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From the Curb

Letter to Clients

Quarter Ending December 31, 2018

A decade of consecutive positive annual returns from the S&P 500 ended in 2018. In the final three months of the year the S&P 500 registered its worst quarterly performance in seven years and thus ended 2018 with a negative annual total return for the first time since 2008.

Contrary to most of the headlines we saw during the last three months, the sharp declines in stocks weren't directly driven by trade wars or ongoing political dramas; all of which were with us for the majority of 2018. Instead, the break down in stocks was driven by a trifecta of classic economic and market concerns emanating from underwhelming corporate earnings guidance, slowing economic growth around the world and disappointment towards Federal Reserve monetary policy.

Stocks initially dropped in early October as the third-quarter corporate earnings season disappointed markets. While most companies beat consensus estimates, profit warnings from select multinational and industrial firms such as PPG Industries (PPG) and FedEx (FDX) highlighted growing concerns from analysts about peak earnings growth for U.S. corporations. That rising concern was reflected by the market's performance during the heart of the third-quarter reporting season, as the S&P 500 declined 6.84% in October.

After a respite from selling in November that saw stocks bounce back slightly from the October losses, earnings concerns were compounded in December by suddenly disappointing economic readings. In early December, multiple economic indicators, including manufacturing surveys and the November jobs report, missed Wall Street consensus estimates, adding the potential of slowing economic growth to the list of headwinds on stocks.

Finally, uncertainty regarding future U.S. monetary policy in the wake of the December rate hike by the Federal Reserve added yet another source of concern for investors, and that additional unknown caused a massive spike in market volatility in late December. Specifically, the Fed increased interest rates for the fourth time in 2018, despite the declines in stocks and wavering economic data, and signaled it expects to increase rates two more times in 2019. That policy decision, which was more restrictive than investors were hoping for, caused stocks to plunge as the major equity indexes dropped to fresh 52-week lows during the final two weeks of December. Markets did bounce modestly during the final days of 2018 to finish off the worst levels of the year, but still solidly negative on an annual basis.

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Despite legitimate concerns about economic growth, earnings and Fed policy, the news in the fourth quarter wasn't all bad. First, the U.S. and China agreed to a temporary trade war "truce" and began an intense, 90-day negotiation period aimed at ending the trade war. Secondly, most major indicators of U.S. economic growth, while exhibiting a loss of momentum, remained in solidly positive territory, meaning the economy is still growing (albeit, at a potentially slower pace). The November Employment Situation Report showed positive jobs growth and an unemployment rate under 4% while regional manufacturing surveys remained in positive territory.

In sum, 2018 was a very difficult year in the markets and for investors. Not only did most major stock indices post a negative full-year total return for the first time since 2008, but the declines came with two episodes of intense, confidence-shaking volatility in the first and fourth quarters.

As our focus turns to 2019, we expect continued volatility in stock, bond and commodity markets in the coming months. Whether the markets continue their downward trend or rebound will depend largely on the resolution of these three uncertainties facing markets: Earnings, Economic Growth and Fed Policy.

Regarding earnings, the bulk of the fourth-quarter 2018 earnings' results will be released this month. Within the next few weeks we should learn whether U.S. corporate results have stabilized, or whether the disappointing guidance we saw from companies in Q3 continues.

Investors will be focused on widely followed economic reports (including the December Employment Situation Report, ISM Manufacturing PMI, Retail Sales, Core PCE Price Index) to determine whether U.S. economic growth has indeed peaked.

From a Fed policy standpoint, the next FOMC meeting occurs at the end of January. Although there is no planned action, Fed Chair Jerome Powell will hold a press conference after the meeting which will afford him the opportunity to communicate more effectively with investors and potentially resolve uncertainty regarding Fed policy.

Finally, we begin 2019 with numerous geopolitical situations to watch. First, the U.S.-China trade talks are ongoing and there remains hope that the two sides will reach an agreement to reduce existing tariffs before the 90-day negotiation period expires. In Europe, Brexit remains unsettled, although negotiations among Britain's largest political parties continues in an effort to approve the Brexit agreement with Europe. Bottom line, this is an environment that requires vigilance and heightened focus on financial market moves, economic news and political developments.

Past performance is not indicative of future results. But history has shown that a long-term approach combined with a broadly diversified portfolio can help sustain you through periods of heightened volatility, market corrections and even bear markets. That said, emotions can run high and we encourage you to reach out to discuss any anxiety you might be feeling. We understand the risks facing both the markets and the economy, and we are committed to helping you navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility like we experienced in the fourth quarter is unlikely to alter your long-term investment objective. We will continue to monitor and digest all new information and adjust portfolio holdings to ensure that they support your goals.

Volatile markets are both unnerving and stressful, and we thank you for your ongoing confidence and trust. Rest assured that our entire team will remain dedicated to helping you successfully achieve your long-term financial goals.