MARKET COMMENTARY
Fourth Quarter, 2018

Overview

The global markets suffered steep declines in the fourth quarter amid persistent worries over the pace of economic growth, escalating U.S.-China trade tensions, Fed rate hikes, and the inversion of segments of the US Treasury yield curve. While we believe these risks may lead to continued volatility in the New Year, we anticipate global growth will continue to expand in 2019 (albeit at a slower pace) and will drive positive returns in the coming months. Real U.S. GDP grew at a 3.4% annual rate in the third quarter, which was slightly below analyst expectations, but is still the second fastest reading in four years and the second consecutive quarter of 3%+ real growth. A resolution on U.S. and China trade may take time, but both sides have shown signs of a willingness to negotiate over the last few weeks spurring optimism that a full-blown trade war will be avoided. Major concerns that the Fed will push the economy into a recession by raising rates too quickly have also been quelled as of late when the Federal Reserve Chairman, Jerome Powell, stated the central bank will be patient in raising rates. A flattening of the yield curve is common during rate hiking cycles, which is where we are today. Additionally, the curve can stay flat for an extended period of time before inverting, and even then, it has taken an average of twenty months between the first inversion of the curve and the start of a recession.

As we enter the tenth year of the global economic recovery, we are cautiously optimistic not only because some of the key risks associated with the drivers of volitilty in the fourth quarter have been alleviated, but also because strengths among the leading economic indicators continue to outweigh the weaknesses. The U.S. unemployment rate is at 3.9% which is below the historical average and the latest jobs report significantly beat analysts' expectations by adding 312,000 jobs in December. Manufacturing, retail sales, job sentiment, and truck shipment levels improved in the fourth quarter, reflecting the relative health of the economy and indicating a near-term recession is unlikely. Additionally, corporate balance sheets are strong with after-tax profits rising nearly 20% in 2018, and tax cuts and reduced regulation should also help fuel economic activity in the coming year.

Equities

The equity markets pulled back significantly in the fourth quarter with the S&P 500 (a measure of U.S. large cap companies) down -13.52% and the Russell 2000 (a measure a U.S. small cap companies) down -20.20%. For the year, large cap stocks outperformed small cap stocks returning -4.38% and -11.01% respectively. Technology was amongst the weaker sectors down, -16.84% in the fourth quarter, while energy names struggled with expectations of softer China demand weighing on oil prices. Less economically-sensitive sectors, such as utilities, generally performed better although most areas of the market lost ground. Despite the pullback in equity markets, consensus estimates for 2018 S&P 500 operating earnings growth currently sits at 26.5%, and earnings growth is expected to rise by 10.5% in 2019. Additionally, given the recent equity market volatility, valuations are now more attractive than they were earlier in the year with the forward P/E ratio of the S&P 500 currently at 14.4x which is now below the 25-year average of 16.1x. Given the relatively strong health of U.S. corporate balance sheets, we expect positive performance from U.S. equities in 2019.

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International equities also had a tough year in 2018 with the MSCI EAFE (a measure of international developed markets) down -13.79% and the MSCI Emerging Markets Index down -14.58%. While fundamentals were generally positive, returns were affected by a decrease in investor confidence and the strengthening U.S. dollar. One of the key drivers impacting sentiment was slowing growth in China, which is expected to come in at 6.6% in 2018 and slow to 6.3% in 2019. To combat a slowing economy, China is taking steps to stimulate their economy including lowering interest rates, loosening credit standards, and implementing tax cuts which should help boost economic growth. With China's monetary and fiscal policy now in easing mode, only a modest further deceleration is expected in 2019. From a structural point of view, emerging market economies have higher potential growth rates, which should translate to higher revenue growth than more developed nations. Although short-term noise may negatively impact emerging markets stocks, we continue to believe the long-term case for investing in emerging markets remains intact. Even with the recent slowdown, emerging markets have higher economic growth rates when compared to developed markets, favorable demographics, low debt levels, and strong corporate earnings growth potential.

In International Developed markets, concerns over weakening growth continue to weigh on markets. While the risks are real, there are still some substantial positives in Europe. Household incomes are growing strongly, given solid employment gains and a notable acceleration in wage growth. Credit conditions remain supportive for growth, helped by relatively accommodative monetary policy. Economic growth prospects remain relatively healthy in both developed and emerging economies in the coming months. We believe the dollar will stabilize, providing the potential to boost international assets. From a valuation perspective, international developed and emerging markets are now even less expensive and, in our view, more attractive than they were in the beginning of 2018.

Fixed Income

The Federal Reserve raised its benchmark interest rate a quarter-point to a target range of 2.25% to 2.5% in December. The move marked the fourth increase in 2018 and the ninth since it began normalizing rates in December 2015. With the Federal Reserve normalizing monetary policy, interest rates rose considerably over the last year and most bond markets were down through the third quarter. However, when extreme volatility returned to the markets in the fourth quarter, investors sought out the safe-haven of bonds. This positively impacted prices and most high quality fixed markets finished the year flat to slightly negative. As long as economic growth remains strong and inflation is subdued, the Fed will likely continue increasing Fed Funds rate in 2019, which will continue to put pressure on prices and lift yields. Given the current rising rate environment, we believe flexibility in investment approaches will be necessary.

Real Estate

With interest rates edging up and previously supportive quantitative easing programs being scaled back, optimism over growth prospects for REITs faded in 2018 and returns in the real estate sector were down in both the U.S. and abroad with the MSCI World Real Estate Index returning -6.36% for the year. Some REIT fundamentals are beginning to show signs of a maturing economic cycle, such as slowing net operating income growth, peaking occupancy rates, and declining demand for commercial real estate loans. However, there is still capital targeting real estate and some causes for optimism about the outlook for the real estate market. REITs are currently trading at earnings multiples near the low end of their five-year range, representing attractive relative value, in our view.

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Additionally, we continue to believe REITs should play a part in an investor's portfolio because of their history of strong returns and the diversification benefits they provide due to their low correlations with other asset classes.

Conclusion

We believe the global recovery is old, but not over and view the fourth quarter sell-off as another correction, not the end of the bull market. Economic growth is slowing, but still growing. The rise in core inflation is steady, not speedy, and central bank tightening is gradual, not rapid. Additionally, corporate profit margins are still expanding, and financial imbalances pose idiosyncratic rather than systemic challenges. Although we believe fundamentals remain solid, we expect the market will continue to undergo bouts of volatility amid ongoing uncertainty, which underpins the importance of selectivity in asset exposure.

We are cognizant the markets are echoing with a tremendous amount of noise right now and are aware it can be nerve-racking in the short-term. While market volatility can create anxiety, reacting emotionally and changing long-term investment strategies in response to short-term declines can prove more harmful than helpful. Trying to time the market is a proven losing game, and we believe long-term success is achieved by adhering to a well-thought-out investment plan. Although the odds of a recession in the near-term are low, we will continue to closely monitor economic indicators for signs of deterioration and will adjust the portfolios accordingly.

We thank you for your continued confidence and support. With Ferrell Wealth Management, "the Future is What we Make of it;" and we're whole-heartedly dedicated to your success. Should you have questions about your portfolio and the environment we're navigating together, please do not hesitate to contact us.

Warmest Regards,

Ferrell Wealth Management

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