

# Q4 2018 MARKET COMMENTARY

## KEEPING CALM AMID CHAOS

“I have learned that peace is not the absence of trial, trouble, or torment but the presence of calm in the midst of them.” – Don Meyer

Few investors were sorry to see 2018 go with the worst December for stocks since the Great Depression, although marginally salvaged by a decent final week. The S&P 500 ended the year in the red for the first time since the end of the global financial crisis. Will the New Year bring in a different path? Almost certainly, as years don't tend to repeat themselves and although past performance is certainly no guarantee of future results, history is somewhat in the bulls' favor, with the S&P 500 declining in back-to-back years only four times since 1929.

The final quarter of 2018 was not good for equity markets, in fact it was historically one of the worst in history for U.S. equities. The S&P 500 dropped nearly 14% in the fourth quarter alone, dragging yearly returns to -4.4%.<sup>1</sup> Investors have had to contend with rising U.S. central bank interest rates, a sharp slowdown in Eurozone business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics and the ongoing trade conflict between the U.S. and China). This all proved to be difficult for investors as the year ended. Below is a return table for world stock market returns in local currency:

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	4Q2018
MSCI Asia ex Japan 38.0%	UK FTSE 100 -28.3%	MSCI Asia ex Japan 67.2%	MSCI Asia ex Japan 15.6%	US S&P 500 2.1%	Japan TOPIX 20.9%	Japan TOPIX 54.4%	US S&P 500 13.7%	Japan TOPIX 12.1%	UK FTSE 100 19.1%	MSCI Asia ex Japan 35.9%	US S&P 500 -4.4%	MSCI EM -7.4%
MSCI EM 33.6%	US S&P 500 -37.0%	MSCI EM 62.8%	US S&P 500 15.1%	UK FTSE 100 -2.2%	MSCI Europe ex UK 20.0%	US S&P 500 32.4%	Japan TOPIX 10.3%	MSCI Europe ex UK 9.1%	US S&P 500 12.0%	MSCI EM 31.0%	UK FTSE 100 -8.7%	MSCI Asia ex Japan -8.9%
UK FTSE 100 7.4%	Japan TOPIX -40.6%	MSCI Europe ex UK 29.0%	MSCI EM 14.4%	MSCI Europe ex UK -12.1%	MSCI Asia ex Japan 19.7%	MSCI Europe ex UK 24.2%	MSCI Asia ex Japan 7.7%	US S&P 500 1.4%	MSCI EM 10.1%	Japan TOPIX 22.2%	MSCI EM -9.7%	UK FTSE 100 -9.6%
MSCI Europe ex UK 6.6%	MSCI Europe ex UK -42.7%	UK FTSE 100 27.3%	UK FTSE 100 12.6%	MSCI EM -12.5%	MSCI EM 17.4%	UK FTSE 100 18.7%	MSCI Europe ex UK 7.4%	UK FTSE 100 -1.3%	MSCI Asia ex Japan 6.4%	US S&P 500 21.8%	MSCI Europe ex UK -10.6%	MSCI Europe ex UK -11.8%
US S&P 500 5.5%	MSCI EM -45.7%	US S&P 500 26.5%	MSCI Europe ex UK 5.1%	MSCI Asia ex Japan -14.6%	US S&P 500 16.0%	MSCI Asia ex Japan 6.2%	MSCI EM 5.6%	MSCI Asia ex Japan -5.3%	MSCI Europe ex UK 3.2%	MSCI Europe ex UK 14.5%	MSCI Asia ex Japan -12.0%	US S&P 500 -13.5%
Japan TOPIX -11.1%	MSCI Asia ex Japan -47.7%	Japan TOPIX 7.6%	Japan TOPIX 1.0%	Japan TOPIX -17.0%	UK FTSE 100 10.0%	MSCI EM 3.8%	UK FTSE 100 0.7%	MSCI EM -5.4%	Japan TOPIX 0.3%	UK FTSE 100 11.9%	Japan TOPIX -16.0%	Japan TOPIX -17.6%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 31 December 2018.

Despite the negative figure for domestic markets, it turned out to be one of the best games in town

for most of the year. As far as asset class and style returns in local currency, see below:

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	4Q2018
MSCI EM 33.6%	Global Agg 4.8%	MSCI EM 62.8%	REITS 27.6%	REITS 7.3%	REITS 20.1%	Small cap 35.8%	REITS 27.1%	Growth 6.5%	Value 15.1%	MSCI EM 31.0%	Global Agg -1.2%	Global Agg 1.2%
Cmdty 16.2%	Cmdty -35.6%	Small cap 40.8%	Small cap 24.4%	Global Agg 5.6%	Small cap 18.4%	Value 29.7%	Growth 11.5%	Small cap 2.8%	Small cap 14.5%	Growth 24.5%	REITS -4.1%	REITS -6.1%
Growth 10.5%	REITS -37.3%	Growth 29.4%	Cmdty 16.8%	Value -4.9%	MSCI EM 17.4%	DM Equities 29.6%	DM Equities 10.4%	DM Equities 2.6%	Cmdty 11.8%	Small cap 19.1%	Growth -5.1%	MSCI EM -7.4%
Global Agg 9.5%	Value -37.7%	REITS 27.4%	MSCI EM 14.4%	DM Equities -5.0%	Growth 16.5%	Growth 29.5%	Value 9.2%	REITS 2.3%	MSCI EM 10.1%	DM Equities 19.1%	DM Equities -6.9%	Cmdty -9.4%
DM Equities 5.2%	DM Equities -38.3%	DM Equities 26.5%	Growth 12.7%	Growth -5.1%	DM Equities 16.4%	MSCI EM 3.8%	Small cap 6.7%	Value -1.2%	DM Equities 9.6%	Value 14.1%	Value -8.7%	Value -10.8%
Value -0.0%	Growth -39.0%	Value 23.6%	DM Equities 10.6%	Small cap -8.7%	Value 16.3%	REITS 3.2%	MSCI EM 5.6%	Global Agg -3.2%	REITS 9.3%	REITS 9.3%	MSCI EM -9.7%	DM Equities -13.0%
Small cap -3.8%	Small cap -40.4%	Cmdty 18.9%	Value 8.4%	MSCI EM -12.5%	Global Agg 4.3%	Global Agg -2.6%	Global Agg 0.6%	MSCI EM -5.4%	Growth 4.4%	Global Agg 7.4%	Cmdty -11.2%	Growth -15.1%
REITS -17.8%	MSCI EM -45.7%	Global Agg 6.9%	Global Agg 5.5%	Cmdty -13.3%	Cmdty -1.1%	Cmdty -9.5%	Cmdty -17.0%	Cmdty -24.7%	Global Agg 2.1%	Cmdty 1.7%	Small cap -12.2%	Small cap -17.5%

Source: Barclays, Bloomberg, FactSet, FTSE, MSCI, J.P. Morgan Asset Management. DM Equities: MSCI World; REITS: FTSE NAREIT All REITs; Cmdty: Bloomberg UBS Commodity Index; Global Agg: Barclays Global Aggregate; Growth: MSCI World Growth; Value: MSCI World Value; Small cap: MSCI World Small Cap. All indices are total return in local currency. Data as of 31 December 2018.

Here you can see that almost all markets, be it equities, fixed income or alternatives, suffered in 2018.

The quarter’s volatility started with the Federal Reserve (“Fed”) chairman Jerome Powell’s comment that the U.S. policy rate was still “a long way” from neutral, implying that the Fed wasn’t about to stop increasing interest rates any time soon. U.S. government bond yields moved higher to price in a faster pace of rate rises, with the U.S. 10-year Treasury yield briefly rising above 3.2%.<sup>1</sup> Equity investors soon started to worry about the potentially faster-than-expected pace of rate rises and equities sold off in October and most of November.

Markets have started to worry that the U.S. is late in its economic cycle. Tax cuts helped boost growth and corporate earnings in 2018 but investors are aware that the fiscal stimulus will fade beyond the first half of 2019. The midterm

elections in early November were important in this regard, as the Republican Party might have backed further tax cuts to support growth through to the next presidential election had they maintained control of the House of Representatives. However, with the Democrats winning the House, the likelihood of further meaningful fiscal stimulus, prior to the next U.S. election, has been significantly reduced.

In November, Fed chairman Powell changed his tune slightly, although not the song, saying rates were “just below” the neutral range. This shift was interpreted as dovish by most, so much so that by the December meeting, markets had moved to price in a greater than 50% probability that U.S. interest rates won’t rise beyond 2.5% in 2019.<sup>1</sup> However, while the Fed did lower its guidance from three to two rate hikes next year after the December meeting, this was less dovish than markets had been expecting, particularly given Powell’s insistence that the plan to reduce

the central bank's balance sheet was essentially on autopilot.

Fourth quarter earnings are expected to increase 14.7% from Q4 2017.<sup>2</sup> Excluding the energy sector, the earnings growth estimate declines to 12.7%.<sup>2</sup> In 2018, we witnessed S&P 500 year over year earnings growth of 23.5%, a very strong figure.<sup>2</sup> Earnings and revenue growth for companies are the foundation on which many investors base their analysis.

In the U.S., the labor market remains strong, with the December nonfarm payrolls report showing 312,000 jobs created, well above the 176,000 consensus expectation, while the previous two months were revised higher by 58,000 jobs.<sup>1</sup> However, the unemployment rate rose from 3.7% to 3.9%; importantly though for the right reason as 419,000 new workers entered the workforce (the labor force participation rate increased to 63.1%), but some are still looking for jobs—resulting in an uptick in the unemployment rate.<sup>1</sup>

In addition to the ample payroll gain, average hourly earnings jumped 0.4% last month with the year-over-year rate moving from 3.0% to 3.2%.<sup>1</sup> That gain is tied with October for the strongest wage gain since April 2009.<sup>1</sup> The better data could help alleviate some of the concern that has crept in regarding the labor market courtesy of the uptick in initial unemployment claims, a leading indicator. That remains an area of focus, although some of the recent uptick was partly tied to weather/hurricanes.

Fixed income saw a decent recovery in December after a shaky start to the fourth quarter. The bear market in equities created an opportunity in the fixed income space. Fixed income government bonds yielded returns of 2.7% in the fourth quarter, and in trying times they can be useful in balancing portfolios from the current volatility of equities.<sup>1</sup>

Over the month of December, the Federal Open Market Committee (FOMC) raised the federal funds rate another 0.25% to a range of 2.25% to 2.50%. Additionally, the Committee revised the dot plot to reflect two hikes in 2019 versus three

previously, while the market is expecting less than one hike for the year. This is partly due to macro challenges that could slow the Fed's pace of tightening. The flattening of the curve may also hinder the Fed's path toward normalization.

Despite the hike, U.S. Treasury yields finished considerably lower over the month, dropping roughly 0.30% across the curve, partly due to risk-off sentiment in the markets. The 10-year Treasury started the month just below 3% and moved to 2.68% before it wrapped up.<sup>1</sup> For the year, 2-year bonds rose more than 0.60%, while 5-year and longer were higher by about 0.30%.

Given the heightened focus on rate hikes and the risk-off tone that permeated both bond and equity markets in 2018, investment grade corporates posted the worst year of total returns since 2008.<sup>1</sup> On the other hand, municipal bond returns were one of the few asset classes globally to generate positive returns for the year, benefiting from the stable environment for credit quality. The Bloomberg Barclays Municipal Index posted positive total returns, while equities, IG corporates and high yield corporates had negative performance.

Municipals rallied over the month of December, with the 5- to 10-year range dropping the most in yield, down more than 0.20%.<sup>2</sup> The 10-year AAA closed out at 2.32%, about 0.30% higher year-to-date.<sup>2</sup> The municipal market finished the year on a very strong note with the 15- to 20-year indices performing best in December. Higher-quality bonds (AAA-, AA- and A-rated bonds) outperformed BBB-rated bonds, while on the sector side hospital, housing and special tax were the best performers of the month. The Bloomberg Barclays Municipal Bond Index returned 1.28% in 2018.<sup>2</sup>

New issue supply for the month came in at just \$22 billion, down markedly from the record \$69.8 billion that came in December of 2017 prior to tax reform taking effect.<sup>3</sup> December's supply was the third-lowest level of monthly issuance for the year. Full-year new issuance totaled \$339 billion, down 24% from 2017.<sup>3</sup>



Credit markets have struggled this quarter. Non-financial corporate debt-to-GDP has risen to the highest level in over 70 years and the credit quality of the U.S. investment grade index has deteriorated. Given liquidity is much lower than it was before the financial crisis, a wave of downgrades could put further stress on credit markets.

There are also concerns about the covenant quality in the leveraged loan market and subprime debt in the auto loan market. Against this backdrop fixed income investors need to be selective. Below is the fixed income sector returns in local currency:

2012	2013	2014	2015	2016	2017	2018	4Q2018
Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	Euro Treas. 1.0%	US Treas. 2.6%
EM Debt 18.5%	US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	US Treas. 0.9%	Euro Treas. 1.5%
US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	US HY -2.3%	IL -0.8%
Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	Global IG -3.6%	Global IG -0.8%
Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	Euro HY -3.6%	EM Debt -1.2%
IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	IL -4.1%	Euro HY -3.8%
US Treas. 2.0%	EM Debt -6.6%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. 0.2%	EM Debt -4.6%	US HY -4.6%

Source: Barclays, BofA/Merrill Lynch, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. IL: Barclays Global Inflation-Linked; Euro Treas: Barclays Euro Aggregate Government – Treasury; US Treas: Barclays US Aggregate Government – Treasury; Global IG: Barclays Global Aggregate – Corporates; US HY: BofA/Merrill Lynch US HY Constrained; Euro HY: BofA/Merrill Lynch Euro Non-Financial HY Constrained; EM Debt: J.P. Morgan EMBIG. All indices are total return in local currency. Data as of 31 December 2018.

In Europe, business surveys have been weakening all year but this quarter moved closer towards the level that has historically been consistent with not just a slowdown in the pace of growth but an outright contraction. Part of the reason for the slowdown in Europe has been a sharp decline in the manufacturing sector’s new export orders, which appears attributable, at least in part, to a slowdown in demand from China. But domestic political factors have also been a drag. The Italian government’s confrontation with the European Union over its budget led to higher borrowing costs in Italy over the course of 2018. Meanwhile in France, protests surrounding the cost of petrol led to widespread unrest in key cities and this appears to have significantly dented business confidence.

In the UK, wage growth has also been accelerating, rising at the fastest pace since the financial crisis. On the other hand, the ongoing uncertainty surrounding the Brexit negotiations has weighed on business and consumer confidence. The political theater around Brexit will inevitably reach its most dramatic point in this final act in 2019.

In China, growth has also slowed, explaining part of the weakness in global exports, with Chinese imports having slowed significantly. Following a clampdown on lending from the shadow banking sector, Chinese money supply growth has slowed, coinciding with a slowdown in the pace of retail sales growth and industrial production. In response to this slowdown, China is seeking to stimulate the economy with a combination of

monetary and fiscal measures, particularly in the face of external headwinds emanating from the ongoing trade dispute with the U.S. With the potential for either a deal or further escalation in the trade negotiations, there are two-way risks for investors.

The price of oil plunged this quarter as rising supply, led by U.S. shale production, caught up with demand. Fears around the outlook for global growth and hence demand for oil have also weighed on the price. Falling oil prices create both winners and losers. Oil producers will be hurt and business investment in the energy sector

will fall. However, oil consumers, both households and many businesses, will benefit from lower energy costs, providing a potential upside surprise to the currently gloomy mood in markets.

Below are index returns in December 2018 (%). Most of the international equities outperformed domestic. While bonds proved be a worthy diversifier.

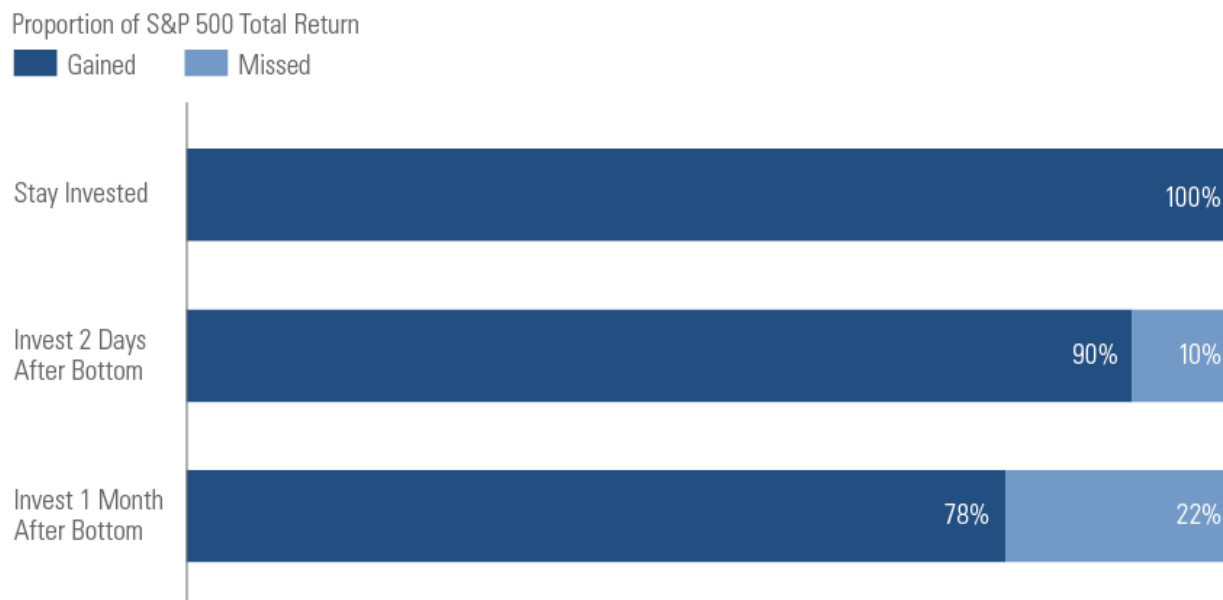
INDEX	GBP	USD	JPY	EUR	LOC
<b>Equities (MSCI)</b>					
MSCI World Index	-7.4	-7.6	-10.7	-8.4	-7.8
MSCI USA	-8.8	-9.0	-12.1	-9.9	-9.0
MSCI Europe ex UK	-4.7	-4.9	-8.1	-5.8	-6.0
MSCI United Kingdom	-3.6	-3.8	-7.0	-4.7	-3.6
MSCI Japan	-6.5	-6.7	-9.8	-7.5	-9.8
MSCI AC Asia ex JP	-2.5	-2.7	-5.9	-3.6	-2.8
MSCI EM Latin America	-0.6	-0.7	-4.1	-1.7	-1.2
MSCI EM (Emerging Markets)	-2.4	-2.6	-5.9	-3.5	-2.5
<b>Bonds</b>					
JP Morgan GBI Global (Traded)	2.7	2.5	-1.0	1.5	1.6
JP Morgan GBI United States (Traded)	2.4	2.3	-1.2	1.3	2.3
JP Morgan GBI Japan (Traded)	4.6	4.5	0.9	3.5	0.9
JP Morgan GBI United Kingdom (Traded)	2.5	2.3	-1.2	1.3	2.5
JP Morgan EMU	2.1	1.9	-1.5	0.9	0.9
<b>Currencies</b>					
Sterling	na	-0.2	-3.6	-1.1	na
US dollar	0.2	na	-3.4	-1.0	na
Yen	3.7	3.5	na	2.5	na
Euro	1.1	1.0	-2.4	na	na

Source: MSCI, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Data as of 31 December 2018.

Missing the bottom, missing the bounce - Investors sitting on the sidelines may give up sizeable gains even if losses are avoided with precision. Historically, some of the S&P 500s

strongest returns have come within days of a bottom. From Christmas Eve through this past Friday, the S&P 500 has already risen by 10%. In our view, perfect market timing is both rarely

achievable and not worth the risk of missing outsized gains. See below:



Source: Bloomberg and GSAM. As of December 31, 2018.<sup>4</sup>

Overall, the risks are probably higher now than they have been at any point since the Eurozone crisis in 2009/2010. But there are risks both to the downside and the upside. Things that could potentially help the global economy in 2019 include Chinese stimulus, avoidance of a no-deal Brexit, a potential trade deal between the U.S. and China and lower oil prices boosting growth and slowing the pace of interest rate rises.

On the downside, Europe could have a recession, potentially restarting concerns about the sustainability of European sovereign debt. U.S. growth is likely to slow and a contraction or recession in the coming years can't be ruled out. Trade tensions could escalate, and British politicians may fail to provide a near-term Brexit solution. Lower oil prices, higher U.S. interest rates and slowing growth could also cause trouble in some of the emerging markets. High leverage in credit markets is a risk, particularly with central banks reducing global liquidity and low dealer inventories reducing trading liquidity.

The housing sector in several smaller economies also looks vulnerable heading into 2019.

There are always risks, but at the moment the risks seem greater than usual. Although there are risks in both directions, at the late stage of the economic cycle, they are currently probably more skewed to the downside. Through the year, we started thinking that having a more elevated cash level was more appropriate than had been the case for most of the last nine years (it also yields something now!). While volatility is painful, we know that eventually it creates opportunities. When that time comes it is important to have some dry powder. Heading into 2019, our usual approach of a balanced, diversified portfolio that avoids big asset allocation bets relative to benchmarks, in either direction, still seems prudent. Despite a poor end to the 2018 market, there are many indications that point to a decrease in rate of growth in the coming year rather than a drastic recession.

2008 Redux? While we are seeing a slowdown in activity, and the possibility of a (mild?) recession, it appears there is still some “muscle memory” from the 2008 financial crisis, with many clients worried about another 2008. We don’t think so. The 2008 financial crisis was a function of a massive housing debt bubble, derivatives tied to that debt, and a heavily over-leveraged global financial system; which ultimately took the entire global economy down with it. We don’t see the extreme of excesses that had built up back then. Banks, according to the Federal Reserve and their stress tests, are much better capitalized and prepared this time around. There are risks—the high yield market and the precipitous drop in oil prices are both showing some signs of increased economic stress, which should not be ignored.

But many of the forces that caused last year’s slowdown are now reversing—oil prices have fallen, U.S. bond yields are back almost where they started in 2018, trade conflicts appear to be

subsiding and China is easing macro policy at least to some extent, and will probably move to outright stimulus if its economy weakens much further. All this suggests that economic growth in 2019 should be stronger than in 2018, at least in the second half.

It can be difficult to remain calm in the midst of stock market action like we’ve seen over the past couple of months, but discipline is necessary during more tumultuous times. Although we do see rising risk of a recession, we don’t see a repeat of 2008 in the cards. Absent a recession, even if we enter a formal bear market, additional weakness may be somewhat limited. Recession-related bears tend to be longer and grizzlier than non-recession bears. Until we get more clarity on the health of the economy, we continue to suggest investors remain diversified and balanced in their investment approach.

**To discuss this commentary further, please contact us at 914-825-8630.**  
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<sup>1</sup> FactSet financial data and analytics. [www.factset.com](http://www.factset.com)

<sup>2</sup> <http://lipperalpha.financial.thomsonreuters.com/2019/01/sp-500-17q1-earnings-dashboard/>

<sup>3</sup> <https://www.breckinridge.com/insights/details/december-2018-market-commentary/>

<sup>4</sup> [https://www.gsam.com/content/gsam/us/en/advisors/market-insights.html#section-background\\_2d70\\_background\\_sectionheaderwithtab](https://www.gsam.com/content/gsam/us/en/advisors/market-insights.html#section-background_2d70_background_sectionheaderwithtab)

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