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2018 Finishes On a Sour Note

The U.S. joined the global bear market in Q4

Q4 2018

Main Points

Stock markets around the world suffered great losses. The S&P 500 joined the global bear market in Q4.

Bond prices fell in the first three quarters due to higher inflation and increased supply, but staged a rally in Q4.

Assuming no U.S. recession, double-digit returns in major stock markets are likely in 2019.

Election uncertainty, trade wars, and rising interest rates made for a recipe of investor concerns this past year. As the saying goes, “there was nowhere to hide,” meaning all reasonable options to invest—from stocks to bonds to gold—suffered losses or showed sub-par returns. **Most major investments were down, with very few returning a gain of 5% or more.**

With tax-cut induced U.S. economic growth outpacing much of the world, and the Federal Reserve’s tightening cycle not far enough along to derail it, **U.S. markets continue to perform better than markets in most other parts of the globe.**

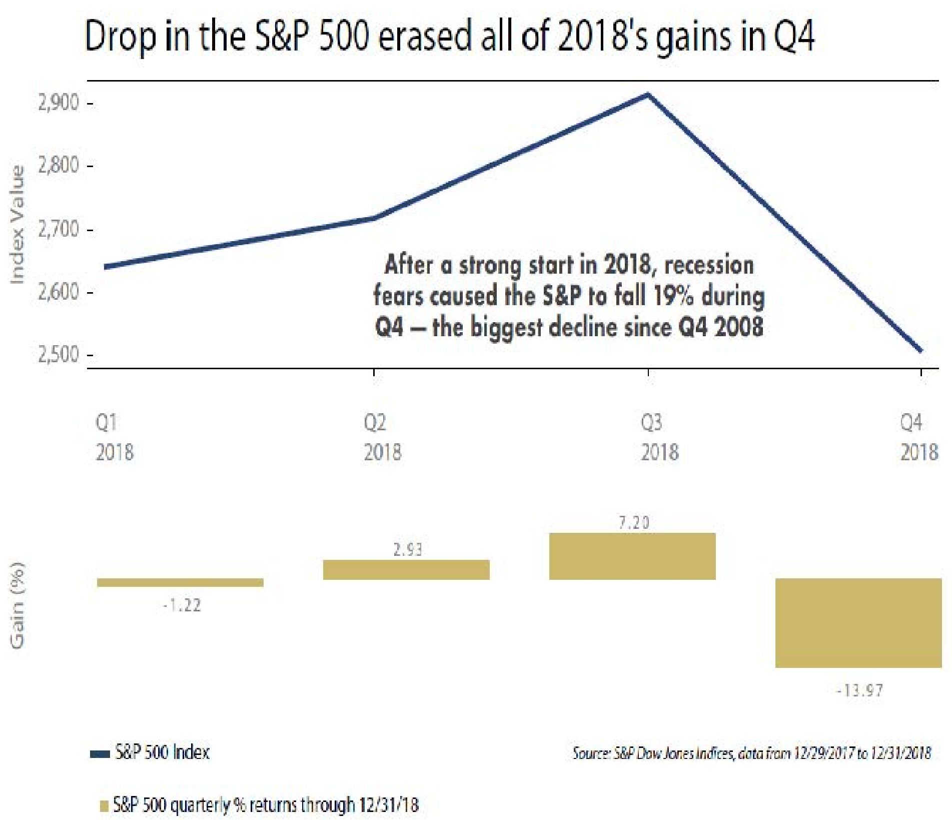
That being said, it was a still a **roller coaster year for stocks.**

After a new all-time high in January, the S&P 500 finished down modestly in Q1. Solid earnings growth supported strong rallies in Q2 and Q3. Investor worries, including fears of a recession, helped to erase all of the year’s gains, and more, as the S&P 500 dropped nearly 14% in Q4 (**shown in the chart below**).

The initial drop of 19% in Q4 was the biggest decline since Q4 2008 and the 10th worst since 1926. A rally in the last week of the year helped to recover some losses.

While inflation fears and an increased supply helped drive weakness in bonds earlier in the year, by Q4, investors flocked to risk-off assets like Treasuries. **Bonds beat stocks for the first time in four years**.

Most commodities struggled. Oil prices plunged 38% during the year. Even gold finished down 2% for the year, despite the 7.4% gain in Q4 as investors ran to safety.



2019 Outlook

Emerging markets likely to see strong gains after stock market bottoms out

The stock market decline is being driven by fears that the decade-long rally since the 2008 financial crisis is over. But the economic backdrop is much stronger than it was in 2008. While **economic growth and earnings will slow, they're unlikely to collapse, which should help mitigate losses**.

However, **stock performance is likely to get worse before it gets better**. According to Ned Davis Research, the signs of a stock market bottom are not yet in place. The psychology of investors hasn't reached extreme pessimistic levels seen at past market lows. Until that occurs, **market rallies could be used to reallocate from stocks to bonds** to help protect long-term performance.

The short-term bear market could be over by mid 2019, and possibly as early as March or April, as investors anticipate a recovery in the global economy in the second half. A bottom in global stocks is likely contingent on a bottom in U.S. stocks.

This would create a great buying opportunity within the long-term bull market in stocks, and the return of double-digit gains in 2019 is likely.

A market low would provide an opportunity to buy into the cheapest stock markets with the greatest upside potential. **Emerging markets are by far the cheapest among regions** (see

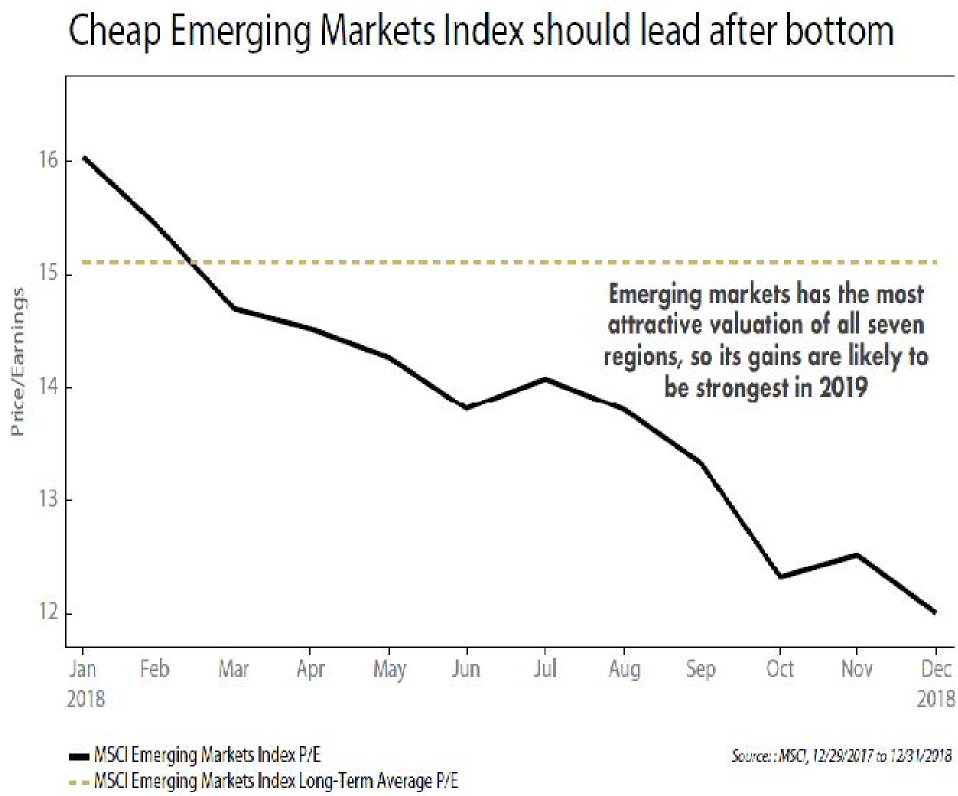


chart at top right), and **should have the strongest gains** after a stock market bottom.

While the market is correcting, expect lower-beta sectors such as Utilities, Consumer Staples and Health Care to perform best.

Resource sectors, such as Energy and Materials, as well as oversold Consumer Discretionary and Industrials could perform well in the rebound phase.

> **Cheap emerging markets stocks may be the top performers following a global stock market low.**

In the second half, investors are likely to turn their attention to sectors that can deliver solid earnings growth in a slower economic environment - Health Care, Energy, and Technology have potential.

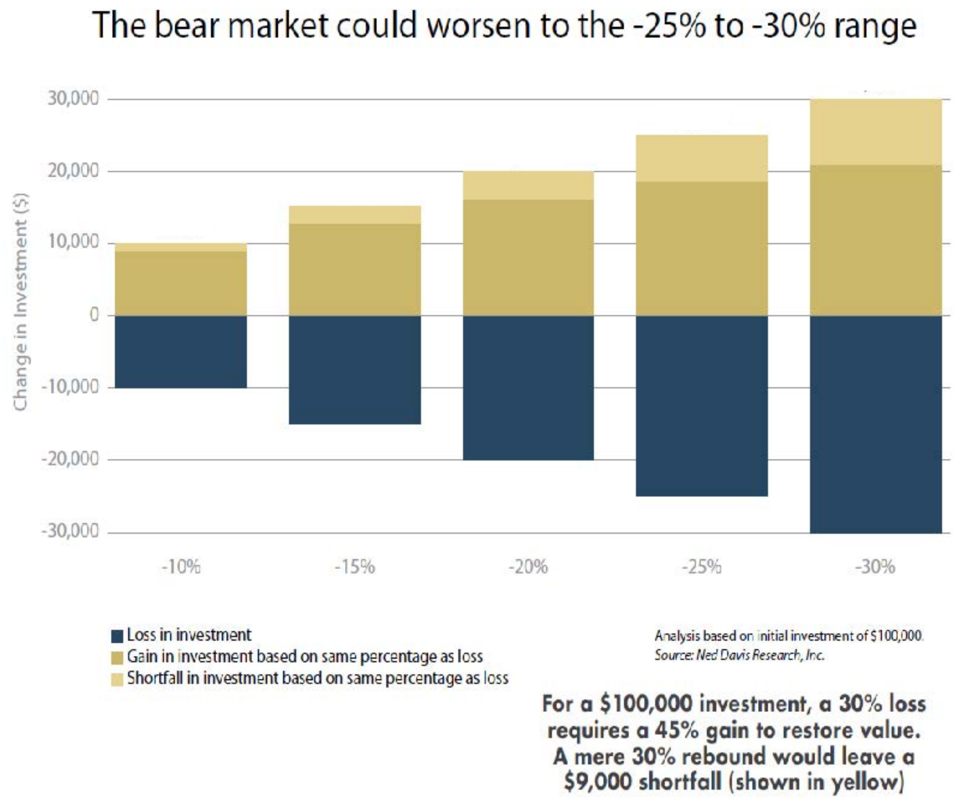
Gold could also be a winner, as it benefits from stronger economic growth and can be used as a hedge against rising inflation (higher prices for goods and services).

Increased bond supply and continued rate hikes should push Treasury yields modestly higher (and bond prices lower).

A bottom in oil would create a great buying opportunity for high-yield corporate bonds and select energy stocks such as oilfield services.

Stocks

The correction is likely to get worse before it gets better



Of the 47 markets in the All-Country World Index, a global stocks index, only three finished the year with positive gains. The S&P 500 finished down 6.24%, while **most markets suffered double-digit losses**.

While the global stock index peaked in January, U.S. stocks didn't peak until late September. U.S. investors began to get spooked by a global economic slowdown, exacerbated by trade war tensions, higher interest rates, slowing earnings growth, and mid-term elections. By the end of October, the S&P 500 had dropped by nearly 7%.

The typical post midterm election rally was short-lived in 2018. The S&P 500 gained only 1.79% in November and then collapsed in December, closing down 9.18% by yearend.

Earlier in the year, the Technology, Consumer Discretionary, and Health Care sectors delivered strong gains. As the market dropped sharply in the fourth quarter of 2018, **investors flocked to safety in sectors such as Utilities and Consumer Staples.**

Technology and Consumer Discretionary dropped 17.68% and 16.70%, respectively, in Q4, wiping out most of the year's gains. Tariff and global growth concerns also drove significant losses in Industrials and Energy in Q4. Financials was down 13.59% in Q4, as it suffered from slowing real estate and higher interest rates.

2019 Outlook for Stocks

The stock market correction is likely to get worse before it gets better. According to Ned Davis Research, **the average decline for a short-term bear market without a U.S. recession tends to be -25% over 10 months**. That means a $100,000 investment could drop to $75,000. Worse, for the investment to return to $100,000, the market would need to gain 33%, as shown in the **chart above**. (A 25% gain on $75,000 would only equal $93,750.)

Earnings skyrocketed in 2018 on the back of tax cuts. In 2019, tax cuts will make earnings growth more difficult, along with higher wages and interest expenses. When earnings growth has slowed rapidly, the stock market has struggled. The market will need to work through the earnings slowdown before it can mount a sustained rally.

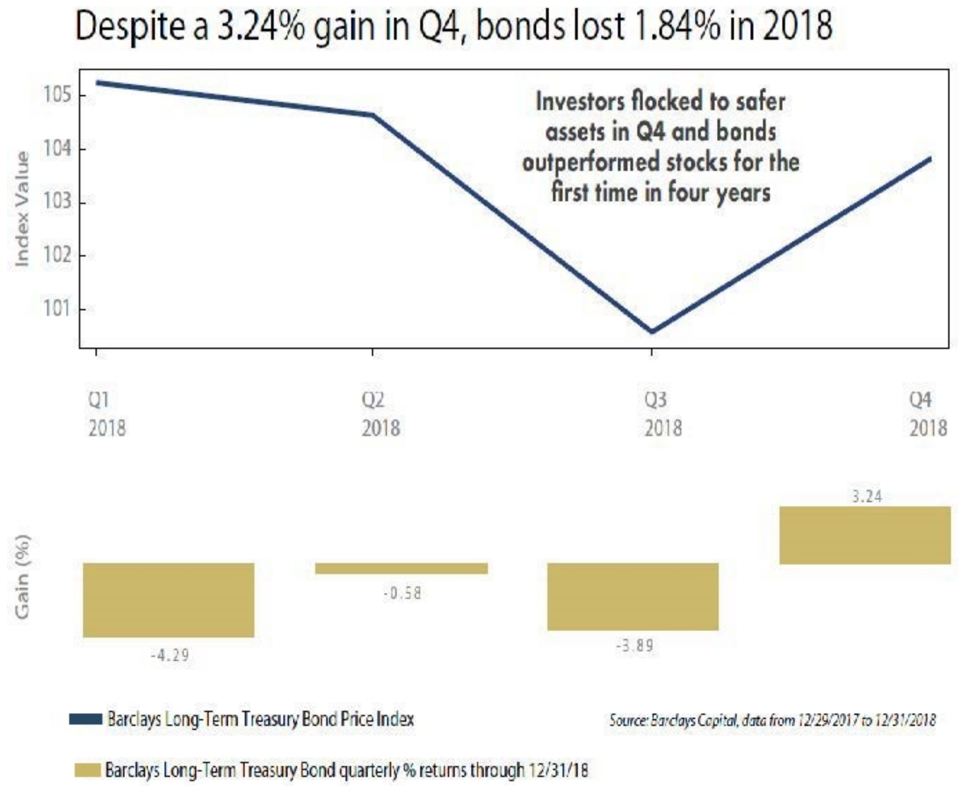
As long as the market is in correction mode, stable sectors like Utilities and Consumer Staples are likely to continue to do well.

Expect sector leadership to shift with the phases of the market. For instance, in the early stages of a new bull market, oversold areas tend to rally. Likely candidates this time around include small-cap stocks and sectors like industrials and materials. **But these gains would likely be short-lived as all of these areas have been weak long-term performers.**

Sectors that can sustain the best earnings growth in 2019 are likely to be more consistent winners; **Utilities and Consumer Staples fall into this category**. Attractive valuations and solid earnings growth could make Health Care and Technology also appealing.

Fixed Income

Bonds fell due in 2018 due to higher interest rates and inflation, but rallied in Q4



Bonds posted losses in 2018 as the Fed raised rates and inflation continued to creep higher. As investors sold off riskier assets and flocked to safer ground, bonds rallied in Q4, as **shown at right**. The Barclays Long-Term Treasury Bond index (comprised of bonds with maturities of 10 years or longer) posted a gain of 3.24% in the fourth quarter.

Despite the long-term bond index being down 1.84% for the year, **in 2018, bonds beat stocks for the first time in four years**.

U.S. bond sector performance varied widely. Asset backed securities (an alternative to investing in corporate debt) was the best performing sector with a return of 1.77%.

Investment grade corporate was the worst performing U.S. bond sector, losing 2.51% in 2018. U.S. dollar-denominated emerging markets bonds were close behind, posting a loss of 2.6%.

Cash was king. T-bills returned 2.0%, the most since 2007, as the Fed raised short-term interest rates four times.

2019 Outlook for Fixed Income

The outlook for bonds is weak. Bond prices are likely to hold up in the short-run. After that, bonds are likely to face many challenges – tighter monetary policy (higher interest rates), rising inflation, more supply, and geopolitical events.

The 10-year Treasury yield should trend from its current 2.83% to 3.35%. With yields and prices inversely related, **this is bad news for bonds**.

At the December 2018 meeting, the Fed made no commitment to future hikes but emphasized its continued desire to get back to “neutral” which likely means a target of 2.75% to 3.0%. **This means we’ll likely see at least two rate hikes from the Fed in 2019.** Of course, any additional hikes will depend on the outlooks for economic growth, inflation, and financial conditions at the time.

With a tighter labor market, expect cost pressures to rise. The prospects of more tariffs and a likely rebound in energy prices raise the risk of higher inflation by year-end. **Higher inflation typically leads to lower bond prices.**

The reduction of the Fed balance sheet and growth in the U.S. federal deficit will add to supply pressures for longer-dated bonds.

The performance of U.S. Treasuries could also be influenced by events in Europe. A successful resolution of Brexit and the Italian budget issue should push up German and U.S. Treasury yields. Again, such higher yields are bad news for bonds.

Expect another volatile year in corporate credit in 2019. However, with little chance of a U.S. recession and credit conditions favorable for businesses, corporate bonds could be attractive to investors once the selling pressure has faded.

Watch for signs of a U.S. recession and monitor leveraged loans for signs of credit and economic stress before deploying cash into riskier assets (such as stocks).