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Fourth Quarter 2018 Newsletter

Fig. 1 – S&P 500

Fig. 2 – NASDAQ Index

U.S. stocks fell sharply in the fourth quarter of 2019, with most indexes finishing the year with losses, on fears of trade wars and slowing economic growth. The large cap S&P 500 index (**Figure 1**) posted a total return of -13.5% and finished the year -4.4%. The Russell 2000 Small Cap index fell -20.2%, ending the year -11.0%. Overseas stocks continued their weakness. Developed economies outside the U.S. dropped -12.5% and emerging markets fell -7.9%. The technology-heavy NASDAQ index, which has been a leader through much of this bull market, dropped -17.4% in the quarter, and briefly entered an official bear market when it closed -20% from the high set earlier in the year (**Figure 2**).

Corporate earnings grew again in the third quarter. S&P 500 earnings rose +26%, topping both 2nd quarter earnings of 25.4% and analyst expectations for growth of 19.3%. Revenue grew +9.3%, a slight decrease from the prior quarter's +9.8% rise. 77% of S&P 500 companies topped earnings expectations. These results indicate a solid corporate earnings picture. However, these results were largely ignored as stocks fell. Investors were more concerned with the slower growth expected in 2019. 2018's growth was boosted significantly by the newly implemented corporate tax cuts. Current projections call for 2019 earnings growth of +8.9%. Market watchers will be focused on company guidance this month. Given recent negative sentiment, any signs of weakness may lead to further stock selling.

Economic news in the quarter was mixed. Gross domestic product grew 3.4%, a step down from the 2nd quarter's +4.2%. GDP is expected to slow to 2.4% in the fourth quarter, and closer to 2% in 2019. This slowing is expected to continue in 2019, which is one of the factors weighing on stock markets. Housing starts remained soft, particularly for single family homes. This has been a concern for the past two quarters: housing is often a leading of economic softness. Purchasing manager surveys early in the quarter were strong, but some readings in December were weak, again suggesting slower activity in 2019. However, consumer spending remained robust, as employment is strong and consumer debt costs are much lower than ten years ago. This is critical, as the consumer segment comprises 70% of our economy.

Headlines once again dogged investors in the fourth quarter. The ongoing trade dispute with China was a significant concern, although, as of this writing, there have been reports of progress. Tariffs on imported steel and aluminum have begun to impact U.S. manufacturers, and this may be more of an issue for 2019 earnings. The Federal Reserve raised interest rates again in December. This was widely expected, although some had hoped that they would hold off, given recent stock market declines. Instead, commentary from Chairman Powell about future rate increases further spooked investors, sparking a sharp sell-off late in the quarter. In addition, our government has been partially shutdown due to a

Index returns taken from Morningstar.com

budget standoff. In the last week, stocks recovered somewhat from their lows, after the Trump administration affirmed the independence of the central bank. In two days, the Dow Industrials logged its biggest single day point increase, and then one of its largest single day recoveries. This market action may help to bolster fragile investor emotions.

Bond investors were rewarded for their patience with modest gains in the fourth quarter. The Bloomberg Barclays U.S. Aggregate Bond Index rose 1.6% to finish the year flat. Traders sought the relative safety of bonds as they sold stocks, pushing down long-term bond yields (**Figure 3**). Looking ahead, with slower growth expected and inflation remaining within the Federal Reserve's target range, interest rate increases are likely to be further apart. This should help bonds register positive returns in 2019.

International stock markets were weak again in the fourth quarter, although emerging markets lost less than their U.S. counterparts (**Figure 4**). China, the 2nd largest world economy, shows significant signs of slowing, after years of rapid growth. By contrast, India appears set to accelerate, aided by lower energy costs. Europe also appears to be slowing, just as the European Central Bank ends its accommodative monetary policy. We have generally held that an international allocation is important for stock portfolios. However, we recognize that foreign stocks may continue to underperform in the near term, and that patience may be required to reap rewards from these sectors.

Recent market declines, coupled with forecasts for slower growth, have left investors concerned. If a recession is imminent, further stock losses would be likely. However, with employment and consumer spending strong, and further interest rate increases less likely, the economy may slow without falling into contraction. In addition, stock valuations are much more attractive than at the beginning of 2018, as earnings continued to rise while prices fell. This may set the stage for gains later in 2019, though volatility may still be a factor, particularly early in the year.

Fig. 3 – U.S. 10-Year Treasury Yield

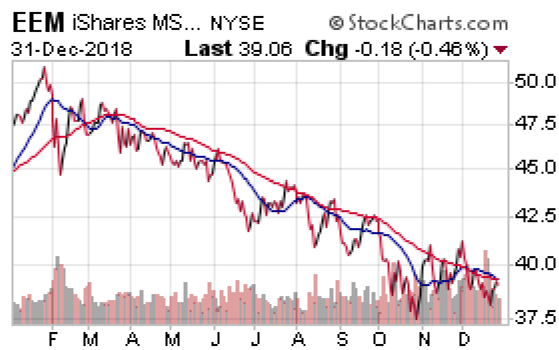

Fig. 4 – iShares Emerging Markets

We have long counseled that investors should maintain their stock positions through bad times to avoid selling during market declines. However, we recognize that your risk tolerance may change over time, and that may influence your feelings about the market today. We look forward to discussing this with you and encourage you to contact us at any time with your concerns.

We wish you and yours a happy and healthy 2019.

Sincerely,

Kenneth M. Bernard, CFA