2018 Year-End Review & Outlook

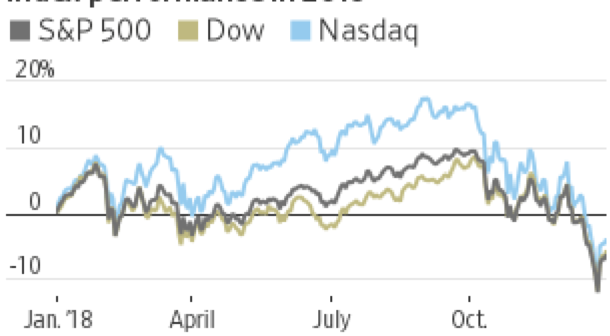
■ Market Review

Equities

After nearly two years of impressive gains stocks took a 180 degree turn for the worst in the last three months of 2018, highlighted with year-end nerve wracking daily market swings. The typical “Santa Clause Rally” was stymied by numerous investor worries. It was a December to remember punctuated by the year’s crazy finish that included a 650-point plunge in the Dow Jones Industrial Average on Christmas Eve, a 1,100-point gain on the day after Christmas, and a 900-point rollercoaster intraday trading swing on December 27. When 2018 came to an end major global stock indexes finished the year with the worst overall annual losses since the 2008 financial crisis; with many foreign markets flirting near or in bear market territory (a drop of at least 20% from the highs).

The Dow closed the year down by nearly 6%. This index of 30 blue chip stocks lost 13% since hitting a record high of 26,828 on October 3. The broader Standard & Poor’s 500 Index dropped more than 6 percent for the year and 15% from its high in September. The technology-heavy Nasdaq Composite finished 2018 down only 4% but shed 18% from its August peak.

Index performance in 2018



Source: SIX

So why was coal found in investors’ stockings instead of presents this Christmas season?

- Fears of the Federal Reserve raising rates too aggressively thus choking off loans, which could damage the economy, corporate profits and stock prices.
- An unresolved trade war with China causing global growth to slow further.
- A U.S. Treasury bond yield curve that could “invert,” with longer bond yields lower than short-term bond yields, foreshadowing a recession.
- And finally on the political front, the federal government shutdown along with perceived chaos inside the White House. And the much anticipated upcoming findings of the Muller investigation into possible Russian election collusion by the Trump campaign.

Fixed Income

At the start of 2018 as stocks rose and the dollar weakened, the yield on the benchmark 10-year U.S. Treasury note climbed higher (lowering prices). Treasury securities’ yields—with the influence of the Federal Reserve interest rates—sets borrowing costs for consumers and businesses. Investors then were content with higher rates given newly-enacted tax cuts plus expectations of rising economic growth and corporate earnings for the rest of the year.

In December though the 10-year Treasury yield retreated from multiyear highs reached in November, falling well below 3% at yearend as stocks slumped in the past quarter driving up demand for safe-haven Treasury securities. Fixed income investors enter this New Year increasingly uncertain about where the bond market is headed given the Fed's opaque/data-dependent 2019 outlook for further interest rate increases, economic growth and inflation.

Global Market Performance

Stock investors are heading into the New Year with a sense of wariness after contending with sharp reversals across all major global markets in the fourth quarter. After rising 9% through the first three quarters of the year, the S&P 500 Index gave up all of those gains plus more and ended the year down 6.2%; its weakest performance since 2008. Small company stocks were hit the worst of any domestic equity category in the fourth quarter due to investor selling of "higher risk assets," and finished the year down 12.2% as measured by the Russell 2000 Index.

Despite a strong performance through August, the Nasdaq Composite fell 3.9% for 2018 with much technology sector instability occurring in the last quarter. Technology shares that had soared in prior years (many included in the Nasdaq Composite) retreated in late 2018, hurt by worries about valuations and signs of slowing sales growth among industry giants such as Apple and Amazon. Health care stocks—considered defensive investments that usually hold up better in times of economic turbulence—overtook technology shares as the strongest performing sector in the S&P 500 for the year. Energy, communication services and materials sectors lagged.

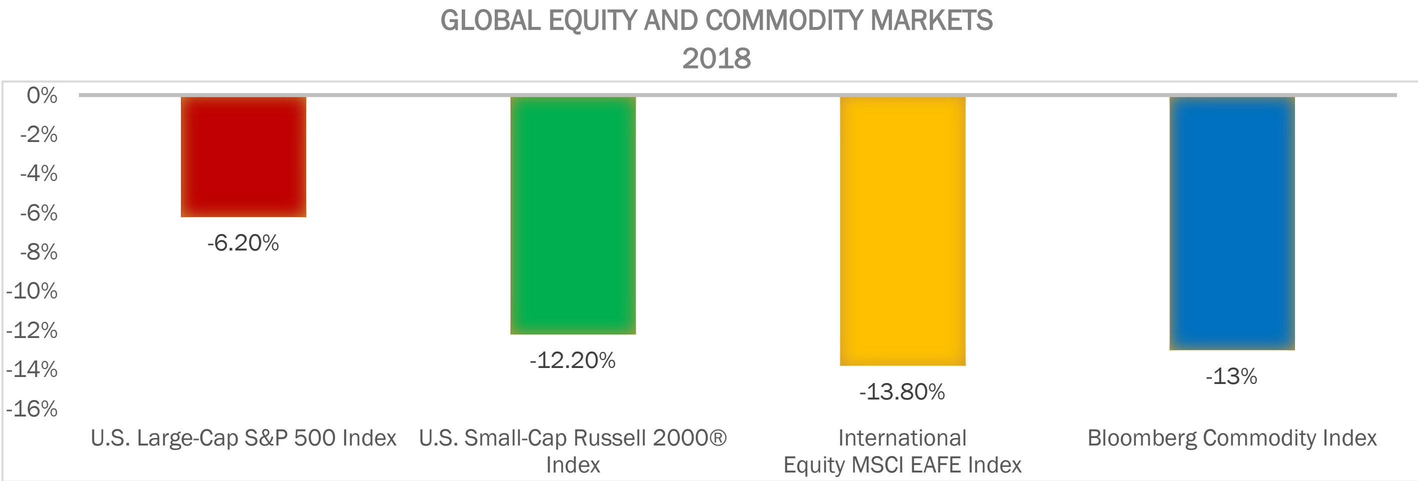
Major foreign stock markets performed even worse than the U.S. market for 2018. Developed international stocks fell 11.5% in the past three months and sank 13.8% for the year, as measured by the MSCI EAFE Index in U.S. dollars. Concerns about slowing growth in Europe and Japan, declining currencies vs. the dollar, and growing political disunity within the European Union hurt returns for foreign developed countries in 2018.

The MSCI Emerging Markets Index fell 7.5% over the past quarter, increasing emerging markets' (EM) decline for the year at 16.1%. Still, despite being categorized as a precarious equity market, EM stocks lost the least percentage-wise compared to developed markets for the fourth quarter, but still ended the full year with a sizable loss. Explaining the recent emerging markets outperformance, some analysts say the concerns that have plagued EM in prior quarters—such as a slowdown in Chinese economic growth and U.S.-China trade tensions—were already reflected in lower EM stock prices relative to earnings. And some investors noticed the discounted valuations and began buying EM equities.

CBOE Volatility Indexes for Stocks

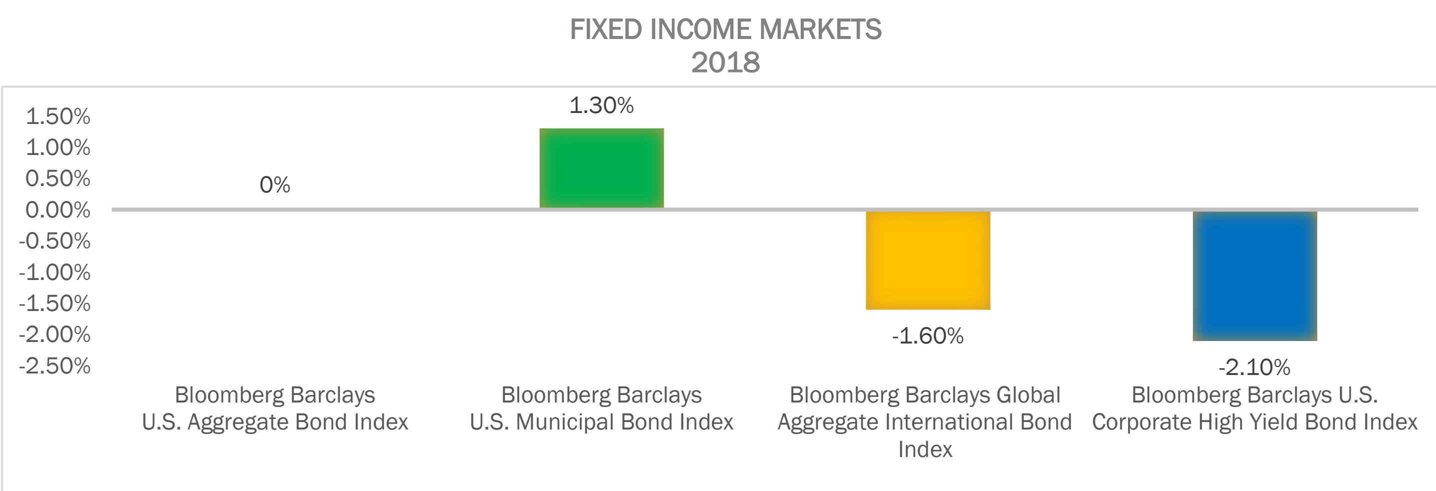
Source: Cboe via FactSet

Natural resources and other commodities dropped 13% for the year as measured by the Bloomberg Commodity Index. The worst performing commodity for the last quarter was oil. U.S. crude oil prices fell 38% from late September through the end of 2018—the biggest quarterly slide since the fourth quarter of 2014. WTI settled at $45 a barrel, after falling 25% in 2018. Even after the Organization of the Petroleum Exporting Countries (OPEC) agreed to reduce oil output in early December, prices continued to decline in the final weeks of the year on bulging inventories. One commodity that shined for the last quarter was gold (pun intended), up 8%. With fears of ever-declining global equities, investor took to the precious metal as a safe haven since antiquity during turbulent times. Nevertheless, despite a strong quarter, gold ended down 2% for the year.



At the start of 2018, with the assistance of Federal Reserve rate hikes, the yield on the benchmark 10-year Treasury note climbed higher—lowering the notes' price and increasing borrowing costs for consumers and businesses. Fast forward to the fourth quarter, the yield on the 10-year Treasury retreated from multiyear highs hit in November; falling below 3% as stocks sunk amid concerns about the slowing pace of global growth, China trade tensions, and rising Fed rates becoming an economic drag. That fueled demand (and higher prices) for "safe" Treasury securities, which become attractive as growth slows. Despite all the intra-year market nervousness the 10-year note closed 2018 at 2.7%, just slightly up from the 2.4% yield at year-end 2017.

As a result, for the past three months the Bloomberg Barclays U.S. Aggregate Bond Index of high-quality government, mortgage and corporate bonds rose 1.6%, and ended exactly flat at 0.0% for 2018. Non-investment grade or high-yield bonds lost 4.5% for the quarter as investors were more pessimistic about holding low credit-quality debt securities amid a slumping stock market and historically "tight" credit spreads compared to investment grade bonds. For the year high-yield bonds were down 2.1%. Tax-free state government municipal bonds gained 1.7% in the last three months and were also up 1.3% for the year, besting high-quality taxable bonds. The Bloomberg Barclays Capital Global Bond Index had a slight profit of 0.3% for the quarter, but finish the year down 1.6% due mainly to weak foreign currency values versus the U.S. dollar and rising U.S. Treasury rates compared to near-zero foreign central bank rates—making U.S. high-quality bonds more attractive for foreign and domestic investors to buy.



Portfolio Review

> *The economy is rolling along but the markets have hit some turbulence, reminding everyone that those two things aren't always correlated. This recent volatility is a good reason to think again about the potential role of liquid alternatives in a portfolio.*
> Fixed Income Channel; Salvatore Bruno

Along with global stock markets, Strategic Financial Concepts (SFC) Tactical Investment Strategies (TIS) model portfolios declined for the fourth quarter and recorded low- to mid-single digit losses for 2018. Still, TIS portfolios outperformed their respective benchmarks in 2018. While we are never satisfied with losses, we are content that our tactical investment positioning succeeded in minimizing client account drawdowns—especially during the two prominent stock market corrections of more than 10% in the first and fourth quarters.

The ride for investors for 2018 was bumpy but made smoother for SFC TIS clients by our underweight of unsteady stocks and underperforming bonds. In its place we used "hedged" alternative investments that can minimize stock and bond losses, and also precious metals that typically attract buyers and notch gains as investors become fearful. As examples, our hedged alternative investments combined were down about 5% for the fourth quarter and 4% for the year, while the S&P 500 Index dropped over 15% since the September-end high and 6% in 2018. Our precious metal investment (mainly gold and silver holdings) actually rose 8% during the abysmal fourth quarter (and down 3% for the year).

Additionally, during a very turbulent time in the market at the end of December, several account investment trades were executed to capture year-end tax losses and improve potential portfolio returns for 2019. Specifically, we sold underperforming materials sector holdings and an international fund. We replaced the sold international fund with a similar investment with a solid track record. We bought a successful alternative tactical fund that uses macroeconomic data to make bets on global equities, interest rates and currencies that management deems to be undervalued. We also decreased remaining cash holdings in model portfolios to near neutral targets by purchasing an ultra-short duration bond fund; with the goal of producing higher returns than money market rates with very little principal fluctuation.

So client accounts are currently somewhat in a defense mode. For portfolio positioning our TIS Moderate Model Portfolio, for example, has two-thirds the risk of its comparable peers. Stock are at a lower percentage than neutral targets, and are more weighted toward higher-growing domestic and emerging markets economies than slower-growing European and Japanese markets. Our bond holdings are not only underweighted versus neutral targets, but overall they are of shorter duration and primarily of investment-grade quality, thus less risk, than the bond benchmark. And finally, our alternative investments are geared toward reducing client account drawdowns during market corrections.

Market Outlook

> *… we think the Fed will have a two-part test for rate hikes in 2019. First…the economy itself. Second, the yield curve. We think the Fed will be very reluctant to see the federal funds rate go above the yield on the 10-year Treasury note and will strive to avoid an inversion of the yield curve.*
> First Trust Advisors; Brian S. Wesbury, Chief Economist

Despite the market weakness in the last months of 2018, we expect the U.S. economy and corporate profits to grow in 2019 (albeit slower than 2018). This usually bodes well for stocks. Nevertheless, we are in the late stages of a 10-year bull market run and a rising economy so it's best to think ahead and be somewhat cautious with portfolio positioning. Also the U.S. Treasury bond yield curve is flattening, which if it "inverts"—with longer bond yields lower than short-term bond yields—could predict an upcoming recession. And while economic indicators such as consumer spending, manufacturing and service sectors are still in growth mode, they are trending slightly downward.

Thankfully stock markets worldwide have begun the New Year in resurrection mode. Investors are hoping for an encouraging month. Not only is January typically a strong month for stocks—a phenomenon known as the "January effect"—but normally also signals potential gains at year end. And historical data further suggests this year is poised to be even better than average. That's because it comes in the third year of a presidential-election cycle, which analysts say is usually the best for equities: The main theory being that incumbents seeking reelection typically implement pro-growth policies ahead of a presidential election in efforts to boost the economy to garner votes.

Furthermore, signs of a strong U.S. labor market and recent dovish commentary from Federal Reserve Chairman Jerome Powell stating that more rate hikes will most likely *not* happen as soon as expected helped alleviate many investors' concerns. This was a pivot from his December news conference where he seemed to indicate that at least two rate hikes in 2019 were all but certain, which disturbed investors.

One additional factor that has boosted stocks lately is the thawing in trade tensions between the U.S. and China. Trade concerns have weighed on investors' outlook for global economic growth. Negotiators for the two countries are engaged in trade talks scheduled to end in March. Solving this critical trade war should propel further market gains.

Still, an important issue that could limit gains is lower-than-expected corporate earnings growth as the bull-market cycle is long in the tooth. As an example, for the first time in two years analysts recently cut their 2019 earnings forecasts on more than half of the companies in the S&P 500 Index, according to FactSet. They expect earnings for companies in the index to grow 7% in 2019, down from their forecast of 10% at the end of September. Looking at the glass half full, corporate profits are projected to continue to show gains, not losses. A critical gauge of future company health will be fourth quarter earnings reports and company forecasted earnings for 2019, which are now beginning.

Another issue is the current partial government shutdown (still in effect as of the publication of this newsletter). A short-term shut down should not hurt the economy for 2019. But a prolonged shutdown would likely lower GDP (gross domestic product) for the year and negatively affect stock prices.

So how have we positioned portfolios in light of our cautiously optimistic outlook? The ride for investors is still expected to be turbulent in 2019, but again potentially made smoother and expectantly profitable for SFC TIS clients by our underweight of stocks and bonds. We will also continue to use alternative investments (such as "hedged" investments and natural resources) that tend to have less swings or can move in different directions than traditional stocks and bonds. This strategy was proven to be effective last year and in other periods of volatile market environments.

We appreciate your continued confidence in our services. Your inquiries are welcomed.

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Sources: Bloomberg News, *Gold prices hold solid amid uncertainty*, January 1, 2019; Fidelity Investments, *How to Get Ready for a Stock Market Decline*, September 28, 2018; First Trust Advisors, *Monday Morning* Outlook, December 31, 2018; Fixed Income Channel, *Looking Beyond the 60/40 Portfolio*, November 3, 2018; Forbes, *Gold Has Beaten the Market Over Multiple Time Periods*, January 3, 2019; The Houston Chronicle, *Stocks end year with the worst drop since '08*, January 1, 2019; JP Morgan Asset Management, *Guide to the Markets*, Q1 2019; LPL Research, *Daily Market* Update, (multiple publications); The Motley Fool, *Here's Why the S&P 500 Plunged Into a Bear Market*, December 28, 2018; State Street Global Advisors, *SPDR ETFs Chart Pack*, December 2018 Edition; T. Rowe Prince Insights, *Disruptive Forces Seen Shaping 2019 Investment Landscape*, December 2018; The Wall Street Journal (multiple publications).