January 2, 2019

Looking back on 2018 and forward to 2019

Dear Investor,

When looking back on 2018 we are reminded that volatility in the stock markets is normal and is part of the investment process. In the first half of 2018, the markets were moving higher, albeit with a few setbacks, and economic growth was accelerating. However, in the fourth quarter of 2018 we experienced milestones in the markets that made for some conflicting news headlines such as:

- "On December 26 we saw the largest point gain on the Dow Jones Industrial Average in US history", and

- "2018 will be the largest market decline since 2008"

In my view, 2018 will look good in the rearview mirror with the major averages including the Dow Jones and S&P 500 declining about 5%, and foreign markets showing an average decline by about 12% (MSCI EAFE). The main factors for these declines were the concerns of: a slowdown in global economic growth, ongoing trade tariff disputes, central bankers withdrawing monetary stimulus, and global political drama. Some these issues may turn out to be just "noise" in the big picture as we move into 2019.

There will always be times when our resolve will be tested that can have a significant impact on investment success. In the past, solid economic fundamentals here in the U.S. took the markets back up after severe drawdowns. And, even as bad as the drawdown has been so far, by historical standards, it is still within normal parameters. Severe drawdowns happen every 5 to 10 years, so we are roughly on schedule. Such drawdowns certainly are not fun, but neither are they necessarily a harbinger of crisis. Sticking with a sound diversified investment strategy may produce the best outcomes in achieving investment goals.

What, then, does this mean for the economy and markets in 2019?

Economic growth. For the US economy overall, things have slowed a bit since the start of 2018. Consumers are still spending (consumer sentiment remains near 18 year highs 1), but businesses are investing less. Also, while government spending growth is likely to continue, it won't accelerate, and global trade may also slow. This should leave 2019 growth about average, at around 2 percent to 2.5 percent on a real basis. According to J.P. Morgan the 50 year average is about 2.3% annual growth in gross domestic product (GDP).

Inflation and interest rates. Despite continued economic growth, inflation has remained moderate through 2018, and the most recent data suggests that it is unlikely to accelerate much further in 2019. Current levels are slightly above, but generally consistent with what the Fed considers acceptable. With moderate inflation, the Fed has indicated they will be monitoring the economic data carefully to determine if future interest rate hikes are necessary to keep the economy from overheating and creating high inflation. If the Fed does not get too aggressive with interest rate hikes, it will most likely create an environment for ongoing economic growth.

Stock markets. This means that stock markets are likely to trade on fundamentals such as revenue and earnings growth. Here in the U.S., both revenue and earnings growth were much greater than expected at the start of the year due to the 2017 Tax Cuts and Jobs Act, which reduced tax rates. While this is a trend that should moderate in 2019, revenue growth is expected to remain strong, at levels last seen in the immediate recovery from the financial crisis, which should support continued growth in earnings through 2019, at a slower but still healthy pace compared with 2018.

With solid fundamentals, the real question will be what stock valuations do. Historically, high levels of confidence have driven valuations higher, which is what we have seen through most of 2018. Recently, however, valuations have dropped to the lower end of the range typical of the past five years or so. As confidence levels moderate and growth slows, we can expect valuations to remain at the lower end of that range.

Given projected earnings growth and a resetting of valuations to levels prevailing through the past couple of years—to about 15 times forward earnings—the S&P 500 may end 2019 between 2,900 and 3,000, which would represent about a 15% increase from where the markets stand right now. There is upside potential if valuations recover to the high levels seen recently. But there may be more downside risk, as even a valuation of 15 is quite high historically. Still, this estimate is consistent with revenue and earnings growth projections and with overall economic growth.

What to watch for

None of this is guaranteed, of course. Things to watch include the apparent slowdown in U.S. and global economic growth, as well as rising interest rates. On the political side, we'll need to watch for potential investigations into the administration; the pending crises in Europe, including Brexit and Italy; and the situation with North Korea. Trade conflicts also have the potential to worsen. These events may create more concern in the upcoming year.

Even if some of these risks come to pass, though, with job growth and confidence high, the economy is likely to keep growing which should limit any damage. Overall, 2019 seems poised for slow but steady economic growth, moderate market appreciation, and more normalization across the board. Despite the headlines, this is not a bad place to be.

Wishing you well and a great 2019!

Sincerely,

Mike

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Certain sections of this commentary contain forward-looking statements based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance does not guarantee future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges, or expenses. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float‐ adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Index consists of 21 developed market country indices.

1 Source: University of Michigan Index of Consumer Sentiment.

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