Markets in 2019 – Where Do We Go from Here?

2018 proved to be a challenge for investors as various asset classes saw falling prices amid higher volatility. The fourth quarter in particular was a tough period, with the stock market suffering notably. The S&P 500® Index declined 13.52% in the quarter, bringing the full-year return to -4.38%. The Index was on the cusp of bear-market territory during the final quarter before starting to stabilize somewhat at the end of the year.

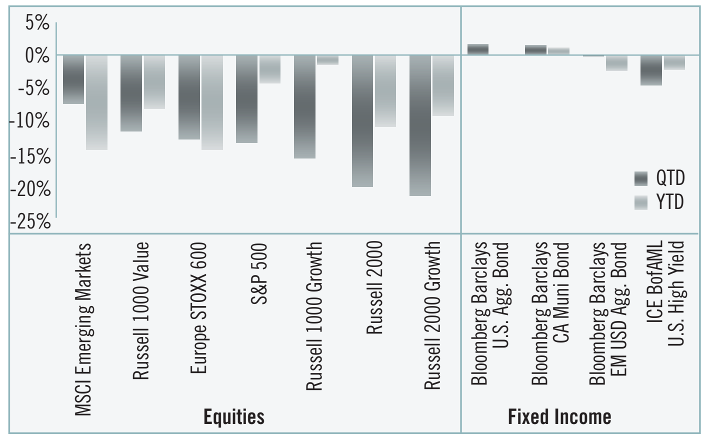
Virtually all domestic equity categories saw fourth-quarter returns wipe out their gains from the first nine months of the year. Small-cap stocks, as measured by the Russell 2000® Index, were hit hard during the quarter (-20.20%), finishing down 11.01% for the year. Growth stocks, as measured by the Russell 1000® Growth Index, declined 15.89% in the quarter, a wider loss than the -11.72% posted by their value counterparts, though growth outperformed value for all of 2018 (-1.51% vs. -8.27%). Stocks crossing both the small-cap and growth categories, as represented by the Russell 2000® Growth Index, had a particularly challenging quarter, falling 21.65%, and ending the year down 9.31%.

Emerging market stocks continued to decline, with the MSCI Emerging Markets Index posting a return of -7.47% in the quarter and bringing the year's losses to 14.58%. European equities were poor performers as well, with the STOXX Europe 600 Index falling 12.92% in the quarter and 14.53% for the year due to poor economic performance.

The 10-year Treasury yield, while rising only slightly over the year despite four short-term interest rate increases, exhibited a sharp drop during the quarter, from 3.06% to 2.68%. This decline allowed most fixed-income asset classes to generate positive returns during the quarter. For instance, the Bloomberg Barclays U.S. Aggregate Bond Index rose 1.64% during the quarter, erasing year-to-date losses and ending the year flat (+0.01%). California municipal bonds advanced 1.45% during the quarter, closing the year up 1.11%. Credit-sensitive areas of the bond market such as high yield didn't fare as well and registered losses of 4.67% for the quarter and 2.26% for the full year. Emerging market debt also declined for the quarter but only slightly (-0.18%), ending the year with a loss of 2.46%.

MAJOR INDEX RETURNS

Periods ending December 31, 2018

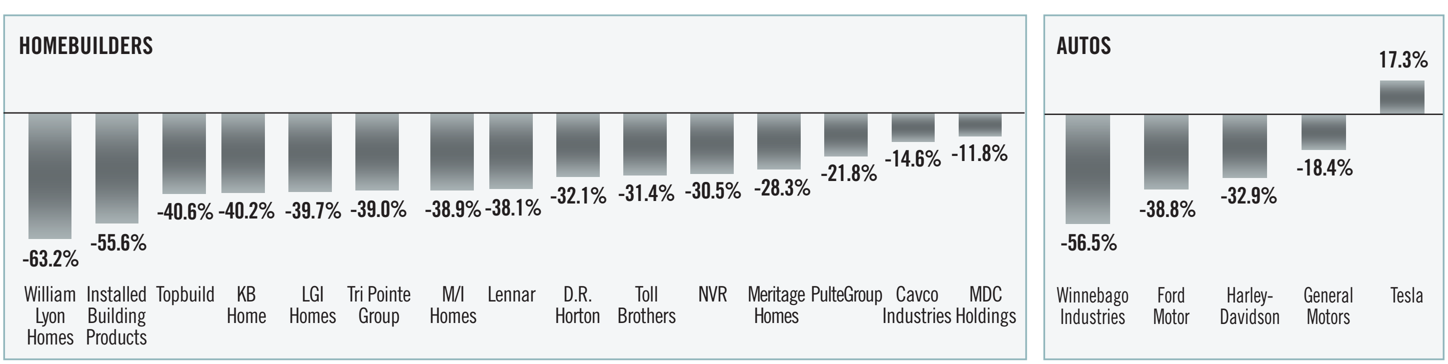


Past performance is no guarantee of future results. Data is obtained from Bloomberg and assumed to be reliable.

WHAT TRIGGERED 4Q DECLINES?

The selling spree began in early October, when Federal Reserve Chairman Jay Powell indicated that short-term interest rates were still far from neutral. These comments spooked investors, who were already concerned about a potential spillover of weakness in Europe and China into U.S. growth, as well as indications of a slowing in domestic housing and automobile sales (see below for the losses suffered by publicly traded homebuilder and auto companies). A combination of rate increases and trade tensions had already

2018 PERFORMANCE: HOUSING AND AUTO STOCKS (U.S. TRADED)



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started to bite into economic growth. Then third-quarter earnings started to pour in, and investors noticed that results were not as robust as those from the first and second quarters, indicating the rate of profit growth was done accelerating and was likely to slow into 2019.

The combination of continued rising short-term interest rates, a flattening/inverting yield curve, and slowing profit growth is not a favorable backdrop for equities. Although some minor progress was made on U.S. trade negotiations with China during the fourth quarter, much is left to be resolved in 2019, and this has continued to negatively impact business confidence globally. Energy prices also declined significantly during the quarter, which is good for inflation and consumers but definitely hurts the domestic energy producers and their earnings prospects.

Given the market's lack of confidence in the sustainability of corporate profit growth, investors—ourselves included—were hopeful that the Federal Open Market Committee would put rate increases on hold for 2019. Instead, the FOMC appeared stubborn and dismissive of market signals in its latest meeting, and only modestly shifted position, from three to two rate hikes expected in 2019.

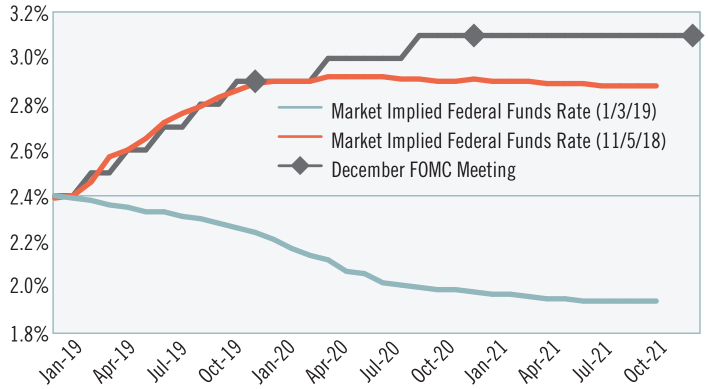
HOW DO WE RECOVER GOING FORWARD?

There is a clear disconnect between the market's view of 2019-2020 economic growth and the Fed's. Equity, bond, and commodity investors are pricing in much slower growth—perhaps even a recession—into this year and the next. The Fed, on the other hand, is looking at current conditions, which are primarily still solid. Markets should perform better when these two points of view converge.

This disconnect is also evident in the predictions of interest rate hikes into the next few years. The market has exhibited an unmistakable change over the past two months in its expectation of rate increases, as shown in the accompanying chart: The orange line indicates the market's prediction as of November 5, 2018 of how the federal funds rate would move through 2019 and beyond. The blue line is the market's prediction as of January 3, 2019. Meanwhile, the gray dots indicate the Fed's summary of economic projections from its December 2018 meeting.

Somebody is wrong here. Either the Fed will back off on further rate increases in 2019 based on a weakening economy and below-target inflation, or investors will prove to have been incorrect about slowing growth, as corporate profits continue to grow into 2019-2020 albeit at a slower rate. The yield curve may steepen if the Fed stops raising short-term rates.

U.S. RATE HIKES: MARKET EXPECTATIONS VS. FED PROJECTIONS



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It is difficult to measure how much of a negative impact the trade conflict had on global growth last year, but it definitely hasn't helped Europe and China, in particular. Trade issues have dragged on longer than we expected, but it appears both the U.S. and China are finally motivated to resolve the dispute. Chinese stocks are already in a bear market, and some sort of resolution would help all markets.

OUTLOOK

We cannot pinpoint where material excesses exist in the global economy that could cause a recession over the next year or two. Yet after meaningful declines in markets over the last three months, we see that it is going to take some time to restore confidence among investors and that companies are going to have to prove that they can deliver positive earnings growth even in a slower-growth economy.

We agree more with the market than the Fed about 2019 growth prospects. Economic growth will be much slower than in 2018 but still positive—our best estimate is in the 1.5%-to-2% range—and the S&P 500 Index will be able to grow earnings-per-share in the 5%-to-8% range. Equity returns may actually exceed profit growth as confidence gets restored in the sustainability of the corporate profit outlook.

It is important to remember that timing the stock market is an impossible task even for seasoned professionals. Stay focused on your long-term goals and make sure you are comfortable with your asset allocation, so you can stomach the inevitable short-term volatility associated with investing.

As always, we will stay focused on managing our investments and your portfolios with diligence. We thank you for your trust and confidence in these volatile times.