4TH QUARTER & 2018 YEAR END REVIEW

Executive Summary

- U.S. and global stocks fell sharply in the 4th quarter. 2018's 4.6% drop in the S&P 500 Index became only its 2nd losing year in the past 16. Over that time, which included some very difficult periods, the Index produced a 7.6% annualized return.
- Most asset classes lost money in 2018, and the few that gained earned returns of 1% or less.
- Negatives currently weighing on markets – U.S. and global economic growth concerns, risks of a global trade war, uncertain U.S. and global policy and politics.
- Positives for long-term investors – very negative investor sentiment and more attractive equity valuations now in-line with historical averages, both implying greater expected forward returns. <u>U.S. stock market history strongly favors gains following quarters incurring double-digit declines.</u> The U.S. economy is strong, marked by full employment and high consumer confidence.
- VWG believes that 2018 was a resetting of expectations and a repositioning of assets. It was **<u>not</u>** a signal of impending recession or something worse. We believe we have identified several investments and strategies offering attractive long-term return potential.

Review of the Markets

The positive mood of the U.S. stock market reversed quickly in the 4th quarter, triggered by a 4% drop in the Nasdaq Composite Index on October 10th. Sentiment rapidly succumbed to growing fears of slowing U.S. and Chinese growth, rising interest rates, fragile Brexit negotiations, flailing French and Italian economies, and U.S./China trade tensions. By the end of October, large U.S. stocks (S&P 500 Index) had fallen 9.5% from their late-September highs. Small U.S. stocks (Russell 2000 Index), which had peaked earlier at the end of August, followed suit. Markets unsuccessfully attempted to recover from those levels through mid-December.

Next came two successive events that further damaged investors' confidence. U.S. Federal Reserve Bank Chairman Powell's commentary, which accompanied the Fed's December 20th 0.25% base lending rate increase (the 4th such move made in 2018), stated that Fed policy was on "autopilot." This implied that there was little forward flexibility or consideration of potentially softening conditions. Within 24 hours it was reported that President Trump had made inquiries about firing the Central Bank Chairman. Given the status of the U.S. dollar as the world's reserve currency, this deeply shook markets. These events, added to already weak markets, thin holiday trading, and quickly appearing losses now ripe for year-end tax-loss harvesting, triggered three straight days where over 80% of U.S. stock volume went into declining issues. Lowry's Research Corporation deemed this to "reflect near capitulation style selling."

Large U.S. stocks ended down 13.5% for the quarter, as measured by the S&P 500 Index. After being positive for most of the year, they ended up losing 4.6% for the year. Small U.S. stocks fared worse, despite expectations that they might be better insulated from international economic and policy concerns. The benchmark Russell 2000 Index plunged 20.3% for the quarter and ended the year down 1.1%.

Equities of foreign businesses, domiciled in less robust economies than the U.S, underperformed despite their more attractive valuations. The benchmark MSCI EAFE Index tumbled 12.6% in the 4th quarter. It lost 13.8% for the year. Emerging markets stocks struggled in 2018, being very sensitive to slowing global growth and trade tensions. The MSCI Emerging Markets Index fell 15.3%. As a dim but hopefully promising sign, they *outperformed* large global stocks in the difficult 4th quarter, down 7.2%.

After losing money all year long as interest rates rose, bonds finally capitulated in 4th quarter's sharp "risk off" shift. The yield of the 10-year U.S. Treasury Note fell to a shockingly low 2.68% at quarter's end, sloughing off earlier inflation fears. The Barclays Aggregate Bond Index rose in turn, earning a total return of 1.8% for the quarter. After quite a contentious roller coaster ride, the index squeaked out a 0.1% positive return for the year. More economically sensitive high yield bonds faltered.   The Barclays High Yield Very Liquid Index of high yield bonds dropped 5.0% in the quarter and lost 3.3% for the year. The S&P National Municipal Bond Index returned 1.9% in the quarter, and earned 0.9% for the year.

Commodities were not immune. Copper, which many view as a bellwether indicator for economic growth, slipped 3.5% in the quarter, and lost 16.7% for the year (NYMEX High Grade Copper continuous futures contract). Crude oil took a staggering *(at least for producers)* reversal in the quarter, plunging 38.0%! The NYMEX West Texas Intermediate Crude continuous futures contract ended the year down 24.8%. Gold, often a "safe haven" asset during times of stress, firmed a bit. The NYMEX Gold continuous futures contract rose 7.1%, but still lost 2.1% for the year.

Surveying the Investing Landscape

2018 became only the second year in the past sixteen in which large U.S. stocks (S&P 500 Index) fell. And it did so by closing the year in stunning fashion. December was the worst month for U.S. stocks since October 2008, and the worst December for the stock market since 1931. Investors, overly complacent after a year-and-a-half of record low levels of volatility, were sharply reawakened. 2018 suffered two double-digit drawdowns. This hadn't been occurred since 1946. Daily price volatility also returned. In 2017 there wasn't one trading day in which the S&P 500 Index moved up or down more than 2%. In 2018 there were 20 such days!

Looking beyond stocks, almost every major asset and sub-asset class lost money in 2018. The few that did not scratched out only very minor returns of 1% or less. In comparison, even the global meltdown of 2008 yielded two asset classes earning healthy gains – U.S. government bonds and federally-backed mortgages.

Most assets losing money, while none rise in value as “risky” assets are swapped to other perceived safe assets – suggests significant declines in global liquidity. Specific drivers of tightening liquidity include the Federal Reserve’s interest rate increases to a yield over 1.5% *(for the first time since September 2008),* the Fed’s runoff of debt accumulated during the post-crisis Quantitative Easing (QE) programs, the rising value of the U.S dollar, and China’s moves to reduce leverage and financial excesses.

As we enter 2019, numerous issues weigh on markets. U.S. and Chinese economic growth is slowing, while the Eurozone struggles. Risks of a full-scale global trade war, and a prolonged U.S. government shutdown, further add to growth concerns. Parts of the U.S. Treasury yield curve are inverting, as the Federal Reserve continues its attempt to “normalize” interest rates. Despite a strong economy, the U.S. is running massive deficits. Uncertain and erratic U.S. leadership is clouding businesses and investment forward visibility. The change in control of the House of Representatives and the release of findings from the Mueller investigation are poised to add to the chaos in Washington. Euro Zone political and economic turmoil are threatening markets. Paul Krake of “View from the Peak” claims that unless “Britain’s Prime Minister Theresa May’s deal passes the Parliament, we will get a ‘Hard Brexit’ which almost certainly will lead to a United Kingdom and a Euro Zone recession.”

There are also positives to consider: Momentum is slowing, but the U.S. economy is strong. Measures of U.S. consumer confidence and purchasing managers’ surveys are solid. Average estimates for 2019 U.S. GDP growth hover around 2.3%-2.5%. Despite claims to the contrary, the odds of a U.S. recession occurring in the next 4 quarters are very low. Inflation is contained, further bolstered by the decline in oil prices. Interest rates are still historically low, and monetary policy is still accommodative. Corporate earnings are expected to grow around 7%. Some optimistic strategists contend that 2018’s corporate tax-cuts have latent persisting positives, and were not one-time “sugar highs.” As seen during previous post-2008 “soft patches,” leaders and politicians around the world will be highly motivated to take stimulative actions. As the U.S. 2020 election comes into focus, more attention to the economy will surely ensue.

The greatest positives for equity investors are investor sentiment and asset pricing. Michael Cembalest, J.P. Morgan's Chairman of Market and Investment Strategy, states that "for the first time in many years, markets are now pricing in pessimism instead of optimism. Investors are finally being paid to take risk around current levels, providing they have a long time horizon." Asset flows confirm this negativity, as Lipper states that "$46 billion was redeemed from U.S. stocks mutual funds and ETFs the second week of December, the largest weekly outflow since Lipper began tracking these in 1992." Valuations are more reasonable. The price-earnings multiple of the S&P 500 has contracted significantly, and is now slightly lower than its average over the past 28 years. The low 2.68% yield on the 10-year U.S. Treasury makes placing money into intermediate term fixed income less attractive.

History strongly depicts the counterintuitive advantage of negative sentiment and more favorable valuations. <u>In the 20 quarters since 1946 in which the S&P Index fell more than 10%, it rose in the following quarter and full year 16 times.</u> Its average forward returns over those 20 periods was 5.1% for the next quarter, and 15.9% for the following year.

Putting it all together, there are numerous real positives and real negatives exerting themselves on markets today, most of which will not be resolved any time soon. The benign calm of 2017 was an outlier, not to reappear. Occasional outbreaks of volatility are to be expected. They will eventually present opportunities to both earn advantage, and to reduce risk. Further pessimism is not called for at this time, as plenty of negativity is already priced into stocks and bonds. We believe 2018 was a resetting of expectations and a repositioning of assets, <u>**not**</u> a signal of an impending recession or something worse.

Portfolio Strategy and Asset Positioning

VWG Wealth Management's overriding narrative on the macro environment is that "the world is starved for growth." Some version of the "growth scarcity" story has been at play in almost every theme that has faced markets since the 2008 financial crisis. This includes central bank zero interest rate and quantitative easing policies, the global rise of populism and nationalism, and struggles over immigration and trade policies. With massive debt balances and aging demographics facing almost all global developed economies, we expect this narrative will persist for a long time. Investors will face risks, opportunities will appear, both requiring patience and perspective. Although it can in no way produce the best short-term returns, portfolio diversification is mandated. Holding an allocation to liquid, high quality short-term fixed income is necessary.

With equities now cheaper and longer-term bond yields less attractive, we will look for opportunities to modestly increase equity allocations for our clients with long-term investment horizons.   Within portfolios we will look for opportunities to upgrade in terms of quality and growth prospects. For more conservative clients, and for those having shorter investment horizons, we will use periods of strength to trim equities and increase “dry powder.” In bonds and fixed income, we remain underweight except in allocations to a very select set of niche managers and strategies who we believe can produce solid, stable returns.

VWG’s optimally diversified portfolio construction reaches beyond publicly traded stocks and bonds. Long-term ownership of equities (and funds managing the same) of quality, growing businesses is a cornerstone of long-term wealth accumulation. However, publicly traded stocks and ETFs of these businesses are extremely liquid, even more so than many bonds. Liquidity and “frictionless trading” has its liabilities as well as its benefits. As we just witnessed in the 4th quarter, stock prices can move quickly on changes in sentiment, detaching from underlying fundamentals.

The implementation of structured note strategies in our portfolios will continue in 2019. As we have just been reminded, there are great benefits in attempting to buffer equity downside, and in converting a portion of equity participation into a fixed contingent coupon. Even if the daily pricing of these notes waiver with market volatility, their asymmetric return/risk metrics should prove out when held to maturity, or when rolled at higher valuations.

VWG continues to research and place entrepreneurially-driven private strategies – focused on forming and growing businesses, on funding business expansion, and on owning and operating commercial and rental real estate. We seek to deploy client capital with focused niche operators, who have experience in creating independent sets of profit and alpha drivers apart from enjoying market beta and riding macro trends. Ideally, these operators and strategies only work with a contained, smaller asset size. They are somewhat insulated from massive asset flows coming in and going out of their respective spaces. We see these strategies’ limited liquidity, restricted access, and periodic asset pricing, as being operationally and behaviorally valuable to both their managers, and to our client investors.

Best wishes to everyone for a prosperous and healthy 2019!

We deeply honor the trust you have placed in us. Our foremost goal is to protect your capital and help you achieve your long-term financial objectives. We will work hard to earn safe, differentiated returns in the coming year.

Regards,

VWG Wealth Management
Suzanne, Ashley, Rashmi, Kay, Lynette, Michelle, Christina, Amanda, Sarah, Justin, Elana, Patricia, John, Rick and Jeff

Who We Are

** Index Data Sourced from FactSet Research, Morningstar, Bespoke Investment Group*

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