MARKET UPDATE
DECEMBER 26, 2018

Despite what was a positive year for U.S. economic growth, corporate profits, and consumer and business confidence, 2018 has turned out to be a challenging year for financial markets. The past few weeks were supposed to be a positive seasonal time of year for equity markets, but stock prices have weakened considerably since peaking in late September 2018. Over the past few months, investor psychology and market technicals have changed course significantly due to trade disputes with China and fears that the Federal Reserve Bank may tighten policy too much and send the economy into recession. Questions about political leadership in Washington, problems in Europe (i.e. Brexit, populist uprisings in France and debt concerns in Italy) and concerns about rising U.S. debt levels have also weighed on financial markets.

It's hard to pinpoint one main culprit for the market's recent swoon. Instead, it is probably the result of several of the factors highlighted above including the impact from market-based factors like hedge funds, algorithmic trading and risk parity funds all looking to suddenly reduce risk at the same time. Historically, the S&P 500 has experienced declines of 20% on average about every three years or so (source: Bloomberg). Therefore, after a nine-year bull market, you could say that we were somewhat overdue. While we would like them to, bull markets simply don't last forever.

As of the market close on December 24th, the S&P 500 has dropped 20.06% (since hitting its all-time high of 2940.91 on 09/21/18). With this 20%+ drop, the index has officially moved into bear-market territory, putting an end to the bull run that has lasted since a close of 676.53 on March 9, 2009. Other market indices have also found themselves in bear-market territory as well, including the Nasdaq Composite (down 23.86% from its 52-week high of 8,133.30 from 08/30/18) and the Russell 2000 Small Capitalization Index (down 27.28% from its 52-week high of 1742.09 from 08/31/18).

Over time, the performance of financial markets typically depends on fundamental factors such as sales, corporate profits, GDP, Fed policy along with the level of interest rates and inflation. Based on current estimates, GDP growth is currently forecast to rise about 2.4% next year (compared with around 3% in 2018), corporate profits are forecast to grow 5-8% next year (compared with around 21% in 2018) and the Federal Reserve Bank may raise short term rates a bit more before moving to the sidelines. Given the fact that inflationary pressures remain moderate (with several commodities like oil and copper declining in price) and market volatility has increased, we think that at a minimum, the Federal Reserve Bank should refrain from raising rates during the first half of the year until it becomes clear that the economy and financial markets remain on solid footing.

Right now, the market appears to be positioned as if a recession or sharp economic downturn is on the way. Looking at a number of different economic indicators, we believe that the probability of a recession in 2019 appears fairly low at this point (although the outlook can always change). Valuation levels have come down from more than 18x (on a forward 12-month PE level) to around 14x today, creating a more attractive backdrop for equity markets. If there is no recession ahead, then equities should start to stabilize (and ultimately rebound) before too long. It's hard to tell exactly when a durable broad-based rebound will take place. Equity markets currently appear deeply oversold (based on technical indicators such as the put to call ratio, upside versus downside volume, the percent of stocks trading below their 200-day moving average etc.…). This indicates that stocks are poised for at least a short-term rebound any day now.

In our portfolios, we currently favor large cap versus small cap stocks, are overweight the U.S.

versus foreign markets and favor high-quality blue-chip type stocks that (in most cases) are leaders within their prospective industries. At times like these, we understand that it may be challenging to stay the course. Having the right asset allocation which includes fixed income investments and alternatives investments (in some cases) are meant to help keep you on course to help you meet your long-term investment goals.

Investors may need to have more patience in the year ahead and we may have to live with higher volatility at this stage of the economic cycle. If economic data continues to come in close to expectations and some of the risks highlighted above can get resolved, this may ultimately set the stage for a more positive environment for equity markets as we head through 2019. Under that scenario, we are probably closer to the end of the current market correction (note: it's also possible that we may experience weaker economic growth as we head through the year). We will continue to stay in touch and share our investment commentary with you in the new year.

As always, if you have any questions please do not hesitate to reach out and give us a call.

Respectfully,

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Disclaimer:

MACD is short for moving average convergence/divergence. It is a trading indicator used in technical analysis of stock prices, created by Gerald Appel in the late 1970s. It is supposed to reveal changes in the strength, direction and momentum of a stock or index's price.

S & P 500 - The S&P 500 Index tracks the performance of 500 large capitalization companies that trade on either the NYSE or NASDAQ Market.

Russell 2000 Index - The Russell 2000 Small Cap Index tracks the performance of the bottom 2,000 stocks in the Russell 3000 Index.

Nasdaq Market - The Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange.

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