

Investment Perspectives

Turbulent Markets Bring an End to the Year

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Key Takeaways

- The sharp market selloff in Q4 led global equities to post losses for 2018 and has raised concerns about the future of the nearly 10-year bull market run
- In our view, the selloff was overdone and we expect 2019 to be a modestly positive year for equities
- A slowdown in economic and corporate earnings growth is expected and priced in, but we believe it will stop short of recession
- Overall, we expect 2019 to be a positive but volatile year given the late economic cycle dynamics at play

The final months of 2018 brought a great deal of turmoil for investors as risk assets came under pressure amidst heightened volatility. U.S. equities, which reached all-time high levels in late September, sold off significantly and experienced the worst month of December in decades. While the final trading days of the year and the early days of 2019 have been more positive for equities, we expect that heightened volatility is here to stay for some time to come.

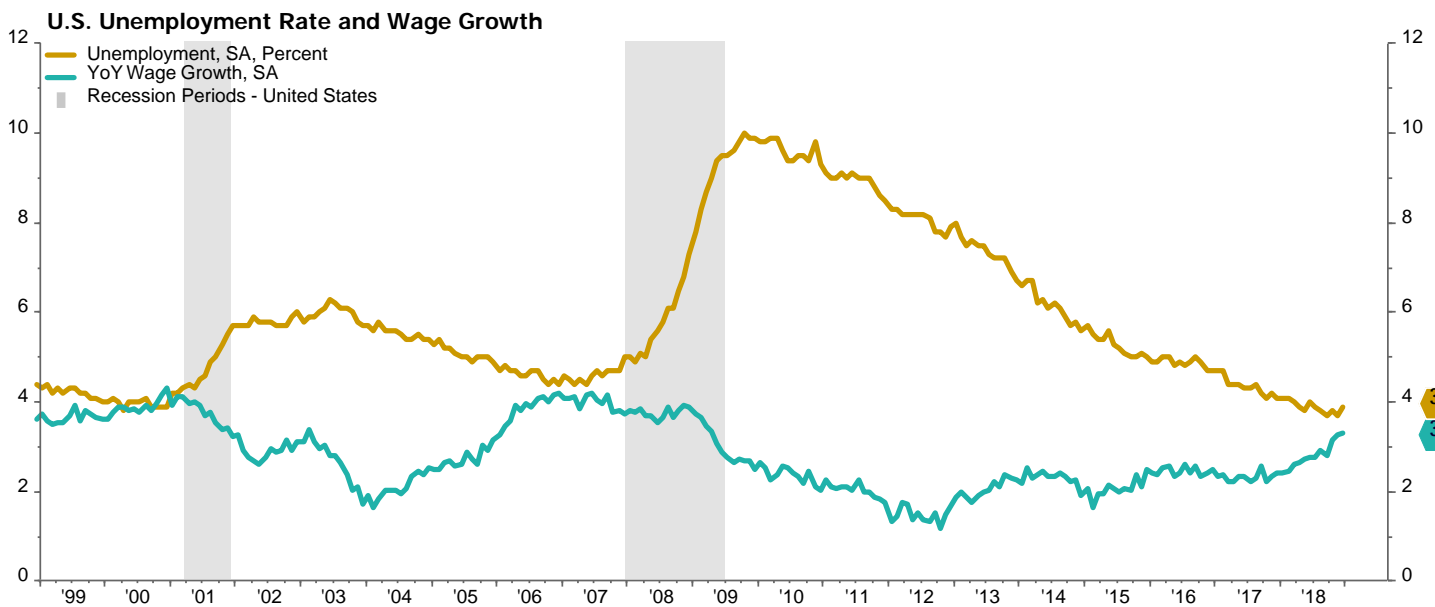


The market rout in the fourth quarter during which global equities fell nearly 13% had a number of drivers despite the positive signals that continued to be sent from the underlying U.S. economy. Concerns over the pace of interest rate hikes, ongoing uncertainty over trade policy, and fears of contagion from slowing economic growth overseas converged to drive the selloff, leaving both U.S. and international equities to finish the year in the red. Global stocks overall lost more than 9% in 2018.

Though equity performance did not reflect it, the year on the whole was a positive one for the global economy as the expansion continued. Growth became less synchronized than it was in 2017 as the U.S. continued to strengthen while the rest of the globe moderated. GDP growth in the Eurozone was particularly disappointing, with growth forecasts being cut throughout the year. Corporate earnings growth was very strong, especially in the U.S., and inflation rose modestly as the strong global economy started to impact supply chains and low unemployment spurred wage growth.

As we look forward, it can be tempting to let negative headlines cloud our investment outlook as the ongoing Federal government shutdown, global trade tensions, Brexit, and other geopolitical concerns hang over the markets on a daily basis. However, in our view it is difficult to read the current environment in such a way that indicates the U.S. economy is in danger of decline.

On the contrary, while growth will likely slow now that the short-term boost from tax cuts and government spending increases has faded, most forecasters are calling for U.S. GDP growth of at least 2.25% this year – still quite a healthy level and far outpacing that of other developed markets. The American consumer remains financially healthy thanks to a supportive jobs environment and rising wages, and consumption should continue to drive domestic growth despite the fact that interest rates have moved higher. Inflation remains muted and the Federal Reserve has lowered their expectations for additional rate increases this year; at this point we are only expecting one or two more hikes in 2019. Leading economic indicators, such as the number of weekly initial claims for unemployment insurance and manufacturer’s new orders for



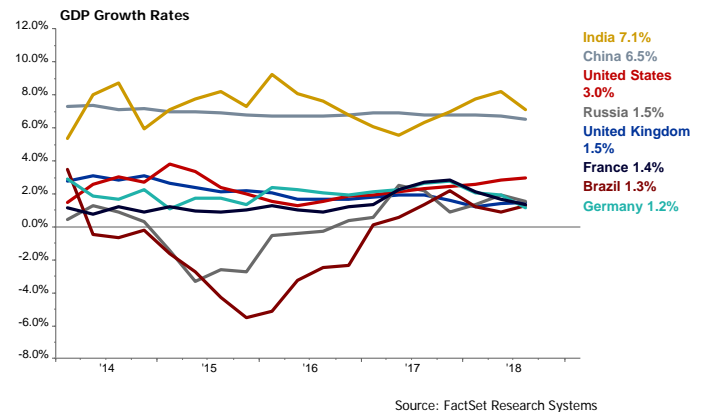
Source: FactSet Research Systems

consumer and capital goods, also continue to point to an expansionary environment.

This positive economic backdrop is supportive for the stock market despite the many potential headwinds. In our opinion, the abrupt selloff in Q4 was overdone and not accompanied by a similar deterioration in fundamentals. While we will likely look back at 2018 as the peak of earnings growth for this cycle, we still expect corporate earnings to grow this year and believe that the market decline helped to price in this lower pace of growth. Valuations on forward earnings now look attractive even with lower earnings growth expected. This environment should justify modest single-digit returns for U.S. equities in 2019 and we are recommending that investors maintain their equity allocations at long-term strategic weights.



The outlook is murkier outside the U.S. We continue to find it difficult to get excited about developed market equities given years of relative underperformance and a weaker current economic environment. European economic growth has been lackluster and several macro concerns continue to loom, including the rise of populism and its impact on policy, the possibility of a messy Brexit, and the local impacts of ongoing global trade disputes. However, corporate earnings in Europe are expected to grow in 2019, and valuations are significantly cheaper than those of U.S. equities. We feel that an underweight allocation to developed market equities remains appropriate and believe that these markets are poised for a modest lift in 2019 based on earnings growth, valuation and an ongoing – albeit slower – global economic expansion.



We are more positive on emerging market equities, which suffered a difficult year in 2018 but actually held up much better than developed markets during the selloff in Q4. Rising global trade tensions, particularly between the U.S. and China, weighed heavily on these stocks as did rising interest rates and the strengthening U.S. dollar. While these headwinds aren't likely to go away completely, their impact should be less in 2019 and emerging market equities enjoy the most favorable valuations of any segment of the market today. We expect EM equities to be highly volatile as their performance will be closely tied to trade developments, but the fundamental conditions in EMs including higher GDP growth, corporate earnings growth expectations, and favorable demographic trends present a meaningful growth opportunity for investors that are prepared for some bumps along the way.

Fixed income investments were showing losses for the first part of 2018 but rallied in Q4 as investors fled to safety during the equity market selloff. Now that short-term interest rates have risen, cash equivalents and short-duration bonds are providing decent yields to investors – in fact, cash was the best performing asset class in 2018 with its 2% return. In addition to providing current yield, core fixed income continues to play a role in diversified portfolios as a stabilizer during turbulent markets, which will be more important than ever as we move further into the late stages of the economic cycle.