SlateStone WEALTH

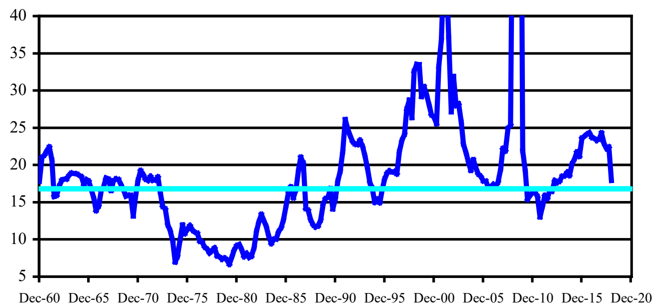
Balancing Your Life Goals with Financial Results

Investment Review & Outlook

January 2019

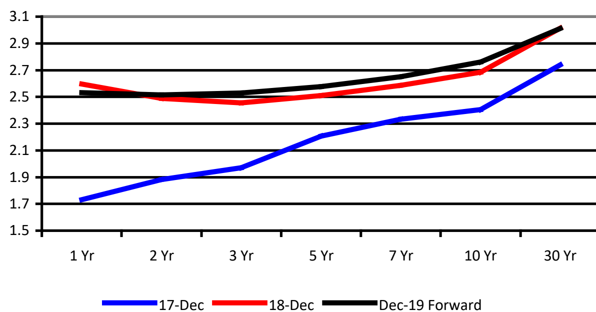
Review

Fourth quarter equity market performance was surprisingly bad on a global scale. We had expected the S&P 500 Price / Earnings ratio to erode over time "as it reverted to the mean," but not collapse over the course of a month or two.



There are a multitude of specific causes as to why. But the simple answer is a dramatic rise in uncertainty, related to politics both domestic and international, monetary policy, and trade. Markets abhor uncertainty.

The Fed raised short-term interest rates 4 times in 2018, as they said they would at the beginning of the year. Their current call is to raise short-term interest rates 2 times in 2019. But, Chairman Powell might be backing away from that call based on a recent speech citing "data dependency."



Forward markets imply very little change in interest rates over the course of the coming year. While the curve is "flat" in historic terms, forward market participants are not anticipating the dreaded "inverted curve." When short-term interest rates rise above long-term rates, the yield curve "inverts," which has been a reliable indicator of impending recession.

Data sources: Standardandpoors.com, Bloomberg

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Global Markets

The US market was doing particularly well through the first nine months of 2018. That came to a screeching halt in the fourth quarter. For the full year, defensive sectors like Health Care and Utilities were the only sectors that generated positive returns. Commodity price sensitive sectors, like Energy and Materials, had the weakest returns. Crude oil prices rose from $60/bbl. to $75/bbl. over the first nine months of 2018, only to collapse to around $45/bbl. by year-end.

The total return on the Bloomberg Barclays 3-5 year US Treasury Index meandered in a sideways fashion for most of 2018 until December, when the total return from these intermediate-term high quality bonds catapulted higher as equity prices collapsed.

The US Dollar, as measured by a basket of major currencies, was weak in the first quarter, but moved sharply higher as 2018 progressed.

Equity Market Performance
To 31-Dec-2018, in US Dollars

	4th Quarter 2018	12 Months 12/31/18
MSCI World Index	-13.4%	-8.7%
Europe	-12.7%	-14.9%
France	-15.1%	-12.8%
Germany	-15.5%	-22.2%
Switzerland	-8.9%	-9.1%
United Kingdom	-11.8%	-14.2%
Japan	-14.2%	-12.9%
Pacific, ex Japan	-7.9%	10.3%
EAFE	-12.5%	13.8%
USA	-13.8%	-5.0%
Emerging Markets	-7.5%	-14.6%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

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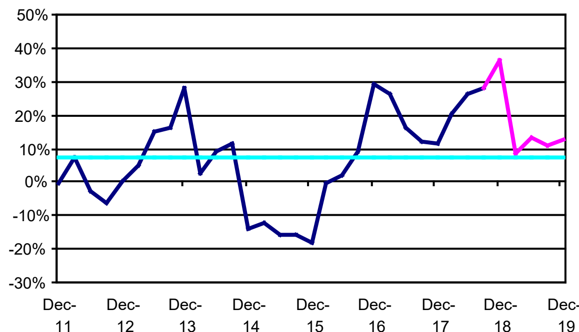
Outlook

Let's assume the S&P 500 reached a meaningful bottom around the 2350 level in late December. In our opinion, that means there are attractive investment opportunities near that level. However, it is unrealistic to expect the market turns right around after the pain of a roughly 20% decline from the September high. Typically, after a meaningful decline such as we have just experienced, it would take at least a month of backing and filling for share prices to regain confidence and enter into a period of sustained advance. We think it is a good idea to add selectively to equity positions but we will be patient in taking advantage of attractive prices over the coming weeks.

The justification for intermediate term optimism comes primarily from earnings expectations. Consensus earnings expectations for 4Q:18 are for very strong growth, in part because of a relatively easy comparison with pre-tax cut 4Q:17. The earnings reporting season for 4Q:18 begins around January 15th. We expect earnings growth in 2019 will slow to a more sustainable rate, but still be above average.



Yes, earnings expectations are always too high at the beginning of the year. Nonetheless, if we assume that the economy continues to grow near the recent pre-tax cut average of roughly 2%, then S&P 500 earnings growth near 10% is achievable.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-12	86.51	-0.5%	16.5	1426.19
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18e	140.14	27.5%	17.9	2506.85
Dec-19e	156.27	11.5%	18.6	2900

If we can achieve our year-end 2019 S&P 500 price target, the price gain would be 15% for the year, an above average year after a disappointing 2018. The all-time high for the S&P500 was 2930.75 reached September 20, 2018.

Decelerating economic growth is a global reality. However, after the drop in global share prices in 2018, valuations are at historically reasonable levels. The boost in growth rates related to US tax cuts was never a source of growth beyond 2018 and now we revert to more sustainable levels.

Real GDP Growth - YoY %				Market P/E
	2018	2019	2020	4-Jan-19
US / S&P 500	2.9	2.6	1.9	17.3
Eurozone / Stoxx 600	1.9	1.6	1.5	15.1
UK / FTSE 100	1.3	1.5	1.6	15.7
China / CSI 300	6.6	6.2	6.0	11.3
Japan / Nikkei 225	0.9	0.9	0.5	13.6
World	3.7	3.5	3.3	

Source: Bloomberg, Jan 4, 2019

There are a few events that need to occur for our optimistic scenario to play out. The trade conflict with China needs to simmer down. The threat of rising US tariffs needs to be delayed or deferred along with the threat of reciprocal actions from the Chinese government. A meaningful resolution of these issues is a "bridge too far," but a cooling of rhetoric would be welcomed by both markets and business leaders.

S&P 500 earnings growth will need to come in near consensus expectations. US consumers must continue to spend. At this point there is no sign of consumer spending falling-off as a function of the "wealth effect" from 4Q:18 equity market weakness. Strong job numbers and low unemployment should bolster consumer confidence.

In addition, the Federal Reserve needs to pause its' planned boost in short-term interest rates from the quarterly pattern of 2018. Falling energy prices should mean that inflation will drift down from the Fed's target of 2% and improve consumers discretionary income.

On the fixed-income side, we use bonds in balanced portfolios to mitigate the risk inherent in equity investing and to provide liquidity for unanticipated expenses. We will continue to be very conservative in our bond investments. But, if our optimistic scenario plays out, longer-term bond yields will rise and there may be an opportunity to increase income levels through extending our average maturity.

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January 2019
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Data sources: Standardandpoors.com, Bloomberg