Investment Update

January, 2019

2018 Fourth Quarter Update and 2019 Outlook

Review: The S&P 500 declined 13.5% in the fourth quarter, erasing the gains for the year. Formerly negative fixed income returns turned positive, as investors sought safety in bonds. International equities fell less than the S&P 500 but were unable to make up significant underperformance from the prior three quarters. As expected, the Federal Reserve raised its target rate to 2.25-2.50% at the December meeting.

Period	4Q18	3Q18	2Q18	1Q18	2018
S&P 500	-13.5%	7.7%	3.4%	-0.8%	-4.4%
MSCI EAFE[1,2]	-12.5%	1.4%	-1.0%	-1.4%	-13.4%
MSCI Emerging Markets[2]	-7.4%	-0.9%	-7.9%	1.5%	-14.3%
Barclays U.S. Aggregate Bond	1.6%	0.0%	-0.2%	-1.5%	0.0%
Barclays Municipal Bond	1.7%	-0.2%	0.9%	-1.1%	1.3%

[1]Europe, Australia, Far East

[2]MSCI returns are in U.S. Dollars

What Led To The Equity Market Selloff?

- Escalating U.S. - China trade tensions would potentially further impact global trade.
- The magnitude and speed of falling commodity price declines were seen by some as an indication that global economic growth was decelerating faster than expected.
- Concern that the number and pace of Federal Reserve interest rate increases might trigger a U.S. recession.
- The market interpreted the flattening of the U.S. yield curve as a sign that the risk of a recession in the U.S. was increasing.
- Unresolved political gridlock in Washington could possibly preclude further fiscal stimulus if needed.

All of the above contributed to rising concerns about 2019 earnings growth and how best to value those earnings to properly incorporate market risks.

What Does History Tell Us?

Stock market moves by themselves do not necessarily inform us about future economic conditions. Since World War II, and including the 20% decline peak to trough during the fourth quarter selloff, there have been 15 official bear markets (defined as a 20% decline in the S&P 500 stock market). However, as shown in the table below, only half of these bear markets were associated with recessions:

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S&P 500 Index Bear Markets Since WWII

Month of Peak	Month of Trough	% Decline	Recession?
05/1946	05/1947	-29%	No
08/1956	10/1957	-22%	Yes
12/1961	06/1962	-28%	No
02/1966	10/1966	-22%	No
12/1968	05/1970	-36%	Yes
01/1973	10/1974	-48%	Yes
09/1976	03/1978	-19%	No
11/1980	08/1982	-27%	Yes
08/1987	12/1987	-34%	No
07/1990	10/1990	-20%	Yes
07/1998	08/1998	-19%	No
03/2000	10/2002	-49%	Yes
10/2007	03/2009	-56%	Yes
04/2011	10/2011	-19%	No
	Avg (All)	-31%	
	Avg (Recessions)	-37%	
	Avg (No Recession)	-24%	

Source: Wall Street Journal, 1/02/19 (original source cited as LPL Research, FactSet 12/20/18)

Outlook: Based on current fundamentals, we do not foresee a recession in 2019. There are three factors, among others we are monitoring, that we continue to prioritize: 1) 2019 expected U.S. economic and corporate earnings growth, 2) Federal Reserve intentions and 3) international economic growth.

Current U.S. economic fundamentals still appear to be solid. According to FactSet consensus estimates, fourth quarter U.S. GDP is expected to be 3.1% as a strong job market continues to support consumer spending, the primary driver of U.S. GDP growth. Benign core inflation should give the Federal Reserve the latitude to pause in raising rates should the economy require it.

Non-U.S. economic growth remains soft and disparate: Eurozone fourth quarter economic growth is expected to be only 1.4% and Japan 0.3%, with no acceleration in 2019. Emerging Markets are expected to have the best relative fourth quarter growth at 5.0%; however, maintaining this rate of growth is highly dependent on China, which continues to transition its economy from highly capital-intensive infrastructure spending to less stimulative consumer spending.

Consensus estimates for the S&P 500's 2019 earnings growth are currently in the mid to high single digits, which would be at or above its long-term trend line. Due to the recent sell off, the forward P/E ratio has declined from 18x to 14.5x and now offers more attractive valuations. International equity fundamentals are not as supportive of earnings and lack a catalyst to generate outperformance versus U.S. equities.

Strategy: We continue to favor domestic equities in the near-term. Given the solid economic fundamentals in the U.S., we believe the fourth quarter selloff was overdone and has provided opportunities to add to quality stocks with strong fundamentals at attractive valuations. We will continue to monitor economic and market indicators. In fixed income, although the Federal Reserve has indicated more openness to pausing in raising rates, we continue to prefer shorter maturity bonds for their ability to generate reasonable income for reduced interest rate exposure.