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1st QUARTER OUTLOOK

The Bear Awakens

In October of 2017 we gave a presentation in which we made the case that investment returns would be harder to come by as we moved into 2018 and beyond. Our feeling was that much of the benefits from lower taxes and deregulation had been pulled forward in 2017, illustrated by the fantastic returns in stocks. Yes, corporate earnings were growing at an impressive clip, but share prices were growing even faster. Thus, valuation, which was once the rallying point for the bulls, was now becoming less attractive, and one might even say a bit expensive. Indeed, now stocks were trading at 18 to 19 times earnings, which again was not necessarily terribly expensive (remember the exorbitant levels that we reached by March of 2000), but certainly stocks were not cheap anymore. So, starting from these levels, we reasoned that valuation would become a headwind in the coming years.

> *"As January was historic on the upside, December was historic to the downside."*

Added to the outlook for muted returns in stocks, would also be the less than stellar outlook for bonds. The more than 35-year bull market in bonds was coming to an end. The Fed had changed course and were now on a path to "normalization" via rate hikes and balance sheet reduction. This would certainly put pressure on bond prices over the long haul (not to mention the mountain of domestic and global debt that had developed). And, even though the Fed was raising short term rates, they weren't going to raise them high enough to satisfy all investor income needs. Alas, the bond market was in a predicament. Prices couldn't go higher, yet yields wouldn't go much higher either given the possibility of a slowdown in global growth.

Add to the outlook for pricing dynamics of stocks and bonds, the headwinds of a hawkish Fed, a less than stable political environment, trade war concerns, and possibility of a global slowdown in growth, and the chances were good that investment returns for 2018 and beyond were going to be harder to come by than they had been in the past 8 or 9 years.

2018

2018 was an interesting year to say the least. We began the year and then ended the year with historic months with regards to market returns. First, January came in like a lion. Stocks rallied right up until the last few days of the month, catching us (and others) a bit

by surprise. Near month's end stocks had tacked on a nearly 6% gain. But, as we moved into February all hell broke loose. Stocks not only gave up those January gains, but from the late January highs, they fell more than 10%. By mid-February, stocks were sporting a nearly 4% loss for the year and January's remarkable surge was all but forgotten. Over the next several months and into early summer, the market averages worked their way back towards the breakeven level and by the end of the second quarter most everything was flat for the year.

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The third quarter of 2018 probably surprised us even more than January did as stocks roared to post new all-time highs in the S&P. All this despite building headwinds which included a hawkish Fed whose Chairman seemed intent on staying the course to neutral for the Fed Funds Rate on what seemed to be a predetermined path. Also, an election was coming in November and political change was likely. Finally, the President had seemed to go all in with regards to China, thus tariffs and trade wars were creating a singularly ominous dark cloud on the horizon. None of this seemed to matter in the stock market- well, until it did.

Indeed, it did matter as we rolled into the first trading days of the new quarter. Stocks fell drastically in October, recovered some in November, but then plummeted in December. As January was historic on the upside, December was historic to the downside. In the end, stocks were down more than 6% for the year, as a bear market had reared its ugly head. When all was said and done, 2018 was a difficult year for stocks, which again, given the headwinds in the market's face, did not take us by surprise.

Cyclical vs. Secular Bear Market

We entered 2019 in a bear market. What we don't know is what type of bear market we are dealing with. Is this a cyclical bear market within a long-term secular bull market? If so, then it would be somewhat short-lived, months not years, and at some point will find support, build on that support, and eventually move back towards new all-time highs. The lows that we hit on Christmas Eve of last year might have been "the" low. If so, after a series of test, stocks could grind higher, recapture support levels, clear moving averages, and resume the long term secular bull market trend. So far, as we are early into the new year, it appears that we are testing the theory that what we just experienced is nothing more than a cyclical bear market and that the worst may already be behind. Yes, it was viscous and nasty, but perhaps it will be short-lived.

On the other hand, (that sounds like an economist, doesn't it?) what if we have begun a secular bear market. Well, first of all, that would likely be accompanied by a viscous recession, and we don't have that at the moment. But, let's explore a secular bear market for what it is. In a secular bear market, stocks would continue to set lower lows and lower highs on each swing. As mentioned, the economy would stall and negative sentiment would continue to feed on itself, creating a continuously worsening situation.

As mentioned earlier, we have acknowledged the headwinds that investors have and will continue to encounter.

But, for the moment we don't necessarily see those headwinds careening us into a secular bear market. Yes, we have expectations of muted returns, but that's different than a secular decline that could last a decade.

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Economy

As we enter 2019, the stock and bond markets are flashing neon warning signs about the economy. Indeed, both the manufacturing and service sectors data are beginning to reveal some cracks. In addition, housing numbers have been weakening and sentiment numbers have turned down for the first time in a while. On the other hand, (who let that economist in again?) December's jobs data could not have been better. 312,000 new jobs were created last month. The unemployment rate did tick up to 3.9%, but that is only because the participation rate improved. The participation rate measures those actively looking for a job, and the robust jobs market continues to bring people who were out of work and had given up on finding a job, back to the workforce. In addition, wages continue to rise at a modest but deliberate pace, meaning people are getting paid more, but not so much that it would become inflationary.

This mixed picture led to a lot of anxiety with regards to the Federal Reserve and their normalization program. The Fed has been raising the Fed Funds rate at the same time they are reducing their balance sheet. The markets were content to accept this somewhat predetermined monetary policy as long as the economy was posting stellar growth numbers, but as trade wars loomed and concerns mounted, market participants began to detect the potential for an economic slowdown. This could become a problem as growth would be slowing as the Fed was tightening. The Fed Chairman Jerome Powell made attempts to explain the Fed's data dependency, but markets sensed that the Fed Chair just didn't understand what was happening. Finally, the Fed Chair strung together the right words to appease the markets last week, and stocks responded with a quick early January rally.

Now that the Fed appears to have capitulated, it's up to the economy to prove or disprove itself. Despite some expected weakening, it will be curious to see if the economy falters as badly as stocks and bonds seem to have been predicting. Yes, the stock market is a leading indicator, but as we often mention, it is not always correct in its predictions.

Stocks and Bonds

We've already discussed how difficult 2018 ended up being for stocks. As we enter 2019, we do so at more attractive valuations. Of course, as we measure valuation as the price vs. earnings (P/E ratio), we acknowledge that obviously share prices have come down over the past 90 days. But, the share price is only half of the equation. The other half is corporate earnings. Stock prices are only cheap if earnings estimates turn out to be accurate. If on the other hand, economic activity drastically slows, corporate earnings would surely be affected. So, if earnings numbers are suspect, then declaring that stocks are cheap could turn out to be inaccurate. We are entering a very interesting corporate earnings season, not only because of the numbers companies will reveal, but more so their commentary on the future. It appears that corporate leadership has been affected by the negative change in sentiment, and how they express

their concerns will set the tone for the markets as we proceed through the first quarter. As always we will be very interested to see how share prices react to these corporate disclosures. What is priced in, and what is not?

Bonds did all they could last year to confound market participants. Rates did rise a bit at the beginning of the year, but by year-end the 10-year Treasury Note was yielding around 2.60%. So, instead of a year where Fed tightening would cause rates to rise, the yield curve flattened. Sure, the Fed raised short term rates, but longer term rates come down to meet them. As we know, an inverted yield curve, one where short term rates are higher than longer term rates, is usually a sign that the economy has already turned down or is about to. The bond market has been skeptical about this economic advance that we have seen for some years now. That, and the pressure of lower rates around the world, has kept yields down for an inordinate amount of time here in the U.S.

Will the action in both the stock and bond market over the last quarter of 2018 end up being correct in its prediction of slower economic times ahead? Of course, we will find out over the coming quarters, but as we mentioned, their predictions are often incorrect.

Summary

We enter 2019 in a bear market. What type of bear market it is remains to be seen. If, indeed, this is no more than a cyclical bear market that is part of a secular long term bullish trend, then perhaps December 24, 2018 marked the low. We would like to see that low tested a few times and for it to hold before we would declare victory as such. Actually, successful tests of the lows would be healthier in the long run than simply going straight up from here. In the meantime, we will be watching the upcoming corporate earnings season very closely. What companies say will be even more important than the numbers they report.

Sentiment is a very strong thing. Just as positive sentiment helps stimulate an advance, negative sentiment fuels a decline. Indeed, we might talk ourselves into a slowdown. Markets also influence behavior. The wealth effect is powerful. If your investments are down in value, you feel less secure. You decide that you don’t really need that new car, or the new washer and dryer. You can go without for now. That thinking actually fuels the slowdown. So, markets and sentiment will be key as we try to determine the course of the economy in 2019.

As we talk about all the time, bear markets are part of the process. Without them stocks would carry no risk premium and there would be no money to made in owning stocks. Bear markets and volatility is the price we pay to board the ride that takes us down the path to our financial success and security. Our job is to get you through bear markets without making dumb mistakes. As the old saying goes, you make your money during a bear market, you just don’t know it at the time.

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. Please don’t hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, who may be going through a life changing event such as divorce, inheritance, selling a business, or retiring soon, be sure to let us know.