-Shiller Home Price Index is up 5.5% y/y. In addition, single-family housing starts were up 3% in the third quarter, but the pace may slow further. Medium term positives for housing relate to increasing demand from growing household formation and moderating price increases. Consequently, renters may become buyers when affordability improves. We have entered the tenth year of expansion and are in the latter part of the cycle. Despite three years of Fed tightening, it is important to note that economic growth does not die of old age and can continue over the foreseeable future.

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EMPLOYMENT GROWTH

A stronger economy has yielded a firming job market. The positive feedback loop of rising household income, improved balance sheets, more payroll taxes, healthy consumer spending and higher confidence has broadened the foundation of this expansion. Job growth has been between 1.5-2% for the last five years and, as a result, the unemployment rate is 3.9% — among the lowest levels since the late 1960s. In response to tighter labor markets, wages are rising with the average hourly earnings up 3.2% y/y – the fastest pace of wage growth in nine years. Positively, the labor force is growing again after declining from 2009 to 2015 due to the sluggish economy and aging baby boom. In December, the labor force participation rate increased slightly to 63.1 – the highest level in over five years. People are coming off the sidelines into a job or job-seeking mode, which increases total employment and suppresses wage inflation that may arise from labor shortages. On balance, the healthy employment situation is a positive support for overall economic progress.

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FED POLICY & INTEREST RATES

Monetary policy remains in a tightening mode, but this may change. Recently, the Fed softened its stance and left open the possibility of less tightening in 2019. The recent 25-basis point increase in December brought the federal funds rate to 2.50% — the ninth hike since December 2015. Depending upon economic data, the Fed may raise rates only once or twice this year. It may also stop tightening sooner than expected. The Fed wants to find a "neutral" stance after a period of accommodation and will be patient. It is too early to know if conditions will warrant a rate cut in 2020, but this is a possibility. The equity markets have responded favorably to signs that the end of rate increases may be near.

Real-time indicators suggest inflationary expectations remain subdued in response to a sanguine view of interest rates and inflation in 2019

Importantly, inflation trends in the U.S. are favorable with modest indications of pricing power. Almost all inflation measures are in the Fed's target range of 2%, which suggests future policy actions will be aimed at keeping inflation in the range. The consumer price index (CPI) is up 1.9% y/y, but core inflation (excluding food and energy) is 2.2% y/y. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.9% y/y. Real-time indicators suggest inflationary expectations remain subdued in response to a sanguine view of interest rates and inflation in 2019. The 10-year Treasury note recently closed at 2.75% -- down from 3.23% in early November. This produces a relatively flat yield curve given the 90-day Treasury bill at 2.44% and the 2-year Treasury note at 2.58%. It signals that inflation is well contained and the economy is not overheating. Also, the 10-year breakeven inflation rate is 1.82%, down from 2.15% in October. The Federal Reserve is successfully engineering an expansion with low inflation and strong employment.

INVESTMENT OUTLOOK

All eyes are on the Fed as investors wait for greater clarity on interest rates. Recent Fed speeches have given investors hope that a successful path of deceleration is possible. During the fourth quarter, investors feared that growth might decline if tightening continued. The markets are experiencing a "relief rally" on the possibility of no further hikes or easing in 2020. The combination of subdued inflation, low interest rates and reasonable valuations is ideal for equities assuming a decent growth outlook. Currently, we are experiencing decelerating growth as opposed to negative growth. However, investors have been quick to interpret deceleration as a decline, which is understandable, but not rational. We believe the process of decelerating growth will run its course and moderate growth will prevail with a favorable stock market environment.

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We expect S&P 500 operating earnings to increase 5% to $171 per share in 2019 versus a 22% increase to $163 last year. Valuation is attractive at 15.3x this year's estimated S&P operating earnings considering the outlook for inflation and interest rates. Based upon forecasts, the five-year growth rate (2014-2019) for S&P earnings will be 7% -- consistent with 90 years of stock market data. Odds favor another period of moderate earnings growth powered by mid-single digit revenue gains, share repurchases and the follow-on effects of the tax rate reductions. Additionally, the repatriation of substantial offshore cash due to tax law changes may boost domestic acquisitions, dividends and improve balance sheets. As a reminder, during the 2014-2016 period, the S&P 500 performed well during a period of flat earnings.

On the technical side, several indicators suggest some healing and recovery is underway. The CBOE market volatility index (VIX) – a popular fear gauge – spiked to 36 on Christmas Eve, the highest December reading since 2008, but has since subsided to 18. In general, stock markets remain oversold on an intermediate-term basis. For example, the percentage of companies selling above their 200-day moving average is 20%, which is the lowest level since 2011. In January, short-term momentum is improving with relative strength indicators recently crossing over their 50-day moving average. The Investors Intelligence Bull/Bear Ratio is at historically low levels – a good contrarian sign. Investors usually "buy the dip" to deploy cash reserves, but may "sell the rally" until confidence is restored. Sentiment is focused on risk rather than reward with most Wall Street indicators suggesting "bearishness" – a positive contrary indicator.

Stock markets remain oversold on an intermediate-term basis

What about the January trend? The old stock market adage is "so goes the first day, week and month, so goes the year." This January, the first five days were up 2.6%. Based on data from 1950, this leads to a positive annual return 82% of the time with an average gain of 13.3%. However, the positive trend last January did not produce a favorable return for 2018.

It is difficult to gauge the impact of sentiment, but a "crisis of confidence" may have caused the plunge in December. Today, we believe the risks are sufficiently discounted

A few key risks include: Brexit, China slowdown, disappointing earnings, dysfunction in Washington, inflammatory tweets, military conflicts, over-tightening by the Fed, stronger dollar, trade war and unexpected inflation. The Trump administration has proposed ideas which may inhibit the flow of trade and sour relations with key trading partners. It is difficult to gauge the impact of sentiment, but a "crisis of confidence" may have caused the plunge in December. Today, we believe the risks are sufficiently discounted. U.S. equities, particularly small and medium-sized growth companies, remain likely to achieve double-digit returns over the next few years. Above-average earnings growth with modest valuation expansion should support appreciation consistent with past trends. The pace of inflows into equities remains below historical trends suggesting better flows in the future.

In closing, 2019 is the Chinese "Year of the Water Pig." The pig enjoys challenges and is generous, hardworking, intelligent and social. Pig years generate energy and growth opportunities. It is one of the luckiest Chinese zodiac animals and a symbol of wealth. Men born in pig years are optimistic while women have good fortune and health. Historically, the S&P 500 has produced positive returns in pig years 100% of the time with an average gain of 16.5% since 1934. Finally, the third year of the presidential cycle produced an average return of 13.6% since 1927 and 12.4% with Republican administrations. We look forward to a double-digit return in 2019.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2017	Yearend 2018	Difference/ Change
Fed Funds Rate (%)	1.50	2.50	+100 bps
10 Yr. Treasury Yield (%)	2.43	2.68	+25 bps
Inflation (CPI y/y % ch.)	2.11	1.94	-17 bps
Gold ($/oz.)	$1,291	$1,279	-0.9%
Oil ($/barrel)	$60	$45	-25.0%
Euro per Dollar	.83	.87	+4.8%