ADVISER
INVESTMENTS

Adviser Outlook

FIRST QUARTER 2019

QUICK TAKES

- ✔ Fundamentals suggest slowing economic growth, but not a U.S. recession
- ✔ Recent market pullbacks and still-rising earnings and dividends make stocks a better value than bonds heading into 2019
- ✔ Bonds and cash remain strong portfolio shock absorbers given the volatile state of the global markets
- ✔ Markets and investor psyches will face pressure from a variety of potentially disruptive factors, only some of which are economic in nature

Last year was a roller-coaster ride for the investment markets from start to finish. After notching new all-time highs to start the year, U.S. stock markets fell into a correction (a decline of 10% from a prior high) in February, rose back to new peaks in the fall, then sold off rapidly in the fourth quarter into another correction to end 2018 close to bear-market territory.

As 2019 opens, and with the backdrop of the past few months as a cautionary tale, we think investors will need to steel themselves for further swift and sudden fear-driven selloffs. That said, we think these often emotional pullbacks will also set the stage for rational rebounds once investors again focus on the fundamentals that drive economic growth.

The litany of fear factors includes the investigations into President Trump's campaign and administration, Brexit, a trade war with China, the potential for a global economic slowdown, questions about the pace of corporate earnings growth, and worries that the Federal Reserve has raised interest rates too quickly. Unanticipated market shocks are always possible as well. These fears have clearly already impacted investor behavior and the markets—we will put them into greater perspective for you in a moment.

For long-term investors like us, significant stock market pullbacks are never welcome, but we know they are the moments that help create wealth-building opportunities for our clients. Moreover, they're par for any long-term investment course.

The U.S. economy, by most measures, including earnings, employment, interest rates and inflation, is still in a healthy, slow-growth expansion mode—a fact that investors who sold on unrealized fears overlooked in their rush for 2018's exits. As always, our approach is to actively manage the portfolio managers who are themselves seeking the best opportunities for their strategies (and thus our portfolios), while also managing the risks in your portfolio to align with our clients' objectives and our outlook.

Fourth Quarter Review

Without a doubt, last year's fourth quarter was a difficult one for stock market investors, as the Dow Jones Industrial Average and the S&P 500 index fell into correction territory and were, at their nadir, a hair's-breadth away from a technical bear market decline of 20%. Despite a rebound between Christmas and New Year's Eve, the MSCI U.S. Broad Market Index declined 14.4% for the quarter while the S&P 500 was down

QUARTER REVIEW

- ✔ U.S. stock markets pulled back more than 10% in the fourth quarter, but finished the year with moderate declines
- ✔ Modest gains for U.S. bonds in Q4 helped them finish flat for 2018; the average money market fund returned 1.5% last year
- ✔ Foreign developed and emerging market stocks lagged U.S. stocks for the year
- ✔ Excepting utilities, all U.S. stock sectors were down in Q4; only health care and utilities stocks were positive in 2018

13.5% and the Dow pulled back 11.3%. The rapidity of these declines, combined with a jump in day-to-day volatility, were difficult to stomach. (For more on the market's volatility, please see the box on page 3.) That said, those same three indexes ended the year with moderate declines, ranging from -3.5% to -5.3%.

Developed foreign markets, represented by the MSCI EAFE index, fell in sympathy with U.S. markets over the last three months of the year (-12.5%), but didn't march in lockstep during periods of gains for their American counterparts earlier in 2018. Brexit concerns, slowing economic growth and civil unrest all weighed to some degree on the developed markets of Europe and Asia and the index fell 13.8% for the year. Emerging market stocks fell 14.6% over the same period.

Cash and bonds were the bright spots in Q4, helping to buffer stocks' negative returns. After years of virtually zero yields on cash reserves, rising short-term interest rates have led to money market funds beginning to generate passable (though hardly meaty) returns. The Bloomberg Barclays U.S. Aggregate Bond Index gained 1.6% over the final three months of the year as worried investors bought bonds with the proceeds from stock sales. For the year, the bond market was only fractionally positive, rising a single basis point, or 0.01%. The yield on the benchmark 10-year Treasury bond nearly took a round trip in 2018, starting the year at 2.40%, rising as high as 3.24% in early November and then ending the year at 2.69%.

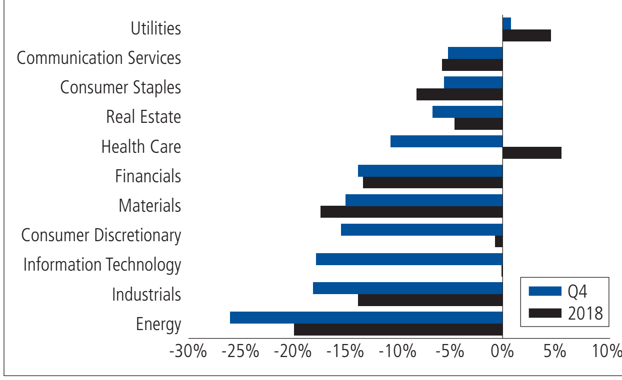
Stocks Pulled Back at Year-End

	Q4	2018
Bloomberg Barclays U.S. Agg. Bond Index	1.6%	0.0%
MSCI Emerging Markets	-7.5%	-14.6%
Dow Jones Industrial Average	-11.3%	-3.5%
MSCI EAFE	-12.5%	-13.8%
S&P 500	-13.5%	-4.4%
MSCI U.S. Broad Market	-14.4%	-5.3%

Note: Performance numbers are total returns, reflecting reinvested dividends through 12/31/18. Source: Morningstar.

U.S. Sector Performance

Ranked by Q4 Return



Source: Morningstar.

Stocks paying relatively large dividends demonstrated strength during the fourth quarter: The utilities, communication services, consumer staples and real estate sectors of the U.S. stock market were the best performers overall. Utilities stocks, seen as a safe haven because of their income potential, were the sole sector to finish in positive territory, with a 0.8% gain. For the year, only utilities and health care stocks, with gains of 4.6% and 5.6%, respectively, finished in positive territory. They were followed by technology (-0.1%) and consumer discretionary (-0.7%) stocks, which both suffered double-digit losses in the fourth quarter (-17.8% and -15.4%).

Energy stocks lagged for both the quarter and the year, losing 19.9% in 2018 after falling 26.0% in Q4 as the price of oil sank more than 40% from its October high.

2019 Fear Factors

We are neither bearish nor irrationally bullish as we consider the year to come. While we see a path for stock prices to rise in 2019, we are erring on the side of safety based on our heightened risk-awareness. We

OUR OUTLOOK

- ✔ Ongoing U.S. economic strength makes recession calls premature, though broader issues confront the global economy and marketplace
- ✔ Expanding corporate earnings, still-low interest rates, strong employment, a healthy consumer and low inflation are net positives for 2019 economic growth
- ✔ Stocks may hold greater return potential than bonds or cash in the coming year, but all three will continue to play important roles in most portfolios

think that the U.S. economy will continue to grow, albeit more slowly than it did in 2018, and that non-U.S. economies will exhibit everything from slowing growth to no growth. The result: U.S. stock markets could finish the year higher than they started, and some global stock markets (thanks to more attractive valuations) could outpace gains at home.

Economic growth is slowing in the U.S. and China, and recently turned negative in Japan and Germany. While daily headlines over every sound bite and Twitter post dramatize the situation, we continue to think that some kind of resolution, as opposed to an outright trade war between the U.S and China, is the most likely outcome. Preserving shared economic and political self-interest is a much better bargain than mutual destruction. This doesn't mean that trade-war fears won't rile markets leading up to the March deadline imposed by the White House. We would not be surprised to see similar trader anxiety leading up to the other big March deadline: Brexit. We would caution against trying to game either situation.

As these and other factors play out on the domestic and world stage, it's important to us that you keep a long-term perspective; there is almost always a way to talk yourself out of the stock market. Over the past decade, investors could have used any number of events as a reason to sell, including domestic and global terrorism; economic contraction in 2011 (spring and fall) and early 2014; problems with the PIGS (Portugal, Italy, Greece, Spain); China slowing; China growing too quickly; the U.S. losing its AAA bond rating; the U.S. government shutting down; tensions with North Korea; Ebola; the Fed buying bonds; the Fed selling bonds; tech stocks soaring then diving; and so on and so forth.

In each of those instances, the concerns which would have tempted investors to sit on the sidelines also created

How Volatile Was 2018?

We've talked quite often about market volatility and its reemergence in late 2018. It's important to remember, though, that volatility in and of itself is not a bad thing—upside volatility is welcomed by investors almost as much as downside volatility is feared.

One basic-but-telling measure of stock volatility is the size of daily (or intraday) moves in the market. A trading session where you see index levels move, say, 2% from their intraday highs to their intraday lows can be considered quite volatile. Historically, a move of 5% or more indicates an extreme shift in sentiment (generally in reaction to some surprising news event). In the table, we've listed the number of days in which the Dow Jones Industrial Average has experienced large swings during the last 20 calendar years.

While 2018 represented a step up in volatility over 2017, you don't have to go too far back to find years with comparable totals in any given column. Looking at this table, it's clear we remain far removed from the white-knuckle days of 2008 and 2009.

You may be tempted to step aside and try to wait periods like this out, but doing so creates the near certainty that you'll miss participating in a market rebound or rally. This is why we believe that "Time in the markets, not market timing" is one key to our clients' long-term investment success.

Year	Daily Moves of >1.0%	Daily Moves of >2.0%	Intraday Moves of >2.0%	Intraday Moves of >5.0%
1999	83	16	45	0
2000	101	31	66	2
2001	97	24	64	2
2002	128	48	107	4
2003	71	15	42	0
2004	45	0	2	0
2005	27	1	1	0
2006	24	0	5	0
2007	56	14	23	0
2008	134	72	124	28
2009	109	45	94	3
2010	69	18	34	1
2011	89	32	50	3
2012	39	4	7	0
2013	24	3	5	0
2014	36	2	7	0
2015	73	9	19	1
2016	51	9	17	0
2017	10	0	0	0
2018	69	21	41	2

Sources: S&P Dow Jones Indices; Adviser Investments.

the kinds of wealth-building opportunities that ultimately accrued to their benefit. In our longstanding investment experience and that of the managers we invest alongside of, as present-day concerns dim and fear dissipates, gains have been the rule, not the exception.

Fundamentals Drive Markets

We have long said that it is earnings and interest rates that drive the investment markets and our outlook. Corporate earnings grew more than 20% in 2018, a remarkable state of affairs, but one that is simply not sustainable. As the sugar high of the 2018 tax cuts wears off, we know that earnings won't grow as fast. That doesn't mean that they will vanish—just that the rate of earnings growth will not be as high. Slow earnings growth is not the same as no earnings growth and, in fact, it is what powered the bull market that began almost a decade ago.

The same theme applies to the economy. Though the final numbers are yet to be tabulated, it appears that the U.S. economy grew at a 3% pace last year. It is unlikely we'll match that growth in the coming year. However, this doesn't mean we're headed into a recession in 2019, but rather a return to a slower-growth environment.

One dynamic that leads some to feel we're moving toward economic contraction is the yield curve, which we discussed in our July 2018 *Adviser Outlook*. In short, when the yield on the 10-year Treasury bond is lower than that of the 2-year Treasury, the yield curve is said to have inverted, a phenomenon that has preceded each of the last five recessions. That "10–2 spread" has narrowed over the last year, but it has yet to go negative. And even if it does, our research shows, based on a limited set of data points, that it has taken an average of 16 months after the yield curve inverted before a recession actually began. While the tightening yield spread reflects increasingly cautious sentiment in the bond market, it is not omniscient.

Meanwhile, interest rates remain low, which may not warm the cockles of most bond investors' hearts, but it means that they are not a substantial headwind to further economic growth. Plus, recent economic data suggests the Federal Reserve may slow its interest-rate hikes or end them altogether in 2019. At full employment, with wages gradually rising and consumers' household debt, income, spending and savings in solid shape, there are reasons for a positive view on the economy.

After reviewing all of the above, we are looking ahead to measured investment gains in the coming year. If one or more of the fear factors is removed, we may be pleasantly surprised by greater stock market returns than currently expected. In that case, we would also expect to, at best, earn the yield from our bond funds without seeing much in the way of capital growth. We'll continue to take a deliberately balanced approach as we proceed into and through 2019.

Given volatility's return to the markets, we think this is a good opportunity to reassess your current asset allocation. If recent market action and the potential for more of it in 2019 will cause you undue distress, it may be time to consider turning to experienced professionals whose guidance can help you sleep better at night.

Daniel P. Wiener
Chairman

James H. Lowell III
Chief Investment Officer

Christopher Keith
Senior Vice President, Fixed Income

Jeffrey D. DeMaso, CFA
Director of Research

Charles M. Toole, CFA, CFP®
Vice President, Portfolio Manager