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## 2018 Global Volatility Returns

According to the Chinese Zodiac calendar, 2018 was the "*Year of the Dog*". A dog can be described as both worried and anxious on the inside. Once they decide on something, no one can persuade them otherwise. Seeing how the year ended, I would say this is an appropriate description.

Looking back, many of our major 2018 market themes played out as expected including short rates up, long rates remained low, wages accelerated, anchored inflation, and continued monetary/fiscal risk.

During the year the Federal Reserve continued to tighten policy with both its balance sheet reduction and rate rise programs. We expect this policy tightening to pause and/or shift in 2019.

Right before year end we experienced something not seen in the last 23 years. The S&P 500, global equities, oil, commodities, corporate bonds, and treasury bonds all experienced negative returns at the same time.

These weak returns might sound surprising given 2018 started out as one of the best economic years of the expansion. It should serve as a reminder that more than economic factors drive market returns. Other factors that contributed to the decline were market technicals, valuations, and liquidity risk.

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## 2019 Market Themes

1. Late Stage Economic Growth
   - slower economic growth
   - business investment weakening
   - wage growth continues
   - low oil prices a net positive for consumers
   - stable consumer spending
   - technological efficiencies improve productivity
2. Monetary Policy
   - interest rate policy approaches normalization
   - Fed may ease interest rate policy through pauses
   - planned balance sheet reductions may slow
   - international monetary policy remains supportive
3. Fiscal Policy
   - significant intertwined political/fiscal risks remain
   - 2018 positive tax reform impact fades
   - short term growth doesn't offset budget deficit
   - government deficit continues to pressure policy
4. Interest Rate Environment
   - 2% plus money market yields return!
   - demand for income pressures longer yields
   - yield curve remains historically flat
   - government debt could lead to higher rates
5. Corporate Profits & Valuations
   - earnings under pressure from higher rates and costs
   - capex reductions in order to support profit margins
   - global trade negotiations disrupt supply chains
   - absolute equity valuations are attractive
   - expect earnings guidance reductions
6. Debt Levels
   - focus shifts to global government deleveraging
   - corporations face higher refinancing rates
   - reduced emphasis on shareholder distributions
   - increased priority on strong balance sheets
   - household balance sheet remains healthy

S&P 500 ANNUAL RETURNS LAST 25 YEARS

| Year Ending | Total Return Change |
|---|---|
| 2018 | -4.40% |
| 2017 | 21.80% |
| 2016 | 12.00% |
| 2015 | 1.40% |
| 2014 | 13.70% |
| 2013 | 32.40% |
| 2012 | 16.00% |
| 2011 | 2.10% |
| 2010 | 15.10% |
| 2009 | 26.50% |
| 2008 | -37.00% |
| 2007 | 5.50% |
| 2006 | 15.80% |
| 2005 | 4.90% |
| 2004 | 10.90% |
| 2003 | 28.70% |
| 2002 | -22.10% |
| 2001 | -11.90% |
| 2000 | -9.10% |
| 1999 | 21.00% |
| 1998 | 28.60% |
| 1997 | 33.40% |
| 1996 | 23.00% |
| 1995 | 37.60% |
| 1994 | 1.30% |
| **Avg. Annualized** | **9.08%** |

*Table Source: S&P Dow Jones Indices*

## 2018 Benchmark Index Performance

| Asset Class | 2018 | As Measured By |
|---|---|---|
| Fixed Income | | |
| Investment Grade Short | 1.6% | Barclays U.S. Gov/Credit 1-3 Year |
| Investment Grade Muni | 1.7% | Barclays Muni Bond 7 Year |
| Investment Grade Taxable | 0.0% | Barclays U.S. Aggregate Bond |
| High Yield Bond | -2.1% | Barclays U.S. Corp High Yield |
| Global Bond | -2.2% | Barclays Global Bond Agg X-US |
| Equity | | |
| Large Capitalization | -4.4% | S&P 500 |
| Large Capitalization Growth | 0.0% | S&P 500 Growth |
| Large Capitalization Value | -9.0% | S&P 500 Value |
| Small & Mid Cap (SMID) | -10.0% | Russell 2500 |
| International Equity | -14.2% | MSCI ACWI X-US |
| International Developed | -13.8% | MSCI EAFE |
| International Emerging | -14.6% | MSCI Emerging Markets |
| Preferred Stock | -4.3% | S&P US Preferred Stock |
| Gold | -2.1% | S&P GSCI Gold Spot Price |

*Data Source: Tamarac and providers to Tamarac. Total returns.*

## 2018 Performance Commentary

There is no question 2018 was a challenging year...Well, the 4th quarter of 2018 made for a challenging year with renewed volatility. As evidenced above, a rare year of almost every asset class suffering negative or very low positive performance. In a world of algorithmic and day traders, this type of overall volatility can be a blessing in disguise for those that focus on fundamentals and have long time horizons.

At the start of the year, interest rates rose substantially given optimistic economic sentiment to only decline in the second half as global risks emerged. The 10 year U.S. Treasury yield ended right around where it started in late January, at 2.69%. Quality bonds went on to produce low returns in the 0-2% range, depending upon the applicable index. Lower quality bonds, such as high yield, had a negative return of 2.1%.

While global equity performance diverged through the first half of the year, the U.S. eventually succumbed to financial market pressures. The S&P 500 returned a negative 4.40% during the year, and dropped 20% intra-year, making it the worst performing calendar year since 2008.

Over the last 25 years there have been only five that ended negative on a calendar year for the S&P 500 (see table to the left). Despite these periodic performance drags, the S&P 500 still returned 9.08% annually over the aforementioned time horizon.

## Portfolio Positioning

### Asset Allocation

Similar to last year, our asset allocation favors equities over bonds. Within equities we remain slightly overweight in large cap U.S. and international. This positioning reflects a risk reduction by favoring large companies over small and more positive valuation prospects across the globe.

Within fixed income, we continue to increase our maturity and duration in portfolios as market yields increase. This enables us to increase the overall income in most portfolios.

### U.S. Equity Style

Our large cap equity portfolio includes growth, core (blend), and value securities. While each style has its unique quantitative characteristics, we look for equities that will deliver above average earnings and revenue growth but are not too expensive.

Entering 2019, we continue to position our portfolios with growth equities at reasonable long term valuations.  These companies also carry attractive secular themes and should prosper during various economic cycles.

### Equity Sector Commentary

We maintain our favorable view of the technology sector and this is expressed with our overweight positioning. While economic growth may be low by historical standards, growth in the technology sector remains robust. There is still a substantial market for those firms focused on the cloud, data analytics, electronic payment processing and artificial intelligence.

Most companies within this sector carry profit margins double those of the market index (22% margins for the information technology sector v. 11% margins for the S&P 500 in aggregate).

We remain cautious on the defensive sectors: telecom, consumer staples, utilities, and REIT. Their growth prospects and intrinsic valuation are not as attractive from a sector perspective in our opinion. We do however recognize the U.S. economy is in the late stage of the economic cycle making these sectors important for managing overall risk.

## Summary of Tactical Views

| Asset Class | Current Tactical View |
|---|---|
| **Cash** | Overweight. Money market yields have risen with each rate increase. Cash is also a lower risk and liquid asset class. |
| **Fixed Income**<br>**Investment Grade**<br>**High Yield** | Underweight & Defensive. We are currently positioned defensively within fixed income in three ways. We have a lower overall fixed income allocation than longer term strategic targets; we use slightly lower duration targets (higher than last year but lower than our long-term targets) to reduce sensitivity to changing interest rates; and we have a reduced allocation toward direct high yield (higher risk) exposure. |
| **Equity**<br>**Large-Cap**<br>**Small & Mid-Cap**<br>**International** | Overweight. Overall, the overweight to equities is marginal. Our portfolios are overweight U.S. large cap and international equities, while underweight U.S. small/mid cap equities. |

Tactical views are focused on the shorter term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer term market cycles up to 10 years.

## Summary

**Key Market Dynamics**

1. **Late stage:** The economic cycle stage continues to suggest caution.
2. **Monetary Policy**: The Federal Reserve entered 2018 with a goal of garnering ammunition for the next cycle downturn. These downturns may need prolonged monetary stimulus, which could include lower for longer rates and substantial asset purchases.
3. **Fiscal Policy**: Corporate and individual tax cuts coupled with slower economic growth may prove to be a strain on the annual budget. The result will be a deficit that continues to rise from $666B in 2017, to $779B in 2018, and estimated at just under $1 Trillion for 2019. The national debt level for the U.S. is now $21.9 trillion, up $11.3 trillion over the last 10 years. These factors may add upward pressure on interest rates. Estimates show a 1% increase in rates leads to an additional $140B in annual interest payments.
4. **Inflation and Yields:** Inflation will remain subdued as technology continues to drive prices lower. The current low yield environment may persist for the foreseeable future. Flatter yield curves and lower long rates may be the result of both monetary stimulus and a demographic demand for income.
5. **Valuations/Fundamentals**: The current forward price to earnings ratio of 14.4 is now below the 25 year average of 16.1 (S&P 500) reflecting attractive valuations. This attractive valuation environment does not yet reflect expected short term earnings guidance reductions.
6. **Deleveraging**: In the early 2000's, we faced corporate deleveraging, followed by households in 2008. While we do not anticipate this in the near future, the next deleveraging cycle could be within the government and/or sovereign sector.

According to the Chinese Zodiac calendar, 2019 is the year of the pig. A pig's personality can be described as calm and helpful to others; and no matter how difficult the problem encountered, they will handle it properly and carefully.

Sincerely,

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## Numbers Talk: 0 1 2 3 4 5 6 7 8 9 0

### Numbers help tell a story ... Inserted for your reading pleasure

**Economic:**

1. U.S. Economic Expansion becomes longest on record in July - debate on who claims the credit
2. Real GDP grew 3% year over year (3.4% Q over Q) by the end of 3rd quarter 2018
3. Wage Growth rose to 3.2% at end of November, as compared to the 50 year average of 4.1%
4. Unemployment Rate was at 3.7% in November, as compared to the 50 year average of 6.2%
5. Household debt service is at a record low at 9.9% (debt payment divided by disposable income)
6. Goldman's recession probability is 10% for 2019 and 43% over the next 3 years
7. Fed's balance sheet has contracted by 7.7% over the past year
8. U.S. Debt ceiling level will need to be addressed and raised in 2019 under a divided congress
9. Sources of funding the government are 39% income tax, 6% corporate tax, 28% social insurance, 5% other, and 22% borrowing

**Markets:**

1. The S&P 500 is up 271% (price only) since its low on March 9, 2009
2. The 20% intra-year drop of the S&P 500 in 2018 was one of the 7 worst since 1980
3. Goldman Sachs base case for 2019 is 4% earnings per share growth and 8% price/earnings expansion to 16.6
4. S&P 500 profit margins at all time record high of 12.1%
5. Forward Price/Earnings of the S&P 500 is 14.4 compared to 16.1 (25 year average)
6. Average dividend yield of the S&P 500 is 2.3%
7. 10 Year Treasury Yields: 2.69% nominal, 2.24% inflation, and .45% real
8. Treasury yield curve spread is flat at 21 basis points (2 year v. 10 year treasury)
9. Corporate bond AA rated 5 year yield is 3.38%
10. Municipal bond AA rated 5 year yield is 2.15% tax exempt