Quarterly Market Commentary

Fourth Quarter 2018

Key Takeaways:

- The Fed's comments failed to reassure investors about future rate hikes.
- Political uncertainty fueled concerns about European markets.
- Emerging Markets benefited from the temporary U.S. - China trade truce.
- Oversupply was the primary catalyst behind the fall in oil prices.

Volatility Travelled Across the Globe

Few markets were spared from the corrective declines of the fourth quarter as the slowdown in global growth heightened concerns about impending recessions in a number of economies around the world.

There is little doubt U.S. GDP, earnings and sales growth peaked in the second and third quarters of 2018. The magnitude of the slowdown is now being widely debated, and this uncertainty contributed to the downturn. Outside the U.S., growth began to slow in many economies earlier this year.

Let's take a closer look at some of the factors that contributed to the widespread volatility.

U.S. Markets

Comments from Fed Chairman Jerome Powell in early October appear to be the primary catalyst for the downturn in U.S. equity markets. He strongly implied that monetary policy was still a long way from neutral. The markets took his comments to mean quarterly rate increases would continue for the foreseeable future, and the Fed was ignoring signs that the tightening might be starting to hurt the economy.

Other contributing factors included:

- **The flattening of the Treasury yield curve.** An inverted yield curve is viewed by many analysts as an important recessionary indicator. The difference between the two-year and ten-year note began the quarter at roughly 0.25% (25 basis points) and flattened to 0.10% (10 basis points) before recovering to .20% (20 basis points) by year-end. Additionally, a portion of the curve between two- and five-year Treasuries actually inverted halfway through the quarter.

- **Solid economic numbers.** Continued strong job growth, burgeoning wage increases and a rather vibrant U.S. consumer convinced the Fed to maintain its tightening stance in December. Going into this meeting, the markets were hoping for assurance that the pace of the hikes would ease in 2019. The concern was that additional rate hikes could put a damper on the economy. The Fed did provide some assurance, although potentially not as much as investors were demanding. It signaled that the frequency of 0.25% increases should moderate in 2019, and Powell characterized current policy as "close to neutral" (a revision from previous comments). This characterization appears to set the Fed up for a defensible pause in hikes as early as March.

- **Ongoing trade dispute.** Trade tensions with China ebbed and flowed during the quarter. President Trump and Chinese President Xi Jinping negotiated a temporary truce in which the U.S. agreed to delay an increase in the tariff rate and the scope of covered imports. China, in turn, agreed to purchase more U.S. goods and decrease tariffs on autos. However, the main points of contention around intellectual property theft, forced technology transfer and cybersecurity were not addressed, and the markets took only temporary solace from this agreement that expires February 1, 2019. The Chinese economy and American companies are just starting to feel the impact of this trade conflict.

Not reflected in the sharp decline in U.S. equities was the third consecutive +20% earnings growth rate and approximately 10% sales growth of the S&P 500 companies reported for the third quarter. Forward-looking company commentary that expressed concern around slowing growth and higher costs was likely the restraining factor to this good news. Fourth quarter earnings (reported in January) will likely not add to the streak of +20% but should show 15% to 17% growth with a 6% to 7% increase in sales. As with the third-quarter reporting season, the markets will be intensely interested in the clues provided by corporate executives

Index Performance Data

	4Q 2018	YTD	3-Year Annualized
Equity Index Returns			
Dow Jones	-11.31%	-3.47%	12.90%
S&P 500	-13.52%	-4.37%	9.23%
Russell 2000	-20.20%	-10.97%	7.34%
MSCI ACWI	-12.75%	-9.38%	6.58%
MSCI EAFE	-12.54%	-13.74%	2.87%
MSCI Emerging Markets	-7.47%	-14.53%	9.22%
Other Index Returns			
MSCI US REIT	-6.72%	-4.55%	2.87%
Bloomberg Commodity Inde	-9.41%	-11.20%	0.29%
HFRI FoF Index	-3.28%	-2.33%	1.75%

	4Q 2018	YTD	3-Year Annualized
Fixed Income Index Returns			
Barclays Aggregate Bond	1.64%	0.01%	2.05%
Barclays 1-10 Year Municipal Bond	1.61%	1.64%	1.66%
Merrill Lynch High Yield Master II	-4.67%	-2.26%	7.25%
Citi World Government Bond	2.27%	2.48%	2.78%
JPM Emerging Markets Bond Index Global	-1.19%	-4.59%	4.73%
Barclays TIPS	-0.42%	-1.26%	2.11%

Source: FactSet
Notes: HFRI FoF Index Performance as of 11/30/2018.
Returns are total returns except for Dow Jones & MSCI US REIT (price returns).
Citi World Government Bond is the hedged index.

Developed Markets

Earlier in the year, Europe was likely hurt by the sharply appreciating currencies in 2017. The situation deteriorated further primarily due to yet-to-be resolved political issues in three of the largest countries.

- **United Kingdom.** Negotiations over Britain's withdrawal from the European Union have become contentious. The U.K. economy is at risk of a recession if Britain leaves without a firm agreement.

- **France.** The country has been hurt by the so-called "yellow vest" protests that are calling for a large backtrack of proposed fiscal reforms by the Macron government.

- **Germany.** The strongest European economy is losing one of the most influential leaders of the European Union. Angela Merkel announced she is stepping down as chancellor after losing important regional elections to upstart populist parties.

Emerging Markets

The outperformance of Emerging Markets equities and debt was one of the bright spots during the quarter, albeit in a relative sense. As these markets are highly dependent on China, the temporary trade truce between the U.S. and China was a contributing factor to this positive relative performance. From a more permanent perspective, the Chinese government has implemented fiscal reforms emphasizing tax decreases with some incremental spending programs in an attempt to control the slowdown.

Commodities

Oil was particularly volatile during the quarter with crude prices peaking at $75 in the first few days and then crashing below previously established floors into the mid-$40s. Slowing global demand is being cited as one of the causes of this collapse, but supply continues to be the primary culprit. The re-imposition of U.S. sanctions on Iran should have reduced supply and increased prices. In reality, both Saudi Arabia and Russia increased production to fill the expected gap while U.S. shale companies continued to produce at a high rate. The market became oversupplied when the U.S. granted temporary waivers to several countries allowing them to continue to import Iranian oil.

Lower oil prices are generally good for the overall economy and particularly for the net-energy consuming countries. However, we learned from the price declines in 2015 that the U.S. is no longer an unequivocal beneficiary of lower prices as the energy sector of the economy has grown substantially over the last decade. Weakness in the U.S. high-yield sector during the fourth quarter is evidence of this fact; roughly 15% of the sector consists of energy-related debt issuers who may be experiencing greater repayment pressure due to revenue and production declines at current price levels.