The Ten Themes of 4Q 2018

After U.S. stocks posted their best quarterly returns in over five years during 3Q 2018, the 4Q 2018 period turned out to be the worst quarter for U.S. stocks in ten years. This stark contrast in positive and negative stock returns that occurred in the second half of 2018 sums up the major investment theme of last year: the return of volatility after a very calm 2017.

There were two negative overhangs for the market in 2018 that were the major factors behind the increased market volatility. The first was the fear the U.S. Federal Reserve Bank tightened monetary policy too much. The second was the ongoing trade conflict between the U.S. and China. While the dollar amounts of the additional tariffs from the trade dispute are immaterial, the longer the conflict persists the more it has impacted confidence among corporations and investors.

The good news about the above two overhangs is they are both self-inflicted. In other words, the Fed can back off its plans to raise interest rates further in 2019 and the Trump administration and China could reach a resolution on trade that improves confidence. Eliminating these two negative factors will go a long way in maintaining an economy that grows at or above its long-term trend this year.

The Fed and trade were not the only two factors that moved markets in 2018. However, they were the two biggest factors. We will discuss in our ten themes other factors that impacted markets the most during the 4Q 2018 period. It remains our view, that investor fears have been greater than reality. As such markets sold off much more than warranted over the last three months of 2018. This is why stock prices are re-setting higher in early 2019 trading. One thing we will be watching closely in the weeks and months ahead will be any further deterioration in corporate earnings expectations that justifies the fears and warrants a change in your asset allocation to preserve your wealth. Because the Fed and President Trump are unpredictable wild cards, we want to maintain a neutral allocation to stocks at this time.

Under a neutral scenario, our assumptions are for both overhangs to persist but soften. We believe the Fed will eventually follow the data and refrain from hiking interest rates further. We also believe the Trump administration and China will arrive at some agreement on trade as it is in neither country's best economic interest to have a trade conflict drag on much longer.

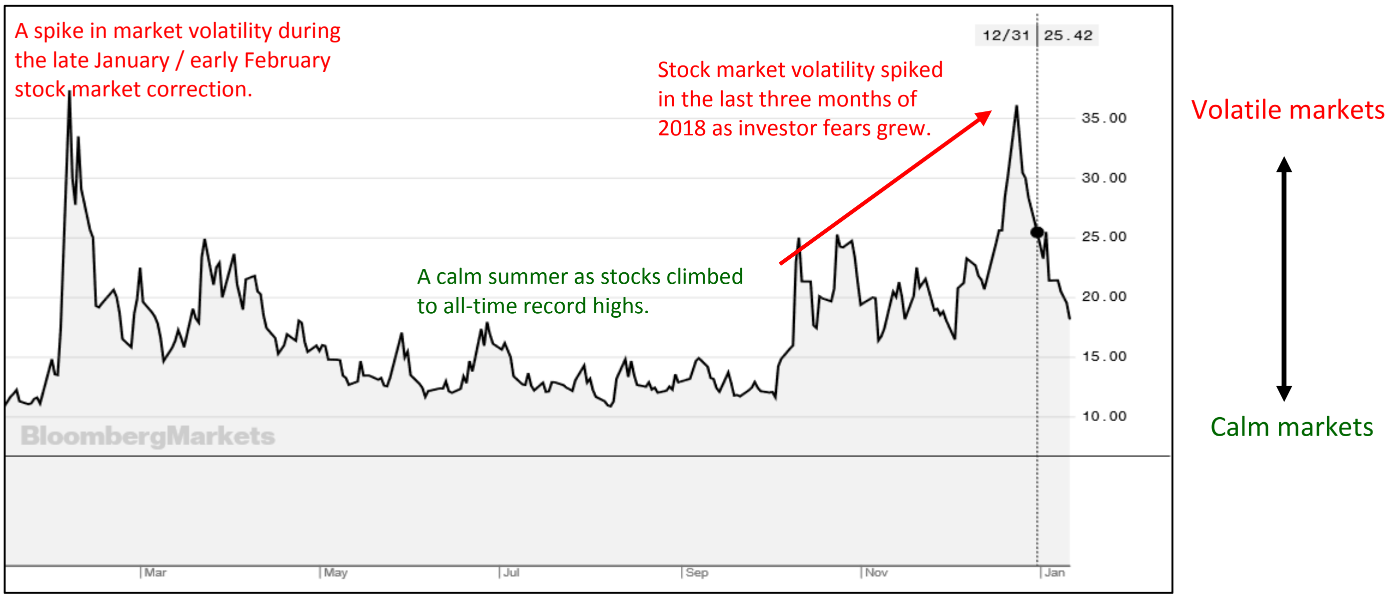
Stay tuned as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.**

1. Heightened Volatility
2. Worst Quarter for Stocks in a Decade
3. A Hawkish Fed
4. Government Shutdown
5. Weakening Earnings Expectations
6. Less Stimulus Abroad
7. Flattening Yield Curve
8. Deflating Commodity Prices
9. Recession Fears
10. Global Stock Market Performance

Heightened Volatility

In 2018, the biggest theme for investing was the return of volatility to global financial markets after a sea of calm in 2017. The Chicago Board of Options Exchange Volatility Index, or VIX, is a widely quoted fear gauge. At the end of the 3Q 2018 period on September 28, 2018, the VIX had a reading of 12.12. The gauge shot up to 36.07 during the Christmas Eve stock massacre when the Dow Jones Industrial plummeted over 650 points as Saint Nick was warming up the sleigh. Talk about bah humbug!

CBOE VIX Volatility Index



Worst Quarter for Stocks in a Decade

The last three months of 2018 would like to be forgotten by almost every stock investor. The returns were the worst we have seen for any quarter since the financial crisis of 2008. During the 4Q 2018 period, the Dow Jones Industrial Average fell -3,131 points, or -11.83%. As bad as that sounds, the S&P 500 declined more at -13.97%. And worst of all, small cap U.S. stocks, as measured by the Russell 2000, dropped a whopping -20.51%. To reinforce just how volatile 2018 was, the atrocious 4Q 2018 stock returns, which were the worst in ten years, were preceded by the best quarterly returns in five years in the prior quarter.

Index	4Q18 Return	3Q18 Return	2Q18 Return	1Q18 Return	2018 Return
Dow Jones Industrial Average	-11.83%	9.01%	0.70%	-2.49%	-5.63%
S&P 500 Index	-13.97%	7.20%	2.93%	-1.22%	-6.24%
NASDAQ Composite Index	-17.54%	7.14%	6.33%	2.32%	-3.88%
Dow Jones Transportation Average	-19.41%	10.00%	-0.50%	-2.03%	-13.59%
Russell 2000 Index	-20.51%	3.26%	7.43%	-0.40%	-12.18%

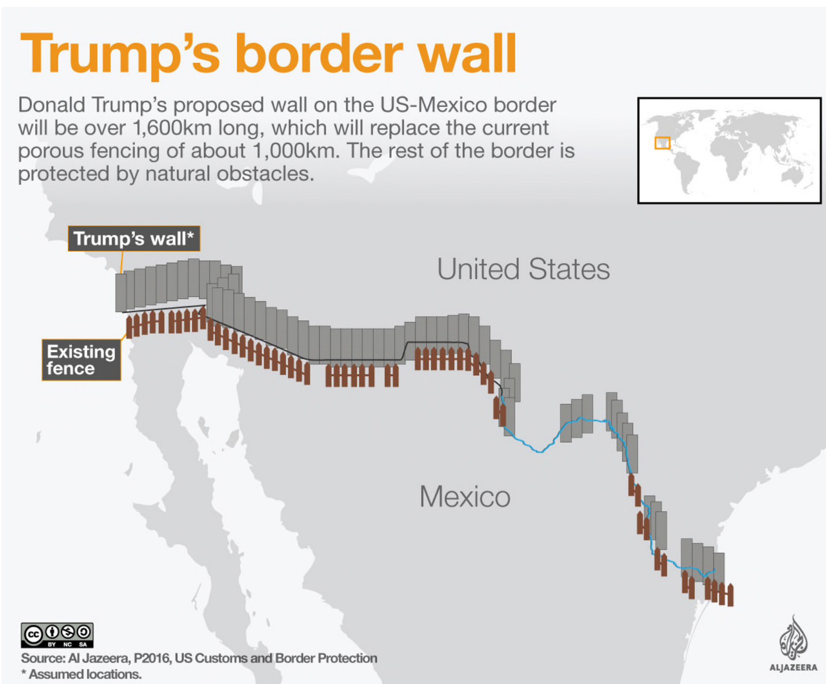
Source: Bloomberg

A Hawkish Fed

On December 19, 2018, the Fed hiked its benchmark federal funds rate by +0.25% to a range of 2.25% to 2.50%. It marked the fourth hike in 2018. Our research indicates the Fed may have tightened the screw one turn too many with regards to raising interest rates. What's more, Fed chairman, Jerome Powell, stated that he expects two more interest rate hikes in 2019. The Fed's "hawkish" stance to continue to raise interest rates, even as economic data is weakening, has increased the chances the central bank will make a major policy error and send the economy into a recession. This is a major reason why stocks were hammered during the 4Q 2018 period.

Government Shutdown

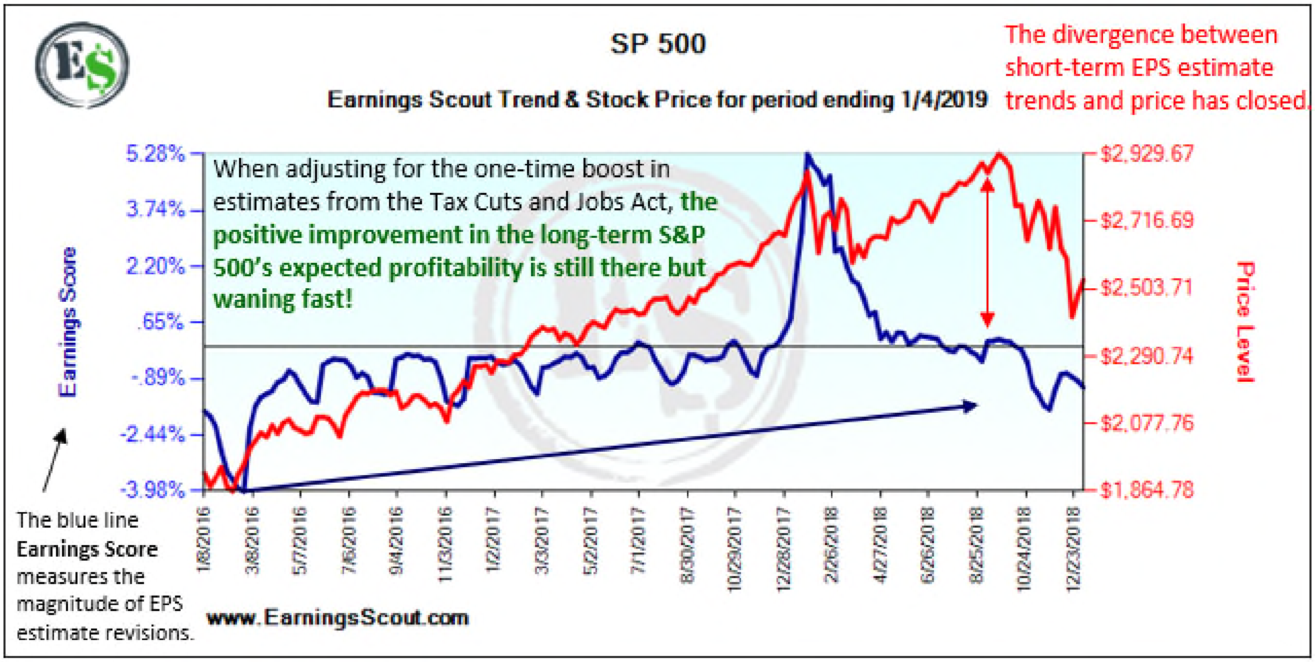
At Midnight on December 22, 2018, parts of the U.S. government shut down when Congress and President Trump could not agree to spend $5.6 billion in federal funds to build a U.S.-Mexico border Wall. While the economic impact from the shutdown has not been material, the timing of it as markets were in turmoil helped contribute to a Christmas Eve massacre in the stock market. Between the Fed and lawmakers in Washington, much of the stock market's poor performance last year has been self-inflicted wounds from poor policy.



Weakening Earnings Expectations

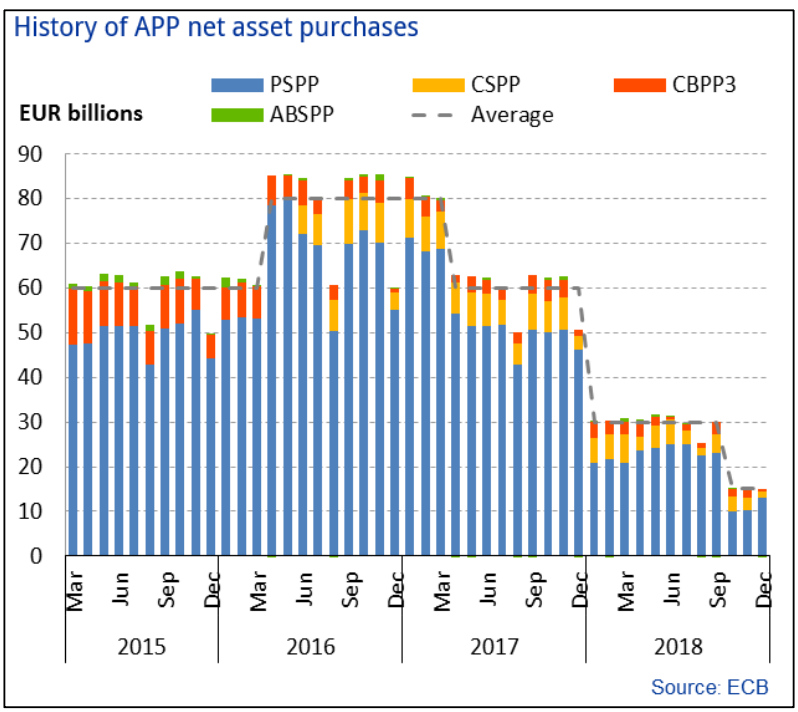
On a rate of change basis, S&P 500 EPS expectations weakened throughout last year. How so? Early in the year, S&P 500 EPS estimates were being raised as analysts scrambled to adjust their estimates when corporate tax rates were cut to 21% from 35% from the Tax Cuts and Jobs Act. During the summer, S&P 500 EPS estimates were relatively unchanged. During 3Q 2018 earnings season, which peaked in late October 2018, S&P 500 EPS expectations were being slashed as the Fed interest rate hikes, slowing economies around the world and the overhang from the trade conflict with China began to outweigh the benefits of lower corporate taxes and less regulatory burdens.

The rate(s) of change to overall S&P 500 EPS expectations the past three years



Less Stimulus Abroad

In addition to the U.S. Federal Reserve Bank tightening its monetary policy by raising interest rates, the European Central Bank was scaling back on its QE bond buying program throughout 2018. This should not be understated because when the ECB stepped on the accelerator to its QE stimulus in early 2016, it helped trigger a global stock rally. As the ECB begin scaling its QE back in 2017 and 2018 (See the chart of its asset purchases below), economic data across the pond began to weaken. Less stimulus abroad is a major reason why we underweighted international stocks last year, which turned out to be a fantastic decision given even worse returns in Europe vs. the U.S. in 2018.



Source: ECB

Flattening Yield Curve

The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond. When the spread widens (i.e. steepening yield curve) between the rates on 2 and 10-year notes, it usually indicates an expanding economy. When the spread narrows (i.e. flattening yield curve) it typically means less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

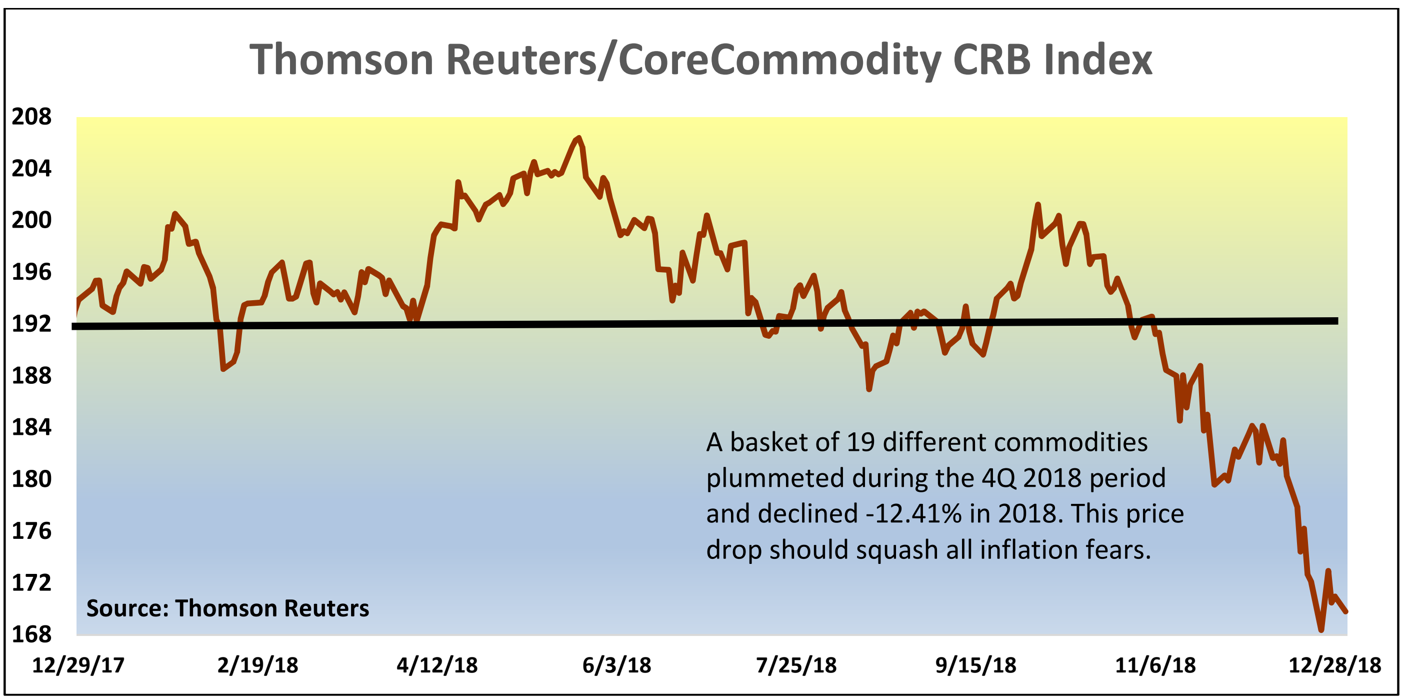
The rate on a 2-year note closed 2017 at 1.89% and the 10-year bond ended the year at 2.40%. Thus, the yield curve was +51 basis points. At the end of 2018, the rate on a 2-year note was 2.48% while the 10-year rate was 2.69%%. If you take a closer look at those numbers, you will see the rates on the short end of the curve (i.e. the 2-year note) rose more than on the long end (i.e. the 10-year note). As such, the yield curve narrowed 30 basis points in 2018 to just +21 bps. Ideally, we would like to see this yield curve steepen so it would reflect better economic growth ahead. However, the bond market remains cautious and market bears keep pointing to the flattening yield curve as a sign a recession looms on the horizon.

Source: US Treasury Department

Deflating Commodity Prices

In addition to the U.S. bond market signaling caution, commodity markets were cautious as well in 2018. Commodity prices, as measured by the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities from crude oil to orange juice, fell -12.99% in the 4Q 2018 period. We use the CRB index as a great gauge of future inflation expectations. With the Fed and some investors worried about inflation rising too fast, we are highly unlikely to see it any time soon given commodity prices cratering in 2018.

We want to also highlight that falling commodity prices are usually a sign of slowing economic activity, particularly in Emerging Markets. Therefore, in 2019 we want to see commodity prices rise gradually to indicate a gradually improving economy. More downside in commodity prices would likely be a negative sign for growth.



Recession Fears

The reason stocks had their worst quarter in ten years at the end of 2018 is because this is the first time in a decade we have measured weakening economic expectations and there is not a central bank willing to step up and provide stimulus. In years past, the one constant in markets has been when economic conditions weakened, a central bank would provide support and prop up the economy with stimlus funds. For whatever reason, that is no longer the case and markets have clearly priced in the increased chances of a recession occuring later in 2019 / early 2020.

Global Stock Market Performance Returns

Country	1Q18 Return	2Q18 Return	3Q18 Return	4Q18 Return	2018 Return
Brazil	11.73%	-14.76%	9.04%	10.77%	15.03%
India	-3.20%	7.45%	2.27%	-0.44%	5.91%
Indonesia	-2.62%	-6.30%	3.06%	3.65%	-2.54%
U.S. Large Cap	-1.22%	2.93%	7.20%	-13.97%	-6.24%
Australia	-5.10%	7.56%	0.21%	-9.04%	-6.96%
Taiwan	2.47%	-0.64%	1.56%	-11.62%	-8.60%
Thailand	1.29%	-10.17%	10.08%	-10.96%	-10.82%
France	-2.73%	3.02%	3.19%	-13.89%	-10.95%
Canada	-5.19%	5.92%	-1.26%	-10.89%	-11.64%
Japan	-5.76%	3.96%	8.14%	-17.02%	-12.08%
U.S. Small Cap	-0.40%	7.43%	3.26%	-20.51%	-12.18%
Portugal	0.32%	2.27%	-3.06%	-11.71%	-12.19%
U.K.	-8.21%	8.22%	-1.66%	-10.41%	-12.48%
Philippines	-6.76%	-9.85%	1.16%	2.60%	-12.76%
Hong Kong	0.58%	-3.78%	-4.03%	-6.99%	-13.61%
Spain	-4.42%	0.23%	-2.43%	-9.05%	-14.97%
Mexico	-6.54%	3.34%	3.86%	-15.89%	-15.63%
Italy	2.55%	-3.50%	-4.23%	-11.53%	-16.15%
South Korea	-0.88%	-4.89%	0.73%	-12.89%	-17.28%
Germany	-6.35%	1.73%	-0.48%	-13.78%	-18.26%
Turkey	-1.40%	-15.72%	4.95%	-7.75%	-19.54%
Ireland	-6.32%	5.90%	-6.59%	-15.98%	-22.14%
Greece	-2.73%	-2.94%	-8.70%	-11.33%	-23.56%
China	-4.18%	-10.14%	-0.92%	-11.61%	-24.59%

Source: Bloomberg

Conclusion

Last year's decline in U.S. stock prices, as measured by the -6.24% drop in the S&P 500 index, came from the combination of slowing global growth and self-inflicted wounds set by both monetary and fiscal policy makers. As we begin trading in 2019, it remains our view that the overall U.S. economy is stronger than most think. However, we do acknowledge that negative factors have begun to outweigh the positive benefits from lower tax rates and less regulatory burdens on corporate bottom lines.

While stocks declined in the U.S. last year, they were even worse overseas. Stock returns in developed countries outside of the United States, as measured by the MSCI Developed International index, declined -16.34% last year. Worse, stock returns in Emerging Market countries fell even more, as measured by the -17.11% drop in the MSCI Emerging Market index. That means, on a relative basis, U.S. stocks outperformed international stocks by over 1,000 basis points last year. Therefore, our decision to underweight international stocks helped preserve wealth last year as their losses were much more severe than those in the U.S.

Given the huge drop in prices overseas, we are now looking to add more international exposure in 2019. Quite simply, sometimes prices just get too cheap to pass up. Our research also indicates more solid performance ahead for small cap U.S. based companies because they sold off significantly more than their underlying fundamentals suggested in the second half of 2018.

More so than ever, we will be paying close attention to U.S. monetary policy. The Fed has taken steps to raise interest rates and reduce the size of its balance sheet. These moves are the opposite of the stimulus the central bank has provided markets for almost a decade. Additionally, we must closely monitor the impact additional tariffs will have on global economic activity. Will all the bricks in the wall of worry derail the improving economic growth? Maybe, but our research indicates that it is still not likely at this point. Of course, we will need some help from the policy makers to stop shooting the economy in the collective foot.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Mark Klopfenstein, AIF®

Nick Raich, CFA®