MarketPoint

Fourth Quarter 2018 | Issue No. 24

TrustPoint
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What matters most over the long-term is not market timing but time invested in the markets.

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An Economic & Market Commentary from Trust Point

An Economic and Market Update from Trust Point

This was an interesting (and volatile) quarter, to say the least. While the economic backdrop didn't materially change over the past few months, market sentiment did—and in a big way. Very few areas were immune to the steep and sudden selloff we experienced recently. As a result of a very weak fourth quarter, 2018 proved to be a difficult year for investors.

"Declining" & "Contracting" are Two Very Different Words

Over the past few months, investors have de-risked portfolios on growing concerns about economic growth. Current macroeconomic conditions are not pointing in the direction of a recession or even a material economic slowdown, but investors have chosen to panic first and ask questions later. This is probably a legacy of the global financial crisis of 2008-2009. It is true that throughout 2018 the global economy showed signs of growing at a slower pace (after an unusually strong and synchronized global expansion in 2017), but indications of an outright collapse in economic growth are simply not present. There is a big difference between economic growth decelerating and outright contracting. While we believe the former trend is real, investors have recently been concerned about the latter. Throughout this cycle, we have seen economic growth accelerate and decelerate on multiple occasions. "Growth scares" develop from time to time; they are part of any normal economic cycle. We believe we are in the middle of a growth scare, not an economic collapse. In fact, we currently project U.S. economic growth to be at around 2.5% in 2019 and global growth to be at around 3.5% (Chart 1). Those are not the macroeconomic conditions historically associated with sustained and prolonged bear markets. In our opinion, asset markets have now discounted much greater economic weakness than we expect next year, repeating a frequent pattern of the past decade.

KEY ECONOMIC DATA

	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Dec	96.2	95.1	92.1
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Dec	54.1	59.8	59.3
ISM Non-Manufacturing (>50 = Expansion)	Dec	57.6	61.6	56.0
Non-Farm Payrolls	Dec	312K	119K	175K
Unemployment Rate	Dec	3.9%	3.7%	4.1%
CPI Ex-Food & Energy (yoy)	Nov	2.2%	2.2%	1.7%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Dec	51.5	52.2	54.5
JP Morgan Global Services Index (>50 = Expansion)	Dec	53.1	52.9	53.8

Source: Bloomberg

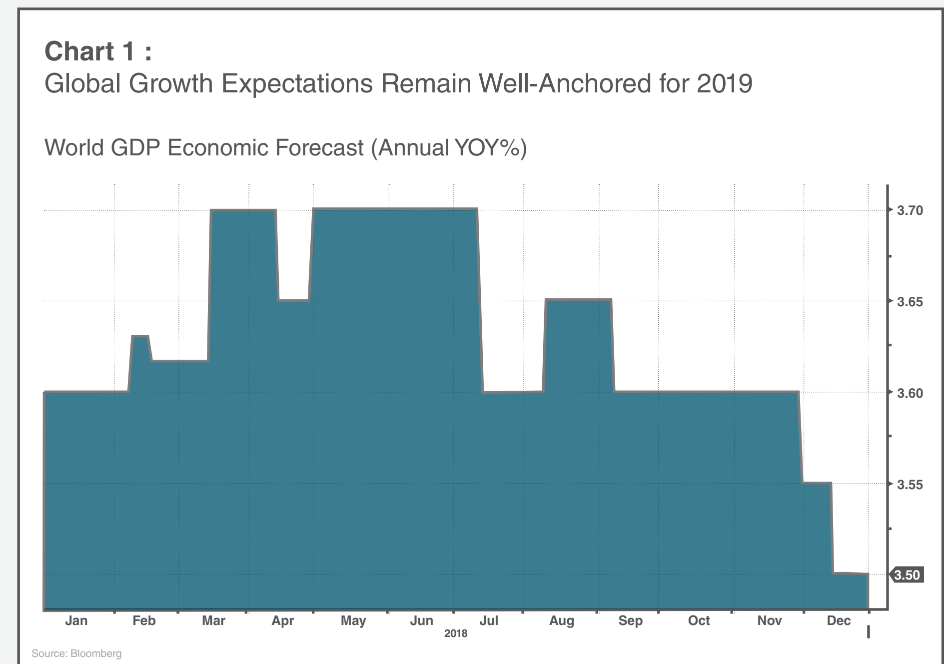
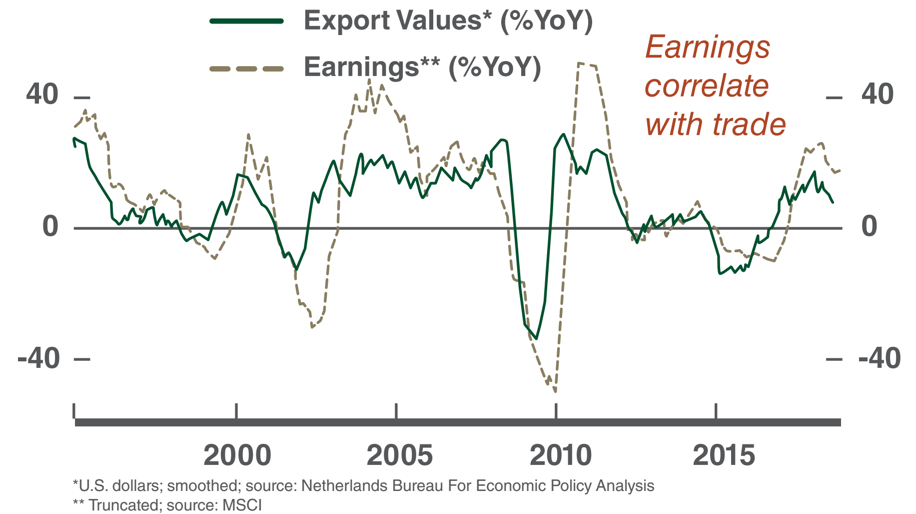


Chart 1 :
Global Growth Expectations Remain Well-Anchored for 2019

When Bad News is Bad News and Good News is Bad News

Geopolitical risks are always present, but they appear magnified when economic growth is slowing. In recent months, the confluence of many of those risks has rattled markets; think of the U.S./China trade dispute, the partial government shutdown over border-wall funding, Italy's budget dispute with the European Union, and Brexit. Politics often generate headlines that move markets in the short term, but their importance to markets over the long run is generally overstated. Having said that, the trade dispute between the U.S. and China is an important, ongoing geopolitical issue that is difficult to model and could be disruptive (Chart 2). We are encouraged, however, by the recent announcement of a "cease-fire" until March 1 and by renewed constructive discussions between the two countries. Aside from politics, recent comments by the Federal Reserve confirmed that it may be patient with further rate-hikes. To our surprise, those recent positive developments have fallen on deaf ears, as far as investors are concerned. We expect some easing of geopolitical concerns in 2019.

Chart 2 :
Global Trade Is an Important Driver of Global Earnings



*U.S. dollars; smoothed; source: Netherlands Bureau For Economic Policy Analysis
** Truncated; source: MSCI

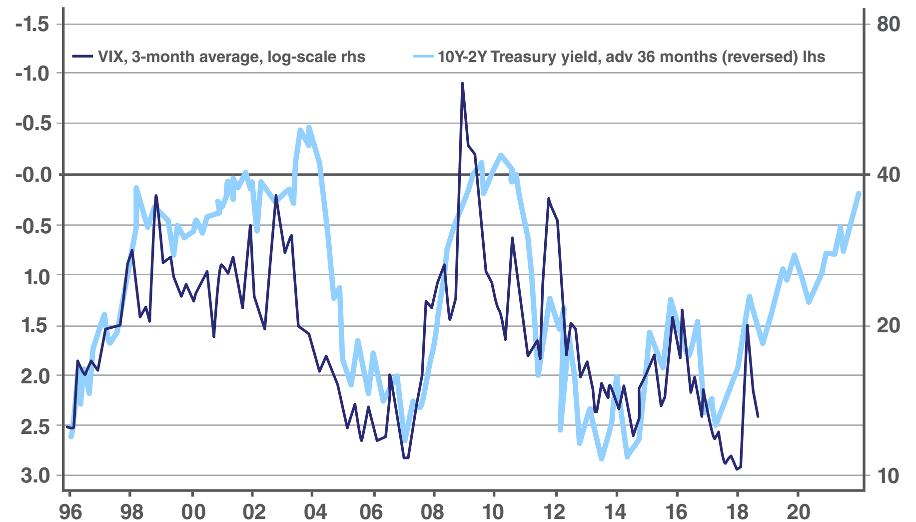
Source: MRB Partners Inc © 12/2018

The Future Still Looks Bright

While investment returns have been disappointing in 2018, the prospect for future long-term returns has improved for global multi-asset portfolios. That is correct! Lower equity prices and improved equity valuations, combined with higher bond yields and credit spreads, have recently led us to positively revise our long-term estimates for investment returns. Those estimates are not a forecast about how the markets will perform in 2019 but represent our best estimate of average annual returns over a long cycle. For fixed income, we now expect 2.5% to 4.5% per year on average, and for equities 4.5% to 7.5% per year, with international stocks expected to outperform domestic stocks.

We also have revised our estimates for short-term expected volatility. Rising short-term interest rates and a flattening yield curve historically have led to periods of increased market volatility (Chart 3). Unlike many investors, we are thankful for volatility, as we believe it creates long-term opportunities and allows us to capture a greater volatility-risk premium with our allocation to a covered call strategy in modeled portfolios. More importantly, we remain focused on the core investment principles that guide success over time: long-term focus, diversified portfolios built to weather different environments, tactical tilts to take advantage of volatility, and periodic portfolio rebalancing.

Chart 3 :
A Flattening Yield Curve Has Historically Led to Increased Volatility ("VIX") in Markets



Source: Nordea Markets and Macrobond

An Equity Market Update from Trust Point

The fourth quarter was the most challenging period for global equities since the financial crisis of 2008. The MSCI EAFE index decreased 12.5%, while the S&P 500 dropped 13.5%. While equity investors are certainly feeling unnerved, we are slightly overweight equities in our asset allocation models because we expect greater relative upside for stocks vs. bonds over the next six to twelve months.

EQUITY BENCHMARK TABLE

US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	2,507	2,914	2,674	2,044	1,848
Dow Jones Industrial Average	23,327	26,458	24,719	17,425	16,577
NASDAQ	6,635	8,046	6,903	5,007	4,177

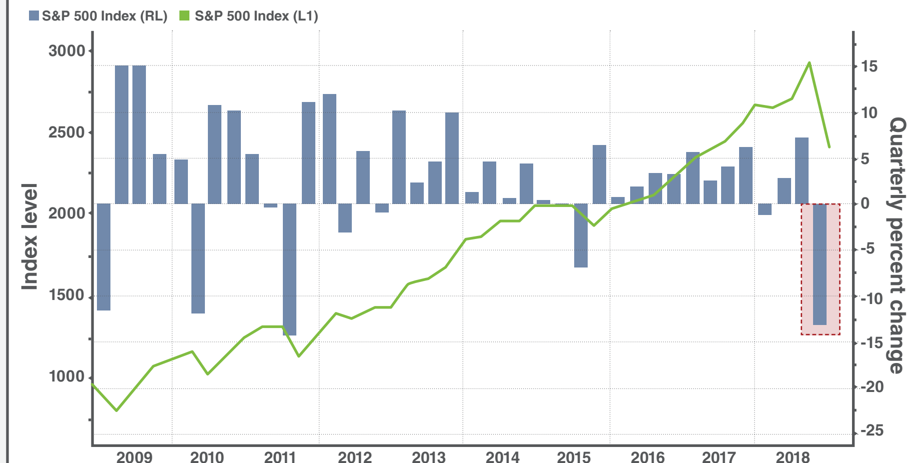
Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	-15.9%	-1.5%	-1.5%	11.1%	10.4%
US Large Cap Value	-11.7%	-8.3%	-8.3%	7.0%	5.9%
US Mid Cap Growth	-16.0%	-4.8%	-4.8%	8.6%	7.4%
US Mid Cap Value	-15.0%	-12.3%	-12.3%	6.1%	5.4%
US Small Cap Growth	-21.7%	-9.3%	-9.3%	7.2%	5.1%
US Small Cap Value	-18.7%	-12.9%	-12.9%	7.4%	3.6%
International Large Cap Developed (US Dollar)	-12.5%	-13.8%	-13.8%	2.9%	0.5%
International Small/Mid Cap Developed (US Dollar)	-16.0%	-17.9%	-17.9%	3.7%	3.1%
Emerging Market (US Dollar)	-7.5%	-14.6%	-14.6%	9.2%	1.6%

Source: Bloomberg, Morningstar

What Happened to Stocks in Q4?

U.S. equity markets declined 13.5% last quarter, the second worst quarter since the global financial crisis of 2008-09 (Chart 4). While it is often difficult to pinpoint all of the reasons why markets move sharply over short time periods, this downturn is likely due to several factors, including the U.S. Federal Reserve taking a more hawkish view than the market expected (even though the Fed's view following the December meeting was more dovish than previously communicated); continued concerns about a global economic slowdown (and a decline in global earnings growth); and the ongoing trade war between the U.S. and China. All of those things contributed to the "growth scare" we discussed above. Fundamentally, we are encouraged that earnings-growth expectations have not fallen to a greater degree than the market's returns in Q4 would imply (Chart 5). It is reasonable to expect earnings growth to decline from 2018 levels, which benefitted from U.S. fiscal policy (especially tax cuts), but recent market returns suggest that investors expect earnings growth will collapse. We see this as highly unlikely, given our expectations for reasonable economic growth in 2019.

Chart 4 :
Second Worst US Equity Performance Since Global Financial Crisis



Source: Bloomberg

Staying Steadfast in Our Overweight to Equities

Our overweight position to equities in our asset allocation models has stood for several years, rewarding clients along the way. However, this positioning has not been without its bumps, such as the one we experienced in late 2015/early 2016, when the U.S. Fed was beginning its rate-tightening cycle and China saw turbulence in its stock market and economic growth rate. The last quarter of 2018 brought another bump. However, as they did in early 2016, equity valuations have recently improved. Sentiment has turned more cautious, and equity markets have largely discounted the expectation of slowing U.S. and global growth in 2019. All of those are bullish signals for equity markets going forward. Since 1929, in periods following an S&P 500 decline of 15% or more, the index has been higher at least two-thirds of the time four and eight quarters after the decline; since World War II, the index has always been higher four and eight quarters later. We acknowledge that each time period is unique, with its own economic backdrop, but we believe now is not the time for investors to flee equities and run to cash. We will not always be overweight equities, as we recognize we are late in the current economic cycle. But, the time to become more conservative is not yet here.

Diversification Within Equities

A funny thing happened toward the end of 2018. International equities, which languished through much of the year as international economic growth slowed, began to outperform U.S. equities (Chart 6). For most investors, it is often tempting to reduce allocations to parts of the market that are underperforming or to avoid investing cash into those sectors, instead choosing to invest in areas that continue to perform well. During the fourth quarter, investors who stayed committed to international equities not only experienced less volatility but saw better relative returns, as well. The outperformance of international equities is partially attributable to the more attractive valuations of international stocks, making them a relative safe-haven. Other contributing factors include improving budget negotiations between Italy and the Eurozone, and the postponement of tariff-rate increases on China by the U.S. We cannot say whether international equities' outperformance will be sustained through 2019, but over the long term we think international will outperform domestic equities. We are staying committed to a globally diversified portfolio designed to reduce volatility and contribute to achieving long-term investment goals.

A Fixed Income Market Update from Trust Point

The U.S. Aggregate Bond Index has been negative only three times in the last 39 years. Absent a strong rally in high-quality bonds in the fourth quarter, 2018 could have become one of those rare negative exceptions. Because of that rally, the index managed to post a very slight gain for the year. Rising interest rates created a headwind in 2018; however, elevated rates will soon reward savers, making high-quality returns easier to achieve in 2019.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	2.4%	2.2%	1.4%	0.2%	0.1%
2 Yr US Treasury	2.5%	2.8%	1.9%	1.1%	0.4%
10 Yr US Treasury	2.7%	3.1%	2.4%	2.3%	3.0%

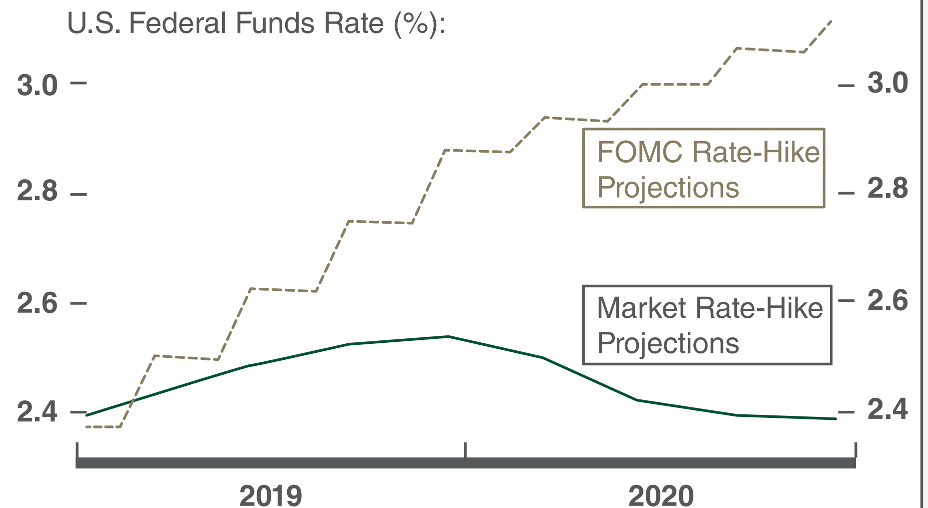
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	3.4%	1.2%	1.2%	1.5%	2.5%
US Treasury Inflation Protected Sec.	-0.4%	-1.3%	-1.3%	2.1%	1.7%
US Mortgages	2.1%	1.0%	1.0%	1.7%	2.5%
US Short-Intermediate T/E Munis	1.6%	1.8%	1.8%	1.5%	2.0%
US Investment Grade Corporates	-0.2%	-2.5%	-2.5%	3.3%	3.3%
US Senior Bank Loans	-3.5%	0.4%	0.4%	4.8%	3.1%
US High Yield	-4.7%	-2.3%	-2.3%	7.3%	3.8%
US Convertibles	-9.3%	0.2%	0.2%	7.9%	6.0%
Int'l Bonds Ex-US (Hedged)	2.4%	3.6%	3.6%	3.7%	4.5%
Int'l Bonds (Unhedged)	1.2%	-1.2%	-1.2%	2.7%	1.1%
Emerging Market Debt (US Dollar)	-1.2%	-4.6%	-4.6%	4.7%	4.2%

Source: Bloomberg, Morningstar

When and Where Will the Fed Rate-Hikes Stop?

The market has recently been telling the Fed that with economic growth likely slowing next year, the economy may not be capable of supporting a Fed Funds rate in the 3% range or higher (Chart 7). In past publications, we mentioned that with rising inflation and a low unemployment rate, it would take a significant correction in equities to cause the Fed to deviate from its plan. Markets have now had a significant correction, while inflationary pressures have eased. Looking forward, we know that the Fed does not want to make a policy mistake by raising interest rates too fast, which could snuff out the economic expansion. Fed committee members have supported this assumption, with several acknowledging recent equity-market weakness and the effect of trade uncertainty on sentiment and economic growth. At the December meeting, the Fed reduced its 2019 rate-hike projections from three to two while lowering the ending point for rate hikes in this tightening cycle. With signs of economic growth moderating, the Fed likely will continue to slow down the pace of rate-hikes next year, attempting to stabilize volatile markets with a less restrictive monetary policy.

Chart 7 :
Market Expectations For Rate-Hikes Remain Below Fed Forecasts



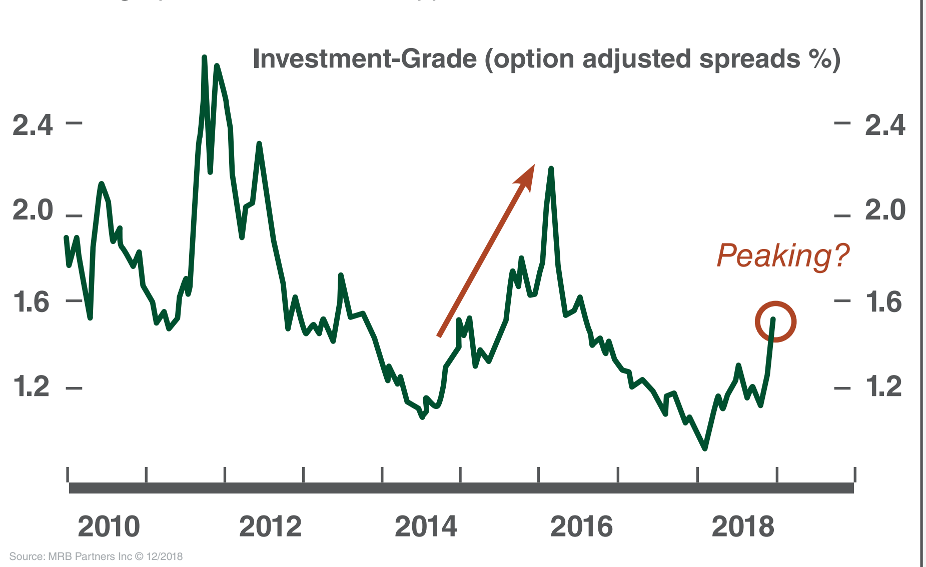
Source: Federal Reserve, Bloomberg

Bond Headwinds Subside

The U.S. Aggregate Bond Index is a broad benchmark for the country's fixed-income market. Over the first three quarters of 2018, the index was on pace to post a rare negative return for the year. The weak performance out of bonds reflected a move away from ultra-accommodative monetary policy, as the Federal Reserve hiked interest rates four times in 2018. This raised the total to nine rate-hikes in the current tightening cycle, which began in 2015. In the fourth quarter, however, we saw a dramatic shift in fixed-income markets. Bond yields tumbled, erasing all of the losses from earlier this year, as investors bought safe-haven bonds to shield portfolios from the recent equity volatility that has spooked many. The 10-year U.S. Treasury yield dropped 40 basis points from November highs, after rising 80 bps earlier in the year (Chart 8). The primary objectives of fixed-income investing are income generation, diversification, and preservation of capital, and the fourth quarter provided a clear example of these benefits at work. As equity markets experienced a difficult quarter, high-quality fixed-income exposure provided good performance as well as downside protection in portfolios.

Replay of 2015

Corporate bonds and other credit-sensitive bonds struggled in the fourth quarter, since credit markets are more correlated to economic activity and corporate health, as opposed to the direction of interest rates. In a pattern similar to one we saw in 2015, slowing global growth in 2018 and fears of a tightening policy by the Fed caused a downward adjustment in corporate bond prices. Also as in 2015, we do not see the tell-tale signs of a U.S. recession, which would justify the recent excessive pessimism and selloff in credit markets. Ever since the recession of 2008-09, credit markets have swung wildly, driven by shifts in monetary policy, political uncertainty, or idiosyncratic events like the collapse of oil prices in 2014-15. Credit markets rebounded strongly each time, as the Fed always erred on the side of caution. Opportunities to capitalize on market weakness are again beginning to emerge for investors who can see through the noise and recognize long-term value (Chart 9). In the short term, markets may get worse before they get better. Yet fundamentals remain healthy, pointing to slow but steady growth. We reduced exposure to credit markets throughout 2018 on the back of a slower growth outlook, but it's too early to position for sustained weakness. There is still room in this cycle for credit-sensitive bonds to benefit investors who are oriented to the long term.



MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment management team. The individuals contributing to Market Point are Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA, Brandon Hellenbrand, CFA®, Steve Brudos, Ryan Bergan and Christine Doll. Please feel free to contact any team member with questions.

Pictured top row left to right: Randy Van Rooyen, Yan Arsenault, Ryan Bergan
Bottom row left to right: Steve Brudos, Brandon Hellenbrand, and Christine Doll.

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