MARKET ENVIRONMENT

STRATEGY ASSET MANAGERS

Unfortunately, our comment in last quarter's OUTLOOK that "While **not a likely near term event**, the Federal Reserve may be the eventual candidate to take the punch bowl away via overly aggressive interest rate hikes" turned out to be true a lot sooner than we expected. On October 3rd, Federal Reserve Chairman Powell declared that interest rates were "… a long way from neutral…" While continued gradual interest rate increases were well telegraphed by the Federal Reserve, Mr. Market decided that the Federal Reserve's forward intent had gotten out of line with economic realities. The ongoing trade tensions with China combined with growing signs of a global economic slowdown provide evidence that perhaps the Fed should pause/slow forward interest rate increases. Looking back, the S&P 500 index was near its all-time high on Oct. 3rd and began its descent the next day despite relatively strong company earnings reports during the quarter. Consequently, market volatility (as measured by the VIX) increased, averaging 19.2 for the quarter versus 15.1 for the first nine months of 2018 and 11.1 for the relatively quiet 2017.

For the fourth quarter, the total return of the S&P 500 index fell a sizeable 13.5% resulting in a negative Year-To-Date total return of 4.4%. The non-US MSCI-EAFE index total return mimicked the US by falling 12.5% this quarter as signs of slowing economic growth in Europe and continued Brexit concerns combined with a 15% fall (in US dollars) in the Japanese Nikkei. The widespread steep declines across most major MSCI-EAFE markets this quarter resulted in an outsized decline of 13.3% for the year. Accordingly, our Global Equity index total return was -13.3% for the fourth quarter and -6.2% YTD. The US bond market, as measured by the Bloomberg Barclays Intermediate Government/Credit index, returned +1.7% for the quarter (+0.9% for 2018) as a flight to "quality bonds" bolstered fourth quarter returns as stocks fell.

From a total return sector perspective, Utilities (+1.4%) led the way during the fourth quarter with the only positive return among sectors as investors sought safety and yield. For all of 2018, Healthcare (+6.5%) joined Utilities (+4.1%) as the only notable positive sectors. On the downside, Energy led the way down for the quarter (-23.8%) and the year (-18.1%) as increasing supply worries fueled a drop in prices. Technology and Industrials were both down 17.3% for the quarter with China concerns the main culprit. Not surprisingly, 7 sectors were down double digits for the quarter and, somewhat surprising, 5 for all of 2018.

OUTLOOK

Remarkably, Fed Chairman Powell speaking after the Fed raised the fed funds rate by a quarter percent (to 2.5%) on December 19th stated "Where we are right now is the lower end of neutral."- a mere 2 ½ months and only one interest rate rise after his "a long way from neutral" comment. Concerns about China trade/tariffs, and visibly slowing China and European economic growth and possibly in the US as well, were apparently enough to change the Chairman's mind to a more flexible stance. In subsequent comments, he stated rates could be lowered and/or other tools could be used to stimulate growth if need be.

We bore you with these details because we believe the change in the Fed stance is an important change in conditions that may lead us back to the "Goldilocks" scenario as economic growth slows back towards 2% in the US in 2019 (current estimates center around 2.5%), unemployment remains stable (which at 3.9% is basically full employment) and the Fed's favorite inflation gauge remains around 2% (currently 1.9%). Quite frankly, we wondered at times what war the Fed was fighting (by consistently raising the funds rate by 2% over the last 2 years) as their mandate from Congress is full employment with stable low inflation (generally considered 2%). Of note, over the last month the change in the probability for fed funds in 2019 has gone from 39% for one 0.25% hike to a 24% chance that the Fed will lower once by 0.25%. Wow.

With the Fed going to the sidelines, the China trade negotiations have moved to the forefront of investor worries and the situation continues to hurt many international companies as well as investor sentiment. According to FactSet, earnings revisions for Q4 2018 during the course of the 4th quarter have lowered the earnings growth rate from +16.7% to 11.4%. In addition, the American Association of Individual Investors (AAII) Sentiment Survey (12/27/2018) showed bearish sentiment exceeding 50% for the first time since 2013.

With the approximately 20% drop in the S&P 500 index from its high during the quarter to the low, stock valuations have moved to the "cheaper side" of average at approximately 15x forward earnings. Additionally, the extreme bearish sentiment in the AAII survey has often preceded strong rallies as evidenced by the 2 year rally in the S&P 500 index from the Spring of 2013 until Spring 2015. We also believe that a return to a Goldilocks economic environment will provide a solid foundation for the stock market as earnings continue to grow, but will keep the Fed from murdering the economic expansion (to paraphrase former Fed Chairman Bernanke).

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Unfortunately, the China situation remains hard to handicap. Meetings continue between the two sides and pronounced slowing in Chinese economic activity may well force a faster settlement. News about the negotiations are certain to add volatility to the market, but without a settlement we believe the market can produce positive returns based on current valuations, a gentler Fed and earnings growth. A positive China trade result could significantly add to returns. Stay tuned.

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