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# Investment Commentary - Fourth Quarter 2018

- Stocks falter; S&P 500 negative first time since 2008
- Bonds rallied in flight to safety
- Question of recession on investors' minds
- Positives still remain, such as economic growth and labor market, despite gloomy headlines
- Stay tuned for Brightworth's 2019 economic & investment video comments in the coming weeks

After a strong third quarter rally, stocks returned those gains in the fourth quarter with the S&P 500 finishing in the red for the first time since 2008. Concerns over a trade war with China, continued rate hikes by the Fed, and slowing U.S. and global growth led to the retreat. In this environment, bonds and alternative investments helped cushion portfolios during the equity retreat. As we turn the corner and head into 2019, having a well-designed portfolio that includes both growth assets and assets that tend to hold up well in downward volatility can help investors weather the late stages of the economic and market cycles. While the risks have been getting the headlines recently, we shouldn't lose sight of positives including solid economic growth, low interest rates and inflation, growing corporate earnings, and potential positive developments such as at least a temporary truce in the trade war with China.

**Economic Review & Outlook**

One question on many investors' minds as we start the new year is, "Will the U.S. economy enter a recession in 2019?" Most economists don't think so. According to the Wall Street Journal's monthly survey of 60 economists, not one predicted a recession for 2019. They do expect the economy to slow down with real GDP increasing at a 2.3% rate in 2019. While it may feel good to know few economists are forecasting a recession next year, historically economists rarely have predicted recessions in advance.

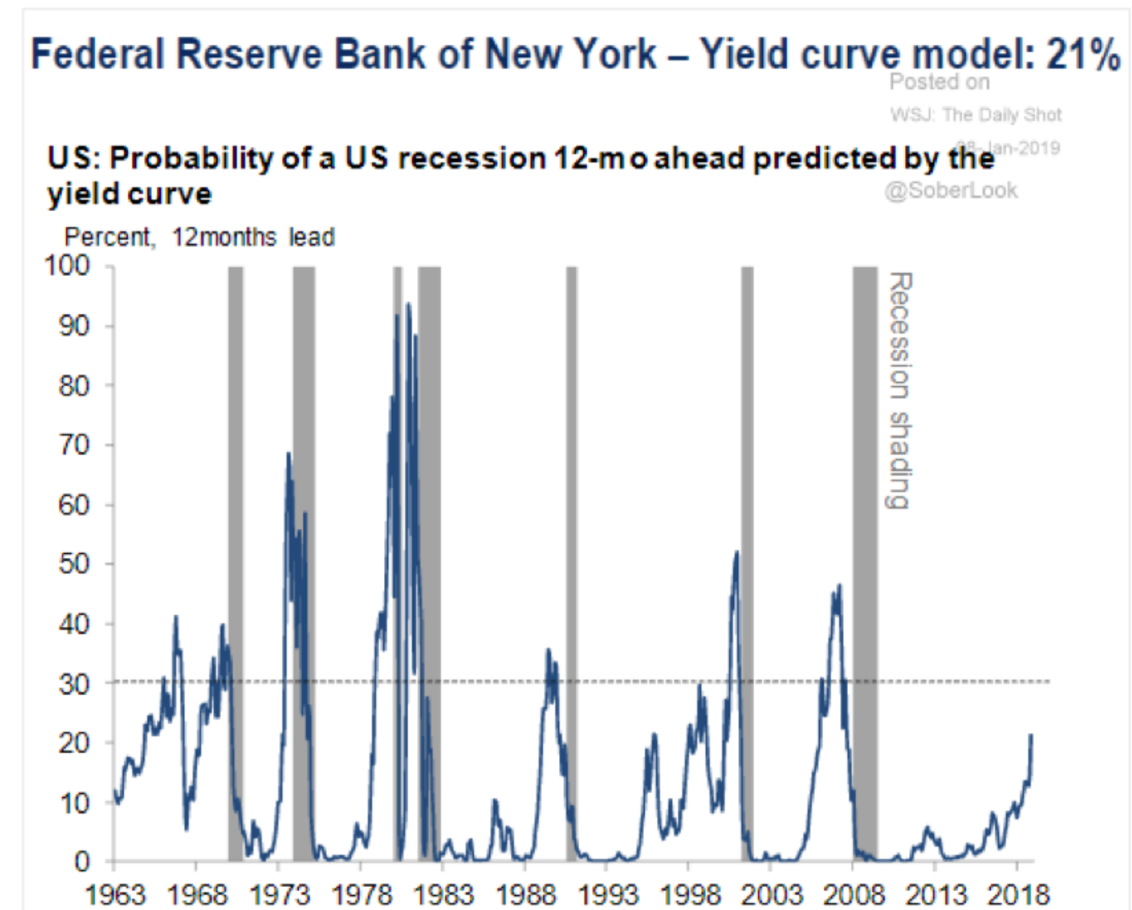
Two economists we respect have opposite conclusions regarding the economy. Dr. David Kelly, Chief Global Strategist for J.P. Morgan Asset Management, doesn't see significant systemic financial issues or areas of the economy that are sharply overheated that usually lead to a recession. Kelly expects a slowdown but no recession in 2019. Conversely, David Rosenberg, Chief Economists & Strategist at Gluskin Sheff, notes, "There have been 13 Fed tightening cycles since 1950. Ten of these landed the economy in recession, and neither the consensus nor the Fed staff saw them coming when they actually started." He believes the Fed's interest rate increases and quantitative tightening will lead to a recession in 2019.

Some leading economic indicators have begun to turn down. The stock market's recent swoon, drops in commodity prices such as oil, the flattening of the yield curve, and widening credit spreads all point to increased risks of recession. The housing market is another leading indicator of economic growth. The chart below shows the sales of existing homes over the past five years. What is most noticeable is the recent deviation from the upward trend from 2014 through early 2018. We last saw a slowdown in the housing market in 2014, however that was quickly followed by renewed buying interest. At that time interest rates were still in decline and the Federal Reserve was more than willing to keep financial conditions accommodative. We didn't know it at the time, but we were about to embark on unprecedented tax reform. Fast forward to today and it seems unlikely the Federal Reserve will remain as accommodative, nor do we have positive news likely to come from fiscal policy with control of the government now divided.

Source: Tradingeconomics.com, National Association of Realtors

The Federal Reserve Bank of New York uses the yield curve to predict the probability of a recession in the next 12 months (see chart below). The chance of recession according to this model has gone up significantly but remains below levels that have typically occurred prior to

previous recessions. If it goes sharply higher in the months ahead then chances are we will have a recession, but this model is not predicting a recession yet. As always, the question on the timing of the next recession is murky, but inevitably one will come. After one of the longest economic recoveries ever we think it makes sense to remain a bit more conservatively positioned.




Source: WSJ The Daily Shot 1.8.19; Oxford Economics/New York Federal Reserve

**Stock Market Review & Outlook**

Stocks did not bring holiday cheer to investors in the fourth quarter. The broad-based S&P 500 Index declined -13.5% for the quarter. Small caps fared poorly as well, declining -20.2%. International stocks held up a little better with the broad based MSCI EAFE Index down -12.5% while the MSCI Emerging Market Index declined- 7.5%. This was the worst quarterly return for the equity market since 2011.

Despite a poor fourth quarter, for the year the S&P 500 was only down -4.4%. Small cap stocks fared worse, down -11.0% for the year. Slowing global economic growth, trade concerns, and a stronger dollar led to bigger declines internationally with developed international stocks down -13.8% and emerging market stocks down -14.6% for the year.

Value stocks often hold up better than growth stocks in downturns and that was the case in the fourth quarter as value stocks outperformed growth stocks across all market capitalizations. However, growth still outperformed value by a wide margin for the year. This continues the trend of growth's dominance over the past couple of years. While our dynamic portfolios have benefitted from a slight tilt to growth, overall we remain largely balanced between growth and value stocks, and expect at some point in the future that value will again

be in favor.

**Bond Market Review & Outlook**
For the first three quarters of the year, solid economic growth and growing confidence led to rising interest rates and to the broad bond market being down -1.6% for the year. However, as uncertainty rose in the fourth quarter, investors sought the safety of bonds, driving interest rates down and the Barclays Aggregate Bond Index gained 1.6%. From the September 20th stock market high to its low on December 24th the broad bond market gained 1.6% while the S&P 500 fell 19.4%. Having a diversified portfolio is crucial to successful long-term investing as most investors are uncomfortable with declines of 20% or more over the stretch of a couple months.

The Federal Reserve raised rates quarterly throughout 2018 and had expressed their intention to continue raising rates in 2019. However, after recent market turbulence and a flattening of the yield curve (longer maturity yields coming down and shorter maturity yields rising), Fed. Chairman Powell has softened his outlook on additional interest rate hikes. We think it is likely now that the Fed will pause on additional rate hikes early in the year and see how economic and market data develops.

**Alternative Investments**
During the turbulence in equity markets in the fourth quarter, many segments and managers within alternative investments were down only a fraction of the equity markets, and some had positive returns. The overall alternative segment as measured by the Morningstar Multi-alternative Category was down -4.4% for the quarter, one third as much as the S&P 500. We were pleased with how the private real estate and real asset managers with whom we invest weathered the fourth quarter storm. Likewise, other strategies such as merger arbitrage, that deliver income and returns not tied to movements in the stock or bond market, were beneficial in preserving capital in a down market as well. Managed futures strategies also provided meaningful diversification benefits.

Toward the end of the quarter, after the S&P 500 was down 17%, we opportunistically shifted a portion of our alternative investments back into U.S. stocks. In doing this, we took a portion of the portfolio that had held up very well to buy into a portion of the portfolio now trading at significantly lower prices than it was just a couple of months ago. That doesn't mean we believe U.S. stocks are now a fist-pounding bargain. We still believe they are expensive, but less so than before. We continue to maintain a conservative stance in the portfolios and remain overweight to alternatives. But after some improvement in valuations we've moved the portfolios to a little less defensive stance. If our outlook for equities continues to improve, we will incrementally remove our remaining alternative overweight.

**Conclusion**
As we close out 2018, some investors may be nervous given the fourth quarter equity drawdown and the economic concerns highlighted in the press. As such, being prepared for continued volatility will be key to maintaining a level head when it comes to your investments. With that said, there are a number of positives in the current environment as well. Current economic growth is solid. The labor market is very strong, corporate profits are growing, and inflation and interest rates remain low. You also have history on your side. According to S&P Capital IQ, since World War II, the S&P 500 has never suffered a loss during the third year of a presidential cycle. Needless to say, it isn't all doom and gloom despite what the headlines may lead you to believe. One of Warren Buffet's most iconic and memorable quotes is, "Be fearful when others are greedy and greedy when others are fearful". It is safe to say the last

couple of years has seen its fair share of greed when it comes to investor expectations. We may be moving to the flip side of this, where opportunities will be created that we will look to take advantage of for our clients.

Stay tuned for additional comments from our investment team and wealth advisors in a video series which we'll send out in the coming weeks.

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