JANUARY 2019

PERSPECTIVES

Market Recap

A quarter to remember, for sure! Returns were fine through the 3rd quarter. What happened? On October 3, Federal Reserve (the "Fed") Chairman Powell gave investors the impression the Fed was going to stay the course and raise interest rates on the Fed Funds rate by a quarter of a percent at every other Fed meeting through 2019 (four more increases). This was not what investors wanted to hear. Furthermore, the Fed has continued to reduce the amount of bonds it buys in the open market. This decrease in the Fed's appetite for bonds has the same effect as raising interest rates and it is estimated that global central bank liquidity will turn negative in the 1st quarter of 2019 – a significant headwind for our economy. Adding to investor angst was the fact that some of the economic data being released began to suggest a softening in global economies, starting in China and emanating outward.

Investors also began to focus on corporate earnings growth, which is expected to slow in 2019 vs. 2018. In 2018, corporate earnings grew about 22%, boosted by the corporate tax cut. 2019 earnings are expected to grow about 7%, which is still very good, but below earlier expectations of 10% growth. That caused investors to re-evaluate how much they were willing to pay for stocks – and so the stock market fell.[1,2]

The stock market was also affected by uncertainty over the trade war with China and the prospect of the government being shut down over a dispute about funding the budget and building a security wall on our southern border. The Thanksgiving and Christmas holidays didn't help matters, as investors were out of the office, trading volumes fell, which caused volatility in the markets to rise. It was the perfect storm. Before we knew it, we found ourselves in a very unexpected and swift market decline of nearly 20% from its high with many stocks down more than 20% from their 3rd quarter highs!

The strange thing about this sell-off is that the economy appears to be on solid footing. The consensus is that there is no recession in sight. Interest rates are still low by historical measures, corporate earnings growth of 7% would be very good in most years, unemployment is low and going lower, and inflation is very much in check. In our opinion, due to the recent market declines and fundamentals not deteriorating as significantly as stock prices currently reflect, the stock market is now valued below the historic average multiple and certain stocks and sectors look cheap. International stocks offer attractive valuations relative to the U.S. and many international markets are in earlier stages of the economic cycle.

Fortunately, stocks were up 9% through the end of the 3rd quarter when the sell-off began, so the net effect was just a 6.2% decline for the S&P 500 for the year. Even then, the effect was softened by a rally in bonds in the 4th quarter.[3] For our take on what lies ahead, read the *Forecast*, below.

Forecast

After a heart-breaking fourth quarter, what lies ahead in 2019? Of course, we don't know for sure, but we can tell you what the consensus is suggesting and give you a few facts to support their case.

First, we know that stocks were hammered in the 4th quarter with the price to earnings ratio at 14.4x after the recent stock market declines, down from 16.8x at the end of the 3rd quarter. The 25-year average is 16.1x.[4] Stocks appear cheap at these levels based on this valuation measure. If earnings grow about 7% in 2019 as consensus expects and if the P/E remains at 14.4, then the market should rise 7-9% (including dividends). If the P/E rises to the 25-year average, then the market should rise about 14% in 2019. One respected economist makes a case that the S&P 500 should hit 3100 by the end of 2019 – a nearly 25% return. He believes that the 10-year U.S. Treasury yield will be at 3.40% by the end of the year and that puts fair value for the S&P 500 at 3100. Time will tell.

Here are the assertions that support this bullish outlook: Corporate earnings growth will continue to benefit from the tax cuts enacted at the end of 2017. Lower tax rates support higher margins and therefore net profits, and consumers will benefit from

The Score Board

	12/31/18	YTD (Change)
Dow Jones Industrial Average*	23327.46	-5.6%
S&P 500*	2506.85	-6.2%
NASDAQ Composite*	6635.28	-3.9%
MSCI EAFE (USD)*	1719.88	-16.1%
Bloomberg Commodity Index	76.72	-13.0%
Barclays Aggregate Bond Index	1946.60	0%
10 Yr U.S. Treasury Bond Yield	2.68%	+28 bps
30 Yr Fixed Mortgage Rate	4.60%	+68 bps
Prime Rate	5.50%	+100 bps
Crude Oil ($/barrel)	$45.51	-24.8%
Gold ($/oz.)	$1,278.30	-2.1%
U.S.$/Euro	$1.15	-4.2%
Core Inflation (ex food/energy)		2.2% **
Inflation (with food/energy)		2.2% **

* Without dividends
** Unadjusted 12-mos. ended November 2018
bps (1 Basis Point = 1/100%)

UNCH (Unchanged)
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

Forecast (continued)

having more money in their pockets, which supports a continuation of strong consumer spending. The campaign to reduce regulation also adds to profits. Above trend economic growth in the 2.0% - 2.5% range is expected in 2019.

Unemployment should continue to fall. A decline to 3.5% by year-end is not out of the question. It would be the lowest rate since the 1950's. The Consumer Price Index, which is right at 2.2% now, may fall near 2.0% in 2019, but some inflation is good for corporate profits and the Fed would really like to see inflation in the 2.0%-2.5% area.[5]

Our feeling is that the Fed will not raise interest rates in March. However, it is likely to raise the Fed Funds rate a quarter of a percent in June. Holding off in March should be a positive for investors, and raising the rate in June may be a positive also, as it will signify that the economy is strong enough to support the increase. We do not think we will see an inversion of the yield curve in 2019 (which can be a predictor of recession, on average about 14 months or so out).[6] We expect bonds to produce higher returns in 2019 than in 2018 as the headwind caused by rising interest rates dies down.

Of course, the questions on everyone's mind is what happens in the trade war with China and will political instability affect our markets? With respect to the trade war, we strongly believe a deal of some sort will be signed within the next few months. President Trump knows how important getting a deal and taking a victory lap is to his re-election prospects. We also think that the effects of the trade war on our corporate profits will become more apparent when Q4 earnings are announced in late January and February. This will further increase the President's resolve to strike a deal.

The campaign for the Presidency in 2020 started the other day when Elizabeth Warren announced her candidacy. It will be a loooong and noisy campaign. Nevertheless, we think (and hope) that both sides recognize the need to compromise for the sake of our country. We think that we may be surprised by how productive our government might be over the next year and a half, as both sides put their best foot forward for the voters. We can only hope! In any event, we think 2019 will be a much better year for investors than was 2018.

Portfolio Management

Since we do not believe the Fed will raise interest rates three to four times in 2019 as was previously forecast (maybe just one or two hikes), we will change up our bond portfolios a bit by increasing our duration slightly.[7] In a rising interest rate environment, you shorten up the average time to maturity of your bond portfolio and own types of bonds that are naturally less sensitive to interest hikes. Now, we must do the opposite as we near the end of the Fed rate hiking cycle.

With respect to stocks, we are eliminating some of the alternative investments that we have relied on in the past for diversification, finding that the cost of that type of diversification was just too steep (mainly opportunity cost) and now that bonds can be used again as an effective hedge for risk. Much of this reduction in alternative assets was completed during the 4th quarter. We believe we are better off diversifying just a little less within equities with the recent reset of stock valuations, but we plan on sticking closer to strategic portfolio weights (our long-term asset allocation mix).

Talk With Us!

Behavioral finance is a discipline to help identify and understand why people make certain financial choices. A seminal concept in behavioral finance is Prospect Theory, a theory developed by Daniel Kahneman, who won a Nobel Memorial Prize in Economics for his work. Prospect Theory states that investors have the tendency to treat losses differently than gains – a loss may have twice the psychological impact of a comparable gain. In other words, a loss makes us feel twice as bad as a comparable gain! Furthermore, if you check your returns daily, you have a 54% chance of seeing a "paper gain" (roughly a coin flip). The odds of seeing a "paper gain" increase the less often you look at performance. For example, you have a 67% chance of seeing a gain if you check monthly, a 77% chance of a seeing a gain every quarter, and a 93% chance of seeing a gain if you only check once a year.[8] As you can see, excessive checking of your investment performance can lead to stress and anxiety, then poor decisions, resulting in sub-par investment performance over time.

To help our clients to focus on the long-term, we are updating the time periods of performance reflected on the quarterly performance reports sent to you, and in the BFS Wealth Management Client Portal (which gives you constant online access to your performance). Instead of quarterly and year-to-date time periods, we are now showing rolling 12-month, 3-year, 7-year, and 10-year periods, and performance since inception.

Investing is an emotionally charged process that challenges investors to contend with uncertainty and doubt. We believe focusing you on the long-term will lead to better investment outcomes over time as we stick to the plan. At BFS Wealth Management, we proactively build diversified portfolios based on a rigorous process used to select skillful asset managers. We also use lower-cost mutual funds and tax-efficient investment strategies like asset location. We do what we do so you don't lose sleep when we have market volatility like we experienced in Q4. However, if you are losing sleep, it may be time to reevaluate your risk tolerance and adjust your portfolio asset allocation. If that is the case, **Talk with Us!**

Sources

1. Source: S&P Capital IQ consensus estimates.
2. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
3. The Barclays Aggregate Bond index is a broad-based index used as a proxy for the U.S. bond market.
4. Source: FactSet, Thomson Reuters, J.P. Morgan Asset Management. Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1993, and FactSet for December 31, 2018. Average P/E is calculated using 25 years of IBES history.
5. Source: Bureau of Labor Statistics. Unadjusted 12-mo. Core CPI (ex food/energy) is quoted. As of November 2018.
6. Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. An inversion of the yield curve occurs when short-term Treasury bills (3-mo.) yield more than long-term Treasury bonds (10-yr.). Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to recession, and the onset of recession.
7. Duration measures the sensitivity of the price of a bond to a change in interest rates. The higher the duration the greater the sensitivity of the bond is to movements in the interest rate.
8. Source: *The figures above are based on the book Fooled by Randomness: The Hidden Role of Change in Life and the Markets* by Nassim Nicholas Taleb.

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