

# **CAPITAL MARKET REVIEW**

Fourth Quarter 2018



# The Economy

**The year was 1999**, I was an analyst for INVESCO and my boss asked me to go with him to meet with one of the firm's most senior portfolio managers. Our mission was to teach an old dog new tricks. We showed the gentleman lots of charts and data about how his investment process was out of touch with the market. He listened with more respect than we probably deserved and then he looked at my boss and said, "The market is wrong." Shortly after that meeting the senior portfolio manager was encouraged to retire. Four months later the tech bubble burst. Turned out he was right and the market had been wrong.

The market can in fact be wrong, and I believe it is wrong right now. However, John Maynard Keynes was also correct when he famously said, "The market can stay irrational much longer than you can stay solvent."

We had a market downturn in spite of record low unemployment and real wage growth. All signs are that the real economy within the US is actually doing very well. So what has the market so upset?

Tariffs. The December Institute for Supply Management (ISM) Manufacturing Index was weaker than expected. The number wasn't bad, although it was lower than the previous month, but when one read some of the surveys there is a theme. Business is on hold until we figure out this tariff situation. Markets are based on moods and emotions, and the trade talk has soured the moods of business leaders. Reality is now very likely to be better than the market is forecasting.

Investing is about balance. Balancing risk and return. Today the market is offering up a lot of short-term risk in return for some attractive long term gain. Finding the balance is what prudent investing is about.



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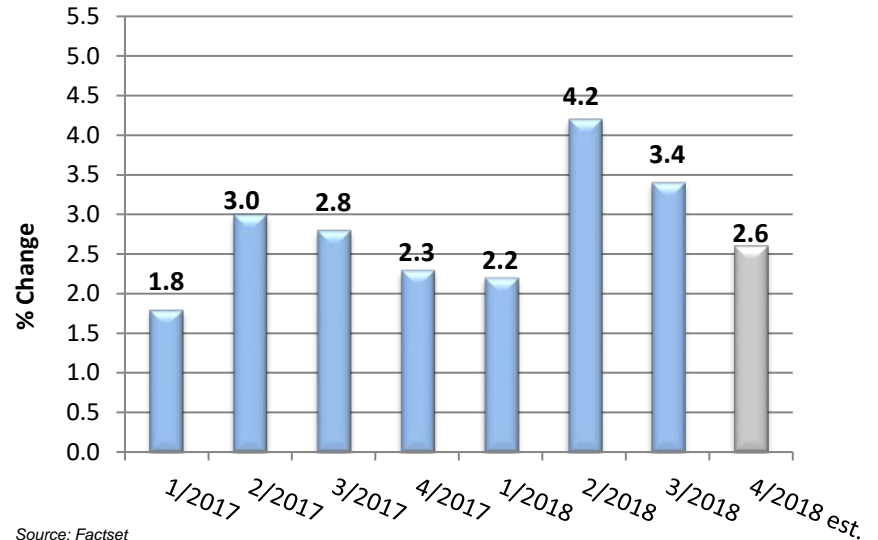
# The Economy

The 3<sup>rd</sup> quarter 2018 GDP growth came in at 3.4 percent which was after a 4.2 percent number the quarter before. The final quarter of the year is estimated to be a little slower, but this is the best sustained growth we have seen in the US in a very long time.

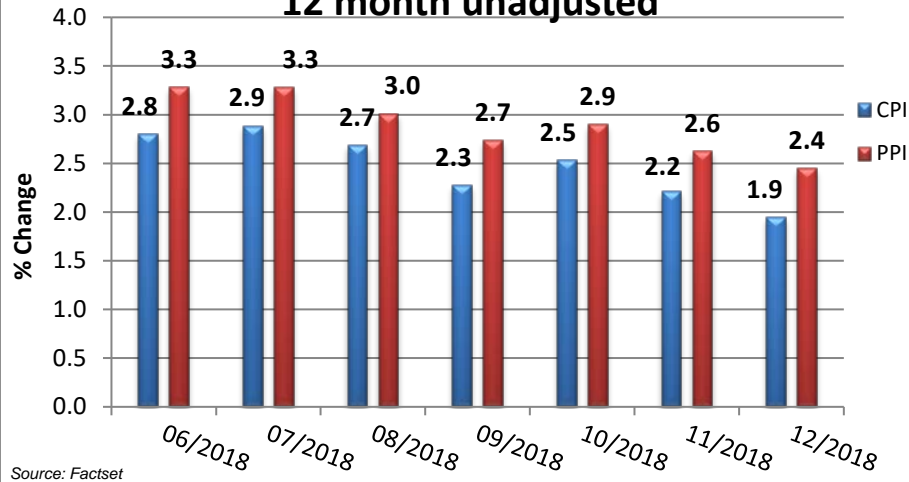
The official unemployment rate is 3.9 percent in August. This is the longest sustained under 4 percent rate since the 1960's. Wages are growing at more than 3 percent which means real wage growth.

Inflation is 1.9 percent based on the latest consumer price index report. That is a lower rate than earlier this year. Put all together, this is simply the best economy we have seen in my professional career.

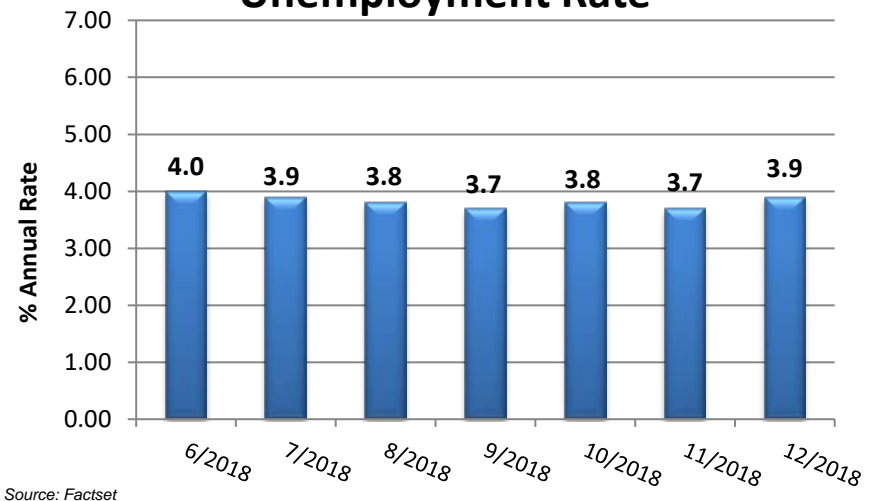
## Domestic GDP

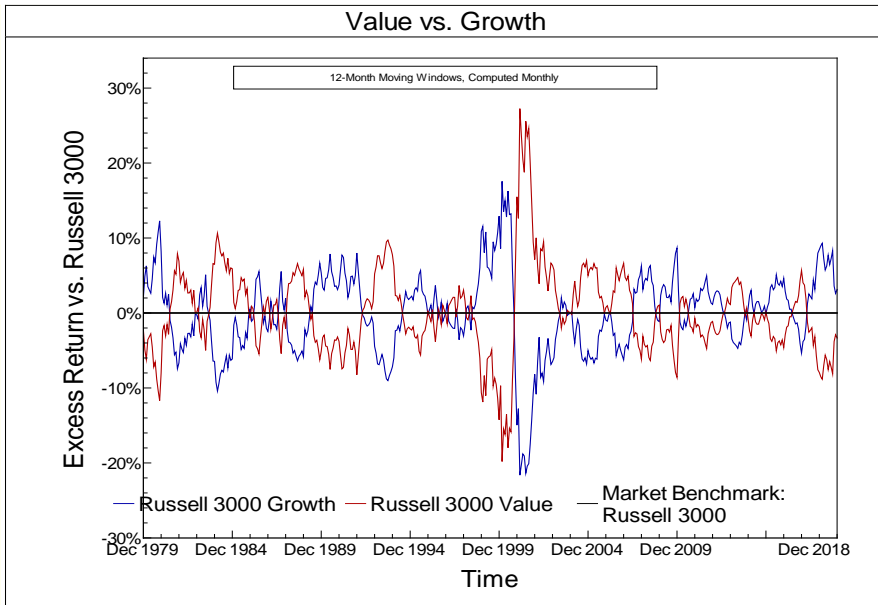
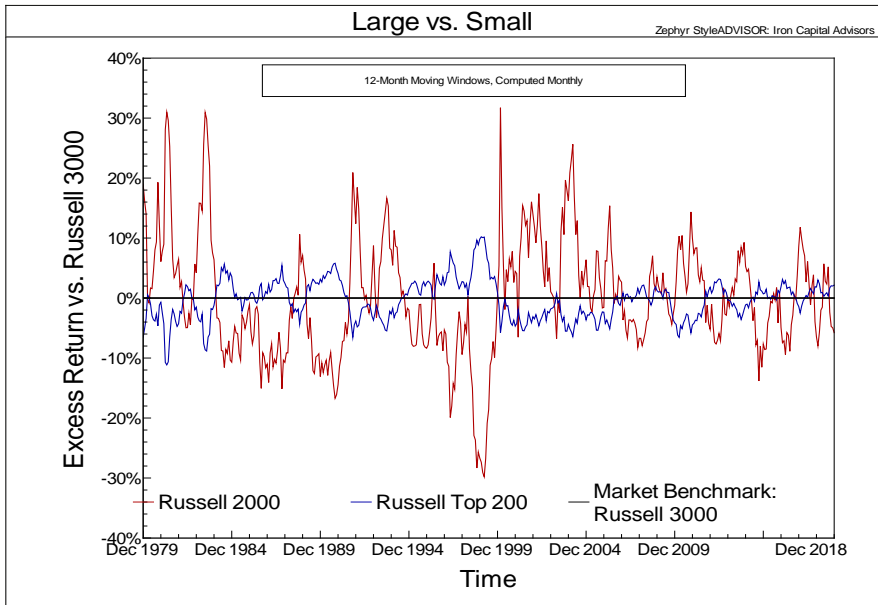
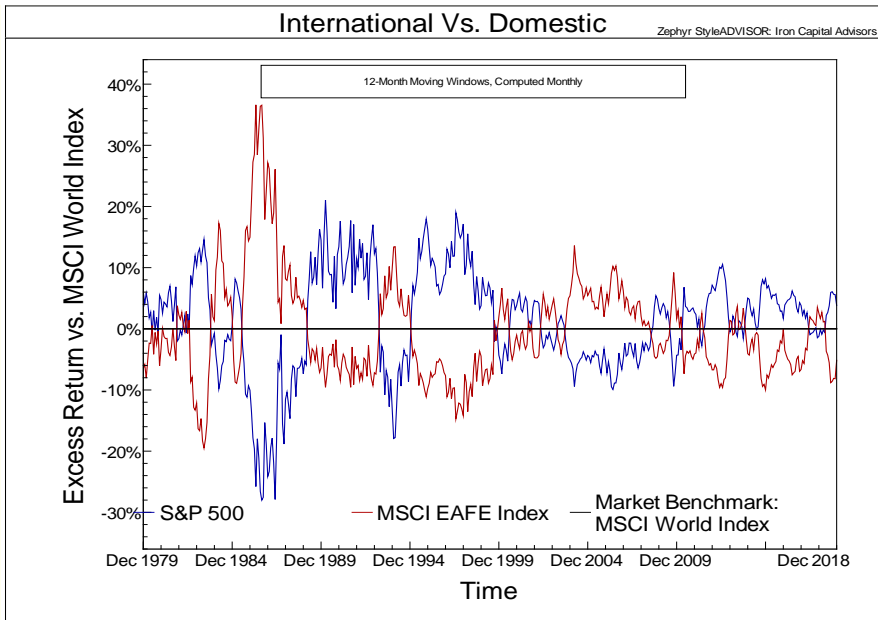
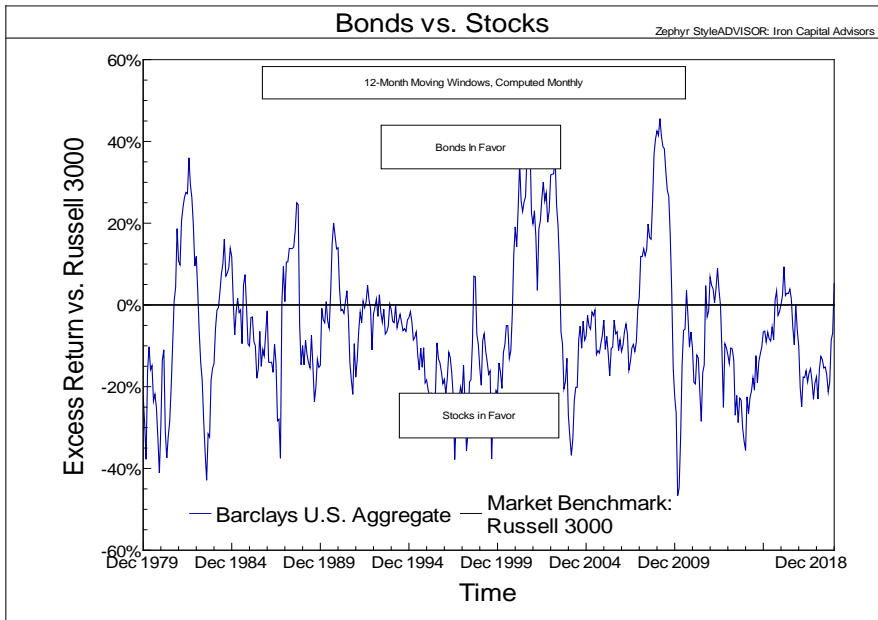


## Inflation Indicator 12 month unadjusted



## Unemployment Rate





# Domestic Equity Markets

**Markets plunge.** For the quarter, the S&P 500 finished down 13.52 percent and small company stocks represented by the Russell 2000 index were down 20.20 percent. Value actually did a little better than growth, but not by much. There was really no place to hide.

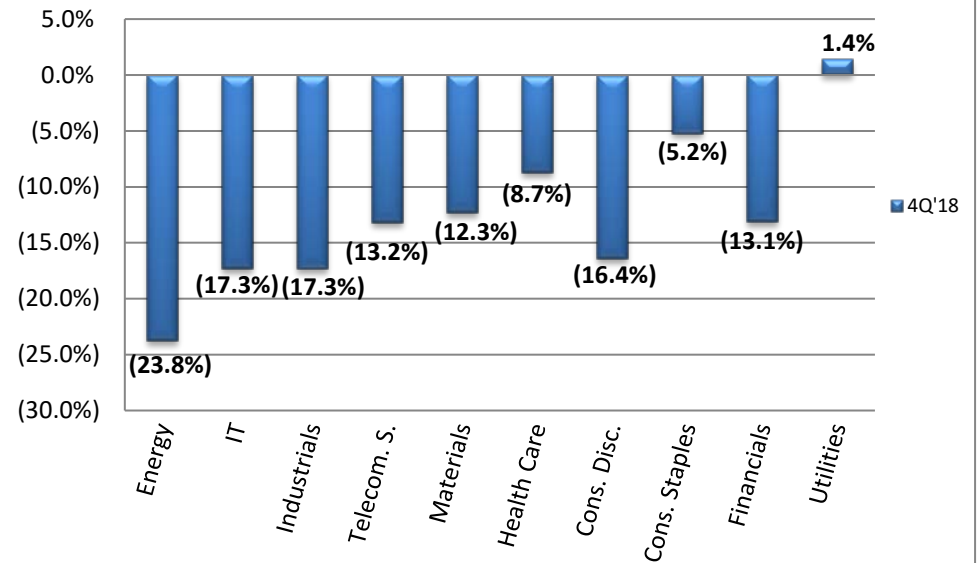
Energy was the worst place to be as pundits starting talking about the possibility of a recession. Technology was also hit hard, even though this is the one area of the market that tends to hold up during slowing economic times.

This quarter was just one of those quarters where no one was willing to be on the opposite side of a trade. Sellers hugely out numbered buyers and the market went down far more than any rational explanation could justify.

## Domestic Indices Three Months Ending December 31, 2018

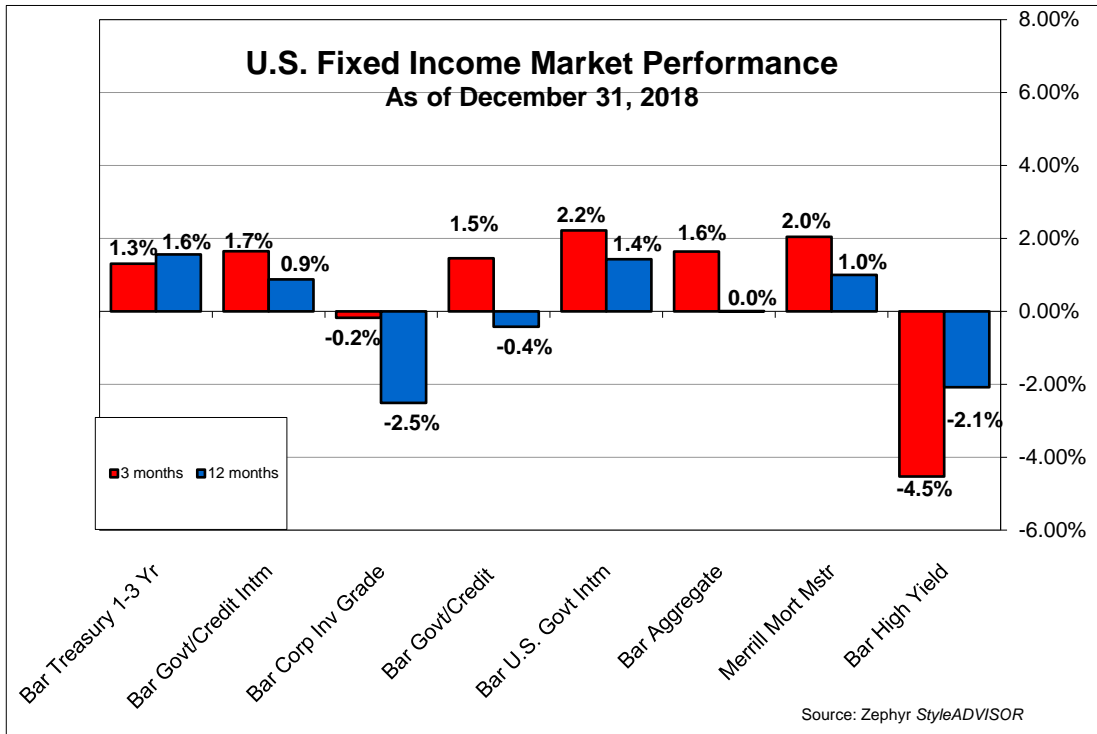
	Yield	Price/Earnings	Price/Book
S&P 500	2.06%	17.5	2.98
Russell 1000 Gr	1.30%	22.6	6.47
Russell 1000 Val	2.71%	14.3	1.85
Russell Midcap	1.84%	17.0	2.38
Russell 2000 Gr	0.69%	53.8	3.56
Russell 2000 Va	2.33%	17.7	1.24

## S&P GICS Sector Returns



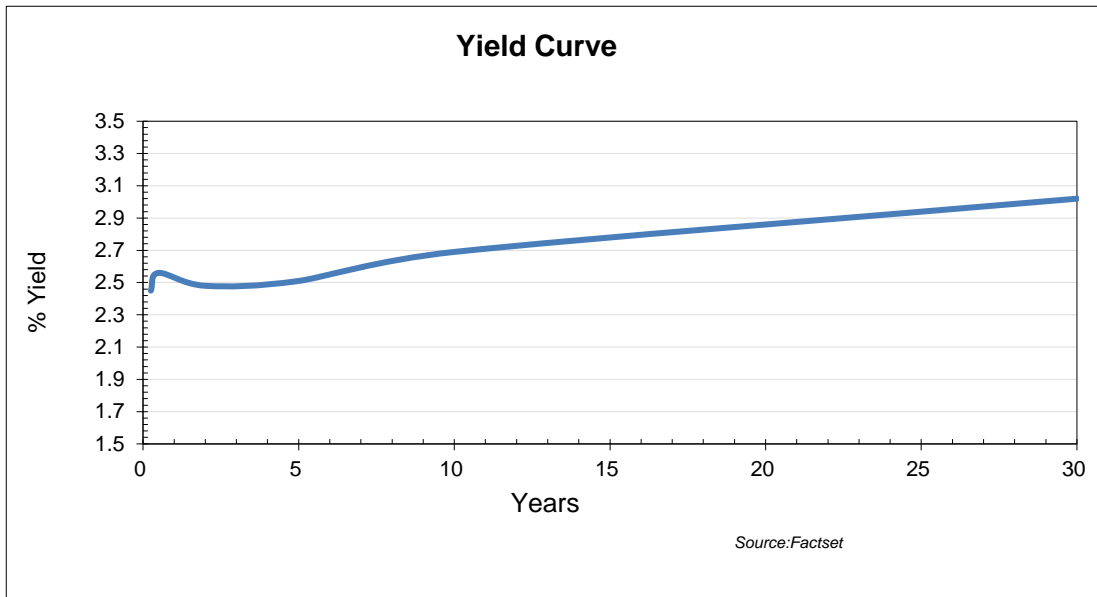
Source: Factset

# DOMESTIC FIXED INCOME MARKET



**Bonds did rally as stock prices fell.** The Barclays US Aggregate Bond index ended up 1.64 percent. High yield bonds, however, were down 4.53 percent.

Now we are right back to sub 3 percent yields. Bonds did their job in a downturn, but don't count on high returns going forward.



## Yield Curve as of December 31, 2018

Time to Maturity	Interest Rate
3 Month	2.45
6 Month	2.56
2 Year	2.48
5 Year	2.51
10 Year	2.69
30 Year	3.02

# INTERNATIONAL MARKETS

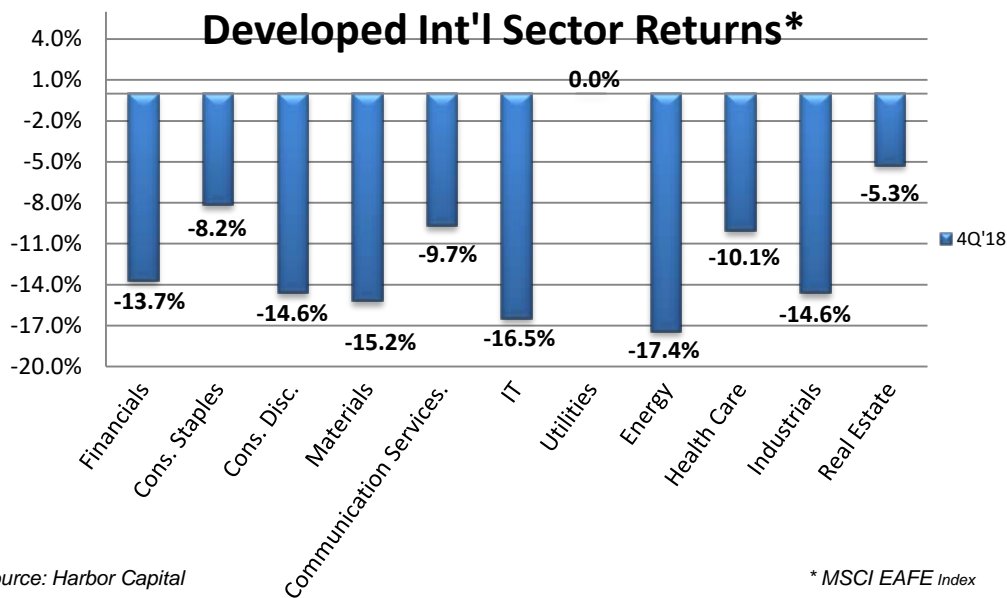
**International stocks suffered as well.** The EAFE index finished down 12.50 percent while the MSCI Emerging Markets index ended the quarter down 7.40 percent.

Europe's economy is showing signs of a slow down. PMI numbers have been dropping and other indicators like retail sales have also been disappointing. It is hard to know exactly how much of this has to do with trade tensions but that has to be part of it.

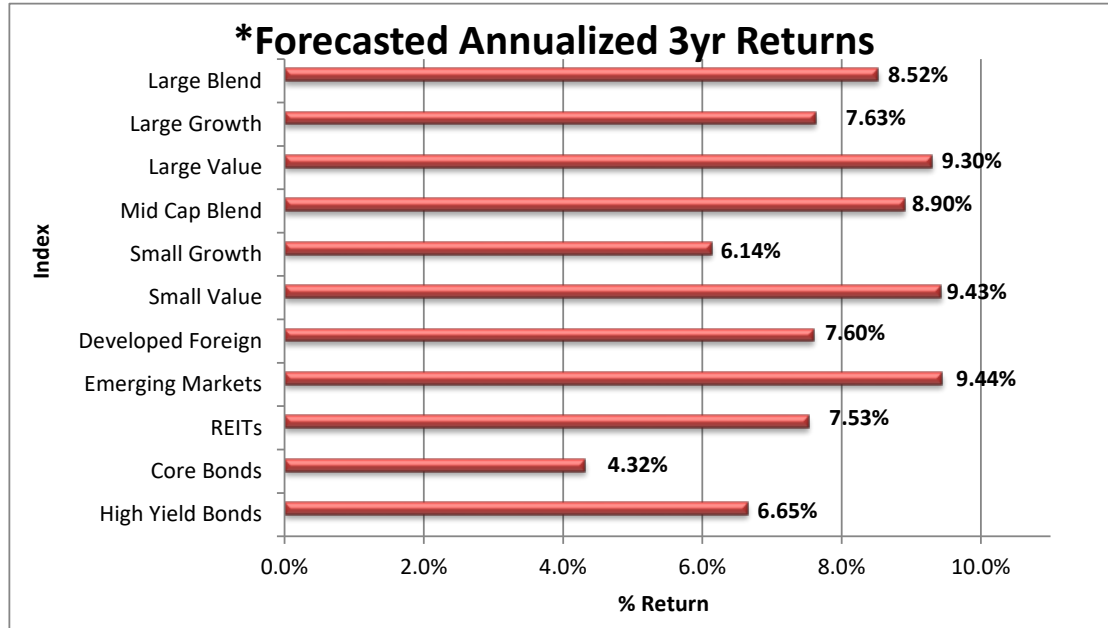
Interestingly, emerging markets held up better and have been leading the global markets relatively speaking. Yes, down less is not what most investors want, but this could be a sign that a market turnaround is near. Valuations are more attractive in emerging market than they have been since 2015. That led to two years of outperformance. We will see if that happens again.

## MSCI Country Returns Three Months Ending December 31, 2018

	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Austria	-20.72%	-19.44%	-1.28%
Belgium	-18.19%	-16.88%	-1.31%
Denmark	-9.74%	-8.22%	-1.52%
Finland	-14.63%	-13.26%	-1.37%
France	-14.96%	-13.59%	-1.37%
Germany	-15.48%	-14.12%	-1.36%
Ireland	-17.72%	-16.39%	-1.33%
Italy	-11.78%	-10.37%	-1.41%
Netherlands	-10.98%	-9.68%	-1.30%
Norway	-17.97%	-12.77%	-5.20%
Portugal	-14.30%	-12.93%	-1.37%
Spain	-8.51%	-7.04%	-1.47%
Sweden	-14.07%	-14.33%	0.26%
Switzerland	-8.94%	-8.10%	-0.84%
UK	-11.77%	-9.66%	-2.11%
<b>Europe Total</b>	<b>-12.68%</b>	<b>-11.20%</b>	<b>-1.48%</b>
Australia	-9.95%	-7.45%	-2.50%
Hong Kong	-4.53%	-4.48%	-0.05%
Japan	-14.20%	-17.24%	3.04%
New Zealand	-6.48%	-7.54%	1.06%
Singapore	-6.71%	-6.94%	0.23%
<b>Pacific Total</b>	<b>-12.17%</b>	<b>-13.76%</b>	<b>1.59%</b>
Brazil	13.56%	10.21%	3.35%
Canada	-15.11%	-10.30%	-4.81%
China	-10.73%	-10.69%	-0.04%
Greece	-15.89%	-14.54%	-1.35%
Hungary	5.86%	6.68%	-0.82%
India	2.53%	-1.25%	3.78%
Indonesia	9.76%	5.92%	3.84%
Korea	-12.83%	-12.32%	-0.51%
Mexico	-18.71%	-14.39%	-4.32%
Poland	-2.94%	-1.08%	-1.86%
Russia	-8.49%	-3.83%	-4.66%
Thailand	-10.20%	-9.59%	-0.61%
<b>Emerging Markets</b>	<b>-7.40%</b>	<b>-7.35%</b>	<b>-0.05%</b>



# Market Forecast



**Eventually markets must reflect reality.** The economy is great and stocks sell off? That cannot last forever and we suspect that stocks will rally in 2019.

Small company stocks should do better as should value stocks. Emerging markets still look attractive and has outperformed on a relative basis this past quarter. That bodes well. International stocks may carry more risk as the economies are not as strong in Europe and developed Asia.

Bonds are doing their job and reducing volatility by remaining stable in the downturn. Yields have dropped once again and are likely to go back up as stocks rally.

**Indices Three Months Ending December 31, 2018**

	Yield	Frwd Earnings Yield	**Hist. Return	***Hist. Risk Prem. + RF Rate
Large Blend	2.06%	8.97%	9.95%	6.50%
Large Growth	1.30%	6.98%	9.64%	6.50%
Large Value	2.71%	10.81%	10.09%	6.50%
Mid Cap Blend	1.84%	8.86%	11.36%	6.50%
Small Growth	0.69%	4.11%	7.49%	7.50%
Small Value	2.33%	10.25%	10.27%	7.50%
Developed Foreign	3.36%	11.80%	4.97%	4.63%
Emerging Markets	2.42%	11.87%	9.52%	6.13%
REITs	4.38%	6.81%	10.95%	5.07%
Core Bonds	3.29%	3.29%	6.61%	3.40%
High Yield Bonds	7.10%	7.10%	8.13%	4.57%

\* Weighted average using 40% earnings yield, 30% historic return and 30% historic risk premium + RF rate

\*\*Annualized 28 Yr return

\*\*\*Hist. risk premium of domestic and international equity as defined by Zephyr Style Advisor's GFD Long Term Index database except for REITs and High Yield which are based on average 20 year rolling returns of the NAREIT Equity REIT Index and the Barclays Corporate High Yield Index minus the average 20 year rolling returns of the 3-month T-Bill and scaled using proprietary data. The Current 3-month T-Bill yield (as of 12-31-2018) is added back to each risk premium.



## SELECTED INDEX RETURNS - PERIODS ENDING December 31, 2018

	Quarter	Year-to-Date	One Year	Three Years	Five Years	Ten Years
<b>US EQUITIES</b>						
Broad Stock Market - Russell 3000	-14.30%	-5.24%	-5.24%	8.97%	7.91%	13.18%
Large Stocks - S&P 500	-13.52%	-4.38%	-4.38%	9.26%	8.49%	13.12%
Dow Jones Industrial Average	-11.31%	-3.48%	-3.48%	12.94%	9.70%	13.16%
Medium-Size Stocks - Russell Mid-Cap	-15.37%	-9.06%	-9.06%	7.04%	6.26%	14.03%
Small Stocks - Russell 2000	-20.20%	-11.01%	-11.01%	7.36%	4.41%	11.97%
Small Value Stocks- Russell 2000 Value	-18.67%	-12.86%	-12.86%	7.37%	3.61%	10.40%
Small Growth Stocks- Russell 2000 Growth	-21.65%	-9.31%	-9.31%	7.24%	5.13%	13.52%
Large Value Stocks - Russell 1000 Value	-11.72%	-8.27%	-8.27%	6.95%	5.95%	11.18%
Large Growth Stocks - Russell 1000 Growth	-15.89%	-1.51%	-1.51%	11.15%	10.40%	15.29%
<b>US FIXED INCOME</b>						
1-3 Yr Treasury (Gov't) Bonds - Barclays Capital	1.31%	1.56%	1.56%	0.95%	0.81%	0.96%
US Government Bonds Int - Barclays Capital	2.22%	1.43%	1.43%	1.21%	1.46%	1.83%
US Corporate Inv Grade Bonds - Barclays Capital	-0.18%	-2.51%	-2.51%	3.26%	3.28%	5.92%
Government/Credit (Corp) Bonds - Barclays Capital	1.46%	-0.42%	-0.42%	2.19%	2.53%	3.46%
Int Govt/Credit (Corp) Bond - Barclays Capital	1.65%	0.88%	0.88%	1.70%	1.86%	2.90%
US Aggregate Bond Market - Barclays Capital	1.64%	0.01%	0.01%	2.06%	2.52%	3.48%
Mortgage Master - Merrill Lynch	2.04%	1.00%	1.00%	1.70%	2.51%	3.11%
US Corp High Yield Bonds - Barclays Capital	-4.53%	-2.08%	-2.08%	7.23%	3.83%	11.12%
<b>INTERNATIONAL (Measured in US Dollars)</b>						
Non-US Stocks - MSCI EAFE	-12.50%	-13.36%	-13.36%	3.38%	1.00%	6.81%
World Stocks (includes US) - MSCI World	-13.31%	-8.20%	-8.20%	6.91%	5.14%	10.29%
European Stocks - MSCI Europe	-12.68%	-14.32%	-14.32%	2.72%	-0.03%	6.79%
Japanese Stocks - MSCI Japan	-14.20%	-12.58%	-12.58%	3.76%	3.40%	5.58%
Asian Stocks (Ex-Japan) - MSCI Pacific ex-Japan	-7.90%	-10.19%	-10.19%	6.92%	2.23%	10.04%
Chinese Stocks - MSCI China	-10.73%	-18.75%	-18.75%	8.23%	4.86%	8.50%
Indian Stocks - MSCI India	2.53%	-7.30%	-7.30%	8.23%	8.07%	10.66%
Emerging Markets - MSCI EM	-7.40%	-14.25%	-14.25%	9.65%	2.03%	8.39%
Int'l Gov't Bonds -Citi World Gov't Bond (Non USD)	1.31%	-1.82%	-1.82%	3.32%	0.28%	1.27%
<b>REAL ESTATE</b>						
FTSE NAREIT Equity-Reits Index	-6.73%	-5.04%	-5.04%	2.74%	7.81%	12.07%
<b>SHORT TERM INTEREST RATES</b>						
T-Bills	0.57%	1.86%	1.86%	0.99%	0.60%	0.35%

Note: Returns for periods longer than 12 months are annualized.