JOHN D. DOVICH & ASSOCIATES, LLC

Market Update — Fourth Quarter 2018

2018: How the Fed and Politicians Stole Christmas

Investors were left a bag of coal for the fourth quarter as global stock markets unofficially entered a bear market, meaning major stock indices sold off by 20 percent or more from their 52-week intraday highs. The only major asset classes posting a gain for the quarter were U.S. taxable and municipal bonds. In the table below, in addition to fourth quarter market returns, we present returns over the past three years. This provides additional perspective with long-term data showing attractive long-term performance, despite the recent setback.

	Total Return				
Index	4Q18	2018	2017	2016	3 Yr. Avg.
S&P 500 (large cap US stocks)	-13.5%	-4.4%	21.8%	12.0%	9.3%
Russell Mid Cap	-15.4%	-9.1%	18.5%	13.8%	7.0%
Russell 2000 (small cap US stocks)	-20.2%	-11.0%	14.7%	21.3%	7.4%
MSCI EAFE (large cap foreign)	-12.5%	-13.8%	25.0%	1.0%	2.9%
MSCI Emerging Markets	-7.5%	-14.6%	37.3%	11.2%	9.2%
MSCI ACWI All Cap (global stocks)	-13.3%	-10.2%	24.0%	8.4%	6.5%
Barclays US Aggregate Bond	1.6%	0.0%	3.5%	2.7%	2.1%

What caused the selloff in stocks?

Most U.S. stock market indices peaked in late September/early October. On October 3rd, Fed Chair Powell provided a rosy outlook for the economy, supporting continued interest rate hikes. In addition, he commented interest rates were a long way from being neutral, subtly suggesting more rate hikes ahead. This led to harsh criticism from President Trump and other market strategists about continued rate hikes in a benign inflationary environment. Unfortunately, heightened media coverage of these attacks on the Fed have only served to increase anxiety and uncertainty for investors and contributed to the stock market selloff. An equally important contributor to the stock market selloff is the continued trade war with China. While there have been numerous headlines and tweets about progress made on trade negotiations, there appears to be little actual progress. Based on recent market data, China's economy is slowing and U.S. companies are citing rising costs related to the trade war. Also, market sentiment toward a resolution of the conflict took a big hit in the fourth quarter. At the time of this writing, iPhone maker Apple warned of weak revenue, citing a material shortfall in Greater China for results below expectations. This report increased concerns that more companies may experience slowing demand and rising costs in their businesses resulting from the uncertainty of the China trade war.

Domestic vs. International Stock Returns

While continuing to post losses for the year, international stocks outperformed U.S. stocks by declining less during the fourth quarter. Large-cap foreign stocks declined 12.5 percent with Emerging Market stocks down 7.5 percent. The sharp selloff in stocks over the past three months lowered the valuation levels for global stocks. International stocks continue to represent an attractive long-term value relative to U.S. stocks. At year-end, international stocks traded at an 11.5X Price/Earnings (P/E) on forward earnings, compared to a 14.4X forward P/E for the S&P 500. This represents a 20 percent discount to U.S. stocks. Exhibit 1 at the end of this commentary shows since the financial crisis of 2008, large-cap stocks represented by the S&P 500 have risen 271 percent. This compares to a 90 percent gain in international stocks (MSCI All Country World ex-U.S.). The significant underperformance of international stocks over the past 10 years coupled with lower valuations and higher dividend yields positions international stocks to outperform US stocks over the next market cycle. While the timing of outperformance is uncertain, this exhibit demonstrates that performance of domestic and international stocks generally converges over market cycles.

Global Economy

Statistically speaking, the U.S. economy remains strong. For the third quarter of 2018, the U.S. Gross Domestic Product (GDP) expanded at an annualized pace of 3.4 percent. This follows a 4.2 percent expansion in the second quarter. Expectations for the fourth quarter of 2018 are approximately 2.8 percent growth. For the full year 2018, approximately 3 percent growth is expected. For 2019, economists are forecasting GDP growth in the range of 2 to 2.5 percent, meaning, no recession is expected. As benefits from lower taxes fade and negative implications from the trade war increase, economic growth is expected to materially slow in 2019. Global economies are expected to grow at a faster pace than the US, as the International Monetary Fund (IMF) forecasts 3.7 percent growth in 2019. This may change as recent data from China reveals further deceleration in their economy. These statistics indicate global economic growth may have peaked, although a recession does not appear to be imminent.

A segment of the U.S. economy remaining weak is the housing market. A combination of higher mortgage rates and deteriorating housing affordability contributed to a slowdown in the housing market. This market is expected to remain weak in 2019. In addition, a collapse in oil prices in the fourth quarter is increasing concerns about slowing global growth. While excess production and supply in oil markets are to blame for weak oil prices rather than weak demand, this market is important to monitor for future clues into overall economic growth. In the meantime, low oil and gas prices may buttress consumer and business spending globally.

The Federal Reserve

The Federal Reserve increased interest rates another 25 basis points on December 19th, the fourth interest rate hike of 2018 and the ninth interest rate hike since December 2015. The Fed suggested there could be two additional rate hikes in 2019 rather than the three projected in September. Based on these comments, we are concerned the Fed may be overly aggressive in raising interest rates. Stable inflation and early evidence of slowing global economies due to the China trade war lead us to conclude the Fed should put interest rate hikes on hold. This would allow them to monitor economic data to ensure these slowing trends do not become more pronounced. The less publicized bond selling program the Fed is performing to reduce its balance sheet is another tool the Fed uses to tighten monetary conditions to stem inflation. The Fed's comments this program is on "autopilot" led investors to believe the Fed is not monitoring current economic trends. However, on January 4th, the Fed reaffirmed their flexible policy.

Politics

With the mid-term elections a distant past, the outcome of the elections is now being felt in Congress. The Democrats took control of the House on January 3rd. This guarantees more obstacles for the Trump administration than in his first two years. Now more than ever, politics created increasing volatility in the financial markets as our government grappled with a trade war, an ongoing government shutdown, immigration policy issues and a burgeoning federal deficit. This is not to mention potential future investigations into the sitting president, the outcome of the Mueller investigation and a steady stream of departures from the current White House administration. Historically, political turmoil has not had a long-lasting impact on the financial markets. This time may be different, as evidenced by the volatility around trade negotiations.

2019 Market Outlook

The 2019 year started off much differently than 2018. In 2017, global stocks increased in the 20-25 percent range. Expectations for strong corporate profits and a strong economy led to continued strength in the stock markets for the first nine months of 2018, with U.S. stocks rallying nearly 10 percent. After stocks tumbled during the fourth quarter, the stock market appears more attractively valued based on long-term stock market valuations. The Price/Earnings ratio of the S&P 500 on forward estimates started 2018 above 18X earnings. At the end of 2018, the P/E of the S&P 500 stood at 14.4X earnings. (Please see Exhibit 2 following this commentary to view a historical forward P/E chart.) While an attractive valuation alone does not mean the stock market will perform well this year, it means markets are factoring in a lot of bad news. We believe there will be continued uncertainty with the current American political environment and the Fed's monetary policy; however, we do not envision an economic recession in 2019. With attractive valuation levels and no imminent recession, there is reason for cautious optimism for the financial markets.

Conclusion

From our perspective, the economy is in a mid-cycle to late-cycle phase. If the US and China do not come to a mutually rewarding trade agreement over the next few quarters, as the two largest economies in the world, a global recession may arrive sooner than expected. On the other hand, a positive outcome for the China trade negotiations, coupled with steady Fed policy, may prolong economic growth for several more years. We believe volatility in the financial markets will persist until these issues are resolved. While selloffs in the stock market are unsettling, they are a normal part of the stock market. It is important to remember your asset allocation is the most important part of reaching your long-term financial goals. We believe a well-diversified, all-weather portfolio customized to your specific needs and risk profile are the keys to staying on course with your financial plan. **Lastly, with increased near-term uncertainty, it remains important to maintain sufficient funds in cash and short-term fixed income instruments for this year's liquidity needs.**

Final Comments

We at John D. Dovich & Associates, LLC thank you for the opportunity to serve you and your family and welcome the occasion to discuss any financial related issues you have and look forward to speaking with you soon!

Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

Exhibit 1

U.S. and international equities at inflection points | GTM – U.S. | 44

International

MSCI All Country World ex-U.S. and S&P 500 Indices

Dec. 1996 = 100, U.S. dollar, price return

	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	14.4x	15.8x	2.3%	2.0%
ACWI ex-U.S.	11.5x	14.2x	3.8%	3.0%
As % of U.S.	*80%*	*90%*	*165%*	*149%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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Exhibit 2

S&P 500 valuation measures | GTM – U.S. | 5

Equities

S&P 500 Index: Forward P/E ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, 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 and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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