MARKET COMMENTARY

January, 2019

A Review of 2018 and A Look Ahead to 2019

The past year provided investors an unwelcome reminder that equity markets tend to be unpredictable. January delivered 3% gains for the S&P 500 before February suffered losses of about 7%. After much up and down throughout the year, The S&P 500 remained up by about 6% in the beginning of October, before it plunged nearly 20% in the final three months of the year. Even the record 1,000+ point rally the day after Christmas left the S&P 500 down nearly 10% on the year. This year's volatility and losses are particularly jarring after a stellar 2017 that delivered not only returns over 22% but also an entire year without losses two days in a row.

With the economy still growing at a healthy rate and numerous economic indicators still showing decidedly positive, why all the angst?

As we noted in past newsletters, the market seemed poised for problems given its departure from more fundamental measures that usually drive equity prices. Our system that rates stocks and industries on a "A" through "F" scale inverted this year with the F-rated companies outperforming the A-companies. This notably happened in 1999 and 2007 immediately before significant market corrections. From our perspective, many large company valuations, particularly those of the large technology companies, were departing from underlying economic drivers as investors drove prices up based more on enthusiasm than earnings fundamentals.

More recently, market volatility has been linked to Federal Reserve moves. In late December, the Fed raised rates despite President Trump's protests that a rate increase could hurt the economy. Disappointed investors sent markets down sharply. Making matters worse, after the rate increase, Fed Chairman Jerome Powell defended the Fed's actions citing numerous reasons that the Fed felt the economy was strong enough to warrant

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the increase. Instead of reassuring investors, his comments kicked off further panic as investors worried that the Fed seems intent on future rate increases.

Yet, a yield curve like today in which the spreads between 10-year and either 2-year or 3-month rates has also been a poor future indicator. During the 1990s, this stage was reached several times and no inversion or recession followed. When levels reached this stage in 2005, the next two years provided a great time to own stocks. Other similar shaped curves occurred before each of the past seven recessions, but the yield curve never inverted, and stocks gained in the following year in five of the seven instances.

It seems more likely that the rate increase kicked off losses because investors already fear many other ongoing developments. The supposed trade truce between China and the U.S. is beginning to look more like a vague agreement to do nothing concrete. In early December, a seldom watched portion of the Treasury yield curve inverted for the first time in more than a decade as 2-year note interest rates surpassed those of 5-year notes. Already nervous investors tanked markets, and technical measures broke through 50-day and 200-day moving averages in the S&P 500. Both events are seen by traders as ominous for future market returns. Housing markets reported troubles and Toll Brothers, a high-end builder, reported results highlighting softening fundamentals. Various tech companies ranging from Apple to Square to Advanced Micro all cut forecasts while issuing pre-announcements suggesting slowing sales for large tech companies. The near death of the seemingly never-ending Brexit negotiations raised prospects for a "hard" exit which would eliminate Britain's preferential trade status with the EU hurting both Britain and Europe.

Looking forward, U.S. growth is expected to remain positive, although it will possibly drop as low as 2% for 2019. Growth of the Eurozone is expected to log only 1.5% growth for 2019 and Japan is projected to be flat for the year.

Yet, while many trends seem less positive, the overall economic picture remains solid. The Fed rightly pointed out ongoing strong GDP growth, revised down a tenth for third quarter, but still strong at 3.4%. Personal consumption, a big driver of the economy, dropped only a tenth and remained very solid at 3.5%. Various combinations of personal income and

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spending appeared firm and consumption for fourth quarter should also be firm. The strong consumer message was reinforced by better than expected University of Michigan sentiment numbers that rose from 97.5 to 98.3.

The U.S. also achieved energy independence for a week during the last week of November, and earlier this year, the U.S. eclipsed Saudi Arabia and Russia as the world's largest oil producer. The ISM manufacturing index also suggests the economy may not be slowing as much as expected, and the strength of new orders is particularly encouraging.

Despite seeming economic strength, recent volatility suggests that investors believe a recession is imminent, yet seemingly no one is actually predicting one. Like many other firms, J.P. Morgan economists put recession probably at only 21%, or below the probability recorded in 2016. UBS analysts Pierre Lafourcade and Arend Kapteyn note that data over the last four quarters in the U.S., Eurozone, and Japan are completely incongruous with any of the recessions that have taken place since 1980. More specifically, Japanese employment is marching steadily higher, while investment in the Eurozone is increasing, both inconsistent with previous downturns. Within the U.S., productivity growth and consumer spending both have increased which historically does not happen before a recession. In fact, worker productivity growth in the second and third quarters was among the best of the current expansion. Simply, most economic trends don't fit with patterns that presaged previous downturns.

While the market is struggling to interpret numerous conflicting signs often associated with an increasingly late stage economic expansion, we remain both optimistic and very cautious. Underlying economic strength and lack of traditional recession signs suggest that 2019 should be a solid year. Still, we remained concerned about overly optimistic earnings estimates according to our measures. Analysts polled by S&P Global Market Intelligence predict equity earnings for the S&P 500 will grow 13.3% a year for the next three to five years. At the end of November, analysts were also more optimistic than at almost any time in history. By any realistic calculation, we believe the earnings growth projections are an impossibility. Unfortunately, the more optimistic analysts are, the more good news is baked into stock prices, and the easier it is for even marginally bad news to send stocks tumbling. Against this backdrop, it seems likely that 2019 will remain volatile. The underlying economy appears solid, but numerous negative trends and a highly valued market will likely cause already skittish investors to panic easily.