Market Commentary

December 31, 2018

Through the first three quarters of 2018, the S&P 500 was up 10.6%, the US economy appeared to be firing on all cylinders and all was right with the world. Then the fourth quarter happened. A combination of rising trade tensions, economic weakness in Europe and China, and hawkish Fed rhetoric were too much for stocks to bear. The S&P 500 was down 6.8% in October, despite solid economic data. Stocks tried to rebound in November with modest positive gains. But the floor fell through in December.

Despite the decline in stock prices and mixed economic reports, the Fed followed through on its highly-telegraphed December rate hike. However, the consensus expectation was for a "dovish hike." In layman's terms, a dovish hike means that the Fed would raise the federal funds rate, BUT the Fed would express great remorse for the hike and promise not to raise rates again for a LONG time. But that is not how events unfolded.

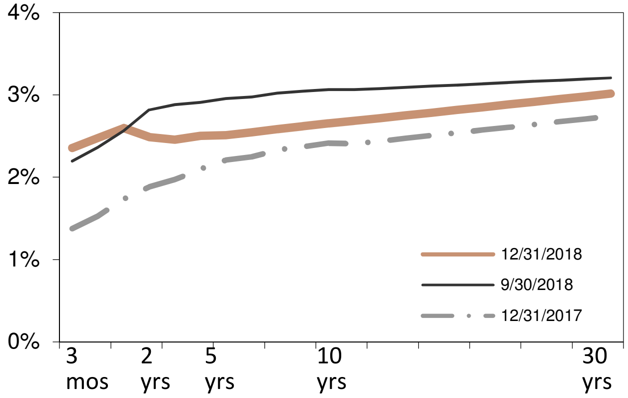
Instead, Fed Chairman Jerome Powell learned the hard way that seemingly innocent, "off the cuff" comments can lead to violent market spasms. In addition to the Fed "dot plots" warning of more rate hikes in 2019, Powell said he wasn't concerned about the pace of the Fed's balance sheet run-off, and that it would continue to run on "auto pilot." Mr. Stock Market was none too pleased. Stock market investors were apparently far more concerned about the rate of balance sheet runoff than Mr. Powell, and they demonstrated their displeasure by hammering stocks.

The S&P 500 fell 9.0% in December, resulting in a Q4 return of -13.5%., the worst quarterly performance for the S&P since 2011. In Q4, Large Cap (-13.8%) beat Small Cap (-20.2%), Value (-11.7%) outperformed Growth (-15.9%), and the international Emerging Market sector (-7.5%) was the place to be in Q4. Every US sector had a negative return in Q4. Energy (-13.3%) and Financials (-12.8%) were hardest hit in the quarter. For the year, only three sectors managed positive returns: Health Care (6.5%), Utilities (4.1%) and Consumer Discretionary (0.8%).

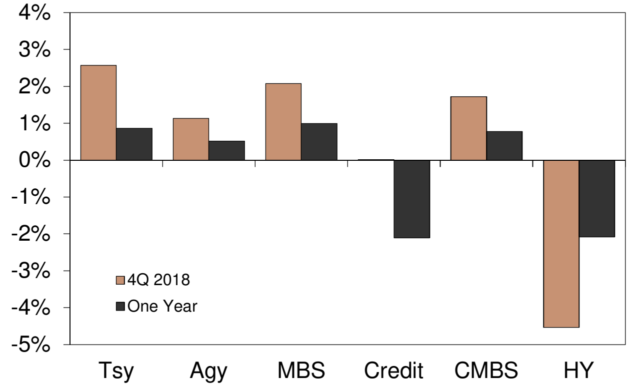
The 10-year US Treasury was at 3.06% on 9/30/18, and hit a high yield of 3.24% on 11/8/18. Then the stock market swoon and fear of an overly hawkish Fed caused investors to scramble for the safety of US Treasurys. 10-year yields fell like a stone, ending the year at 2.68%, and eventually bottomed out at 2.55% in early January. The Barclays Aggregate Index returned 1.64% in Q4, pushing the 2018 return to a barely positive 0.01%.

The Federal Reserve has hiked rates nine times since 2015, and policy makers in Europe and Japan are slowly winding down their accommodative monetary policy programs. For the first time since the Great Recession, world central banks are now in net tightening mode. Financial markets have swung from $2.1 trillion of global quantitative easing in 2017, to a net quantitative tightening. This enormous evaporation of worldwide liquidity helps explain the underperformance of risky assets outside the US and it is now impacting US financial markets.

US Treasury Yield Curves



Sector Index Returns



The Fed and Chairman Powell have faced great scrutiny over the past few months. Powell has been accused of being tone deaf, seemingly determined to continue raising rates in the face of weakening economic data, faltering stock prices and a lack of inflationary pressures. After the stock market route, Powell appeared to back pedal, sounding much less strident regarding future rate hikes. Market expectations of 2019 Fed rates hikes have changed dramatically over the past several months. At one point, as many as four rates hikes were expected in 2019. Currently, the market has priced in zero hikes, with the small probability of a rate CUT in late 2019.

The Q4 stock market sell off has certainly improved equity valuations. While 2019 earnings estimates are currently being slashed, stocks look much less expensive that they did a quarter ago. In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. For the past several weeks, in expectation of higher rates, our client portfolios have maintained average maturities that are shorter than their respective benchmarks. While this defensive posture did not pay off in Q4, we believe that the US economy is on solid footing and rates are likely to drift higher in Q1 2019.