## Review & Outlook - 4Q 2018

The year 2018 was proclaimed by a finance media that is more adept at coining catchy phrases than giving level-headed advice as the "year when nothing worked". What a difference a quarter can make in the performance of equity markets. At the beginning of the fourth quarter, the S&P 500 had returned 10.6% in 2018 and over 18% in the trailing 12 months. Markets continued to advance higher despite growing concerns of a prolonged trade dispute with China, the Federal Reserve raising interest rates to normalize monetary policy and slowing growth in Europe and Japan. The final quarter of 2018 changed the narrative of the year entirely, as the S&P 500 declined 13.5%, including a 10% decline in the three days after the Federal Reserve announced an interest rate increase on December 19th, and ended the year down 4.4%. The year ended not with a positive double-digit return in stocks, but as the worst year in a decade.

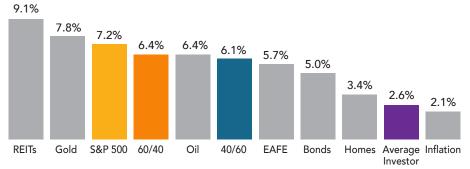
The proclamation that "nothing worked" is not true, though nearly every major asset class was negative or barely positive for the year. Diversification "worked", to the continued benefit of patient, disciplined long-term investors. The volatility of the fourth quarter, while unnerving at times, illustrated the wisdom of selecting the proper asset allocation and sticking with it, while avoiding making decisions during market volatility. As U.S. stocks were falling 13.5%, the Bloomberg Barclays U.S. Aggregate Bond Index gained 1.7% in the quarter and finished the year unchanged. A well-diversified investor owning stocks and bonds therefore cushioned the volatility of equity markets. As we have written before, double-digit pullbacks in equities occur regularly, even in upward trending markets. Market timers who try to avoid these normal declines are rarely able to do so with any consistency, creating capital gains tax bills and missed opportunities rather than providing downside protection.

Heading into 2019, fears of a policy mistake either in trade or monetary policy remains the biggest concern for investors. There is growing evidence that trade uncertainty may be hurting business confidence and slowing capital expense spending. The benefits of the tax cuts and increased government spending was greater than the drag created by tariffs in 2018. However, scheduled tariff increases, absent a trade agreement with China, will begin to dwarf the fiscal stimulus beginning in 2019. China announced tax cuts and monetary stimulus to counteract their economic slowdown, perhaps giving the Chinese an incentive to resolve the trade issues. The Federal Reserve is now anticipated to raise the Federal Funds rate twice in 2019, a decrease from the three times expected earlier in the year. While

real interest rates are still barely positive, the flat yield curve suggests the Fed is very close to raising rates higher than markets think is appropriate given the low inflation rate.

While acknowledging the validity of the possibility of a policy error, the underlying U.S. economic data are strong. GDP growth accelerated, reaching 5.5% in the third quarter on an annualized basis, the highest growth rate since 2006. Earnings growth in the S&P 500 remains healthy, although unlikely to repeat 2018's level of greater than 20%. The consumer is in good shape: debt service levels are manageable despite rising interest rates, unemployment is low, wages are growing at 3% and the first refund season since the tax cuts were passed in late 2017 should be strong.

## 20-Year Annualized Returns by Asset Class (1998-2017)



Source: JP Morgan Asset Management

We will refrain from participating in the ubiquitous prognostications for the upcoming year, knowing confidently that you are best-served by a patient, diversified, long-term outlook. History shows that equities advance about 7-8% per year over long periods of time with an average intra-year decline of about 14% per year. The investor who remains invested recoups the intra-year decline and receives the full benefit of the 7-8% annual return. Market timers chase returns, trading in and out of the market, explaining why the average investor's returns consistently trails every asset class. No matter how common, large declines in equities are unnerving, breeding impatience and the strong desire to do something, often at the worst possible time. In choosing an appropriate asset allocation and investing in a globally diversified portfolio, the hard work has already been done and these market declines become opportunities to invest in great companies with strong competitive positions and solid management teams at discounted prices.