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Market Commentary
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Introduction

2018 was expected to be a year of synchronized global growth and strong stock market returns but this did not come to fruition as headlines surrounding trade, a more hawkish Fed and specific country risks outweighed the positive economic data in the United States. Although there were a few economic data points that came in softer than prior readings (i.e. deceleration from Q2 to Q3 GDP growth), the data remains positive on an absolute basis. The labor market stands on solid footing with the unemployment rate at 3.7%, inflation (CPI) under control at 2.2%, and third quarter GDP growth up 3.4%. The Federal Reserve raised short term rates by 25 basis points four times in 2018 bringing the overall Fed Funds rate to a range of 2.25% to 2.5%. With concerns looming about global growth and the effect of fiscal stimulus such as tax reform fading, the Fed plans to take a more cautious approach in hiking rates with only two hikes forecasted in 2019. As global markets felt pain throughout most of 2018 and prices reset to close out the year, the economic landscape remains healthy and we would not be surprised to see some relief in diversified portfolios in the early parts of 2019.

Domestic Equities

U.S. stocks took investors on a roller coaster ride throughout 2018, closing the year with negative returns as the S&P 500 was down -4.38% year-to-date. Even more surprising, the 4th quarter of 2018 was one of the worst quarters for stocks since 2009 with the S&P 500 selling off sharply down -13.52%. Concerns of global growth, ongoing trade tension between the U.S. and China, fading fiscal stimulus and a hawkish Fed was enough to derail positive sentiment from strong Q3 earnings as companies within the S&P 500 posted earnings growth of 26% and sales growth of 8%. The Russell 2000 index and Russell Midcap index finished the year down -11.01% and -9.06% respectively. Although small sized companies experienced better performance than large sized companies through the first half of the year, this trend reversed due to the potential disproportionate negative impact on smaller companies from rising costs such as higher interest rates and wages. With strong economic data releases helping the bottom line of U.S. corporations, a more cautious Fed in 2019 and a reset in prices resulting in better valuations to end the year, we are still taking equity risk in our portfolios in the event fundamentals become the driving factor for stock market performance once again.

International Equities

International developed equities and emerging market equities returned -13.79% and -14.58% year to date, respectively, both lagging the S&P 500 by a wide margin despite the correction in U.S. stocks. Some of the major headwinds against equities, especially foreign equities, have been a stronger dollar, rising interest rates in the U.S., escalating trade tensions between the U.S. and China, looming political risks, and concerns over slowing global economic growth.

Global economic expansion became less synchronized as the year unfolded with activity moderating more than expected in some major economies. Among advanced economies, growth disappointed in the euro area and the United Kingdom, due to slower export growth and political uncertainty. Within emerging markets, energy exporters saw some improvement except for Argentina, Brazil, and Turkey due to country-specific factors, which soured investor sentiment. Some major emerging market economies, such as China and several Asian economies, have been tremendously challenged by the recently announced trade measures. Overall, while we acknowledge that the aforementioned headwinds could persist for an extended period of time and weigh on foreign equities, we believe a few negative forces could potentially be lifted in 2019 - the Federal Reserve may stop hiking rates after reaching the “neutral rate,” the U.S. dollar may stabilize or soften as the effects of fiscal stimulus wear off, the leaders from the two largest economies may make progress on trade deals, and the U.K. may see improved growth once the uncertainty surrounding Brexit dissipates. As a result, we believe that foreign equities have been oversold and are selling at a large discount, which may present buying opportunities.

Fixed Income

Fixed income sold off early in the year and never fully recovered, finishing only slightly positive despite a pickup in the fourth quarter as the market turned more defensive in the face of a severe stock market selloff. Following four Fed rate hikes, short-term rates increased to 2.48% while the 10-year U.S. Treasury yield ended the year at 2.68%, close to where it started the year despite reaching a high of 3.23% in November. As long term rates unexpectedly fell in the fourth quarter, the difference between long and short-term rates narrowed to as little as 0.10% during the year. When the two-year yield surpasses the 10-year yield, it has historically been a leading indicator of a recession in the next 12 months, but we do not expect this to happen in the near term. Monetary and fiscal policy imposed upside forces to interest rates, but natural economic forces such as demand for yield from both retirees and foreign investors from lower yielding countries, as well as a broad based flight to quality from risk assets helped to keep rates capped. We believe the projected path for interest rates remains slightly upward, but we anticipate fewer rate hikes in 2019 (as trade begins to impose a greater impact on economic growth and fiscal stimulus effects start to wane off.) Higher credit quality bonds outperformed low credit quality bonds, as investors sought security amidst the year-end selloff in risk assets. Heading into the next year, we believe fixed income securities will continue to benefit portfolios from a diversification perspective despite low returns.

Alternatives

Alternative asset classes were not immune to the market volatility which hurt global equities in 2018. Oil prices plunged into a bear market following concerns of global growth and the possibility of excess supply, with WTI crude ending the quarter at $45.41 per barrel, falling from $73.25 per barrel at the end of the third quarter. Though risk-reducing alternatives were unable to provide positive returns to end the year, they provided valuable downside protection during a quarter that saw investors fleeing risky assets due to fears of rising rates and geopolitical tensions, as the Morningstar Diversified Alternative index was down -4.14% on the quarter while the S&P 500 was down -13.52%. Hedge fund-like alternatives will continue to play a key role in downside protection and reducing volatility within a portfolio by maintaining low correlation to equity and fixed income markets as the economy potentially slows.

Real Estate

Real estate slowed in 2018 as rising interest rates and increasing construction prices slowed the housing recovery. Recent data has been positive with residential start ups 3.2% in November, led by the jump in multi-family home starts up 22.4%. Existing home sales in November grew 1.9% to 5.32 million. However, affordability issues continue be a concern. Due to the Fed raising interest rates four times this year, the average 30-year mortgage rate increased to 4.84% for the week ending December 28th, compared to 4.23% as of January 5th 2018. The NAHB index, an index that tracks homebuilder optimism and a leading indicator for the housing market, fell to 56 from 60 in December, the lowest level since 2015. Coupled with record high job openings in the construction industry and two more planned Fed rate hikes in 2019, affordability concerns will continue be an issue in the new year.

Conclusion

This year was a challenging environment for multi-asset class portfolios as most asset classes posted negative returns. Diversification simply did not work as global equities were down significantly and even bonds, the safest of assets by historical standards, were of little help. 2019 should be an interesting year as many of the risks that derailed markets in 2018, such as trade negotiations, tough decisions by the Fed, and global growth concerns remain in place; however, these headwinds appear to be largely priced in. As we look forward to 2019, we believe a recession is still not an issue but changing the portfolio as the economy potentially slows is critical to risk management.