Quarterly Update & Economic Commentary—December 31, 2018

Quarter in Review

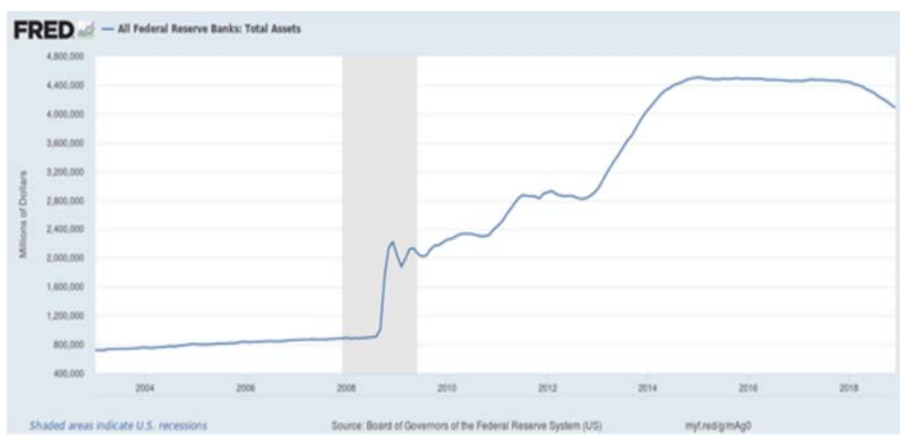
The equity markets finished the year off strong, rallying more than six percent between Christmas and New Year's Day. Unfortunately, the rest of the quarter was not as prosperous. The S&P 500 Total Return (TR) lost 13.52 percent during the quarter, which was its worst quarterly drop since losing 13.87 percent during the third quarter of 2011. The nine percent loss suffered in December was the worst monthly loss since February 2009. The poor performance during the fourth quarter caused the S&P 500 to suffer its first calendar year loss, on a total return basis, since 2008. The index lost 4.38 percent for the year. Only one S&P sector had positive performance during the fourth quarter, which was Utilities—positive by 1.36 percent. The Energy sector led the decline, falling 23.78 percent for the fourth quarter, followed by Technology (-17.34%) and Industrials (17.29%). Only three sectors had a positive calendar year return: Health Care (6.47%), Utilities (4.11%) and Consumer Discretionary (0.83%). Small and mid-cap stocks suffered more during the quarter and the year. The S&P MidCap 400 TR lost 17.39 percent during the fourth quarter and the S&P SmallCap 600 lost 20.10 percent during the quarter. Year-to-date, the mid cap index lost 11.51 percent and the small cap index is down 8.48 percent. Emerging Market equities were one of the better performers during the quarter. The MSCI Emerging Market Net Return index lost 7.47 percent during the fourth quarter and finished 2018 down 14.58 percent.

As market volatility increased during the quarter, interest rate yields fell. The 10-year Treasury yield fell from 3.07 percent at the start of the quarter to 2.69 percent at the end of the quarter. The drop in yield drove prices higher. The Barclays US Aggregate finished the quarter positive by 1.64 percent during the quarter and narrowly finished the year in positive territory (0.01 percent). Municipal and government bonds performed slightly better for the quarter, finishing positive by over two percent and finishing the year positive by over one percent. High Yield fixed income, which tends to be more highly correlated to equities, lost 4.53 percent during the quarter and finished the year down 2.08 percent.

The oil markets saw significant declines during the quarter as global growth concerns caused demand expectations to fall. The S&P GSCI Brent Crude Spot price fell 34.97 percent and is off 19.55 percent for the year. Soybean prices had a notably good quarter after China made some large purchases in December and trade talks between the U.S. and China showed some promise and compromise. The spot soybean price rose 5.85 percent during the quarter but is down 6.94 percent for 2018. Gold and Silver had strong quarters, finishing positive by 7.11 and 5.63 percent, respectively. However, both metals finished the year in negative territory, Gold by 2.14 percent and Silver by 9.36 percent.

The quarter started off with October losing 6.84 percent, which was the worst calendar month loss, at the time, since 2011; the December monthly return ended up being worse. The sell-off was sparked by an increase in interest rates. The 10-year Treasury yield started the quarter yielding 3.07 percent but jumped rather quickly to 3.25 percent early in the month. The rise in interest rates was driven by the expectation of future interest rate increases and inflation expectations. In addition to the rise in interest rates, markets also had to deal with the uncertainty of the November midterm elections. The result of the November elections broke up unified control of Congress as Democrats took control of the House of Representatives and Republicans strengthened their control in the Senate. The split Congress is believed to signal a slightly less pro-business government and makes getting anything accomplished more difficult. Further amplifying the gridlock was the shutdown of the federal government, which began in December while Republicans still controlled the House but has continued on into the new Congress in January.

The Fed announced another rate hike in December, making it the fourth rate hike of 2018 and the ninth rate hike since the Fed began raising rates this cycle. The central bank's current benchmark interest rate is set to a range between 2.25 and 2.5 percent. Rate hikes may be having an impact on the economy and the markets but the major, albeit less discussed, impact, is the Fed's policy around reducing the balance sheet. The Fed grew the balance sheet as an act of stimulus and stability following the Financial Crisis until around 2015 and kept the balance sheet stable until late 2017. In October of 2017 the Fed began decreasing the balance sheet at a rate of $10 billion per month and rose the dollar amount quarterly until eventually in October2018 they were reducing it by a much higher amount, setting a cap of $50 billion per month. During the first month of the near $50 billion reduction the market fell 6.84 percent. Given the other concerns that are circulating it is hard to know for sure if this coincidental or a meaningful correlation. The Fed Chair had also commented that the balance sheet reduction was on "autopilot"; after much discussion from the market watchers this comment was eventually walked back.



Trade was another major contributor to market volatility during the quarter. The three members of the North American Fair Trade Agreement (NAFTA), the U.S., Mexico and Canada, agreed to update the deal. The resulting update lacked any substantial adjustments but it was enough to please President Trump. President Xi of China and President Trump met at the G-20 Summit and had what appeared on the surface to be productive talks. The U.S. agreed to pause raising tariffs from 10 percent to 25 percent on $200 billion worth of Chinese goods being brought to the U.S. and the Chinese agreed to purchase a very substantial amount of agriculture, energy, industrial and other products from the U.S. The agreement will be in place until March 1 which will give the two countries time to negotiate a trade deal. The trade discussions have been and will continue to be a risk to the economy and stock market; however, the recent developments provide some hope that a deal can be worked out.

A Look at the Numbers

Name	3 Month Return (%)	YTD Return (%)
DJ Industrial Average TR USD	-11.31	-3.48
S&P 500 TR USD	-13.52	-4.38
S&P MidCap 400 TR	-17.28	-11.08
S&P SmallCap 600 TR USD	-20.10	-8.48
NASDAQ Composite TR USD	-17.29	-2.84
MSCI EAFE NR USD	-12.54	-13.79
BBgBarc US Agg Bond TR USD	1.64	0.01
Wilshire US REIT TR USD	-6.93	-4.84
IA SBBI US 30 Day TBill TR USD	0.56	1.81

Forecast in Brief

With such a disappointing final quarter of 2018, investors are anxious for a fresh start in the new quarter and year. But many question whether things will get better for the stock market in 2019 or if the fourth quarter was just the start of a protracted bear market.

The Fed's actions and comments will be a driving factor of market and economic results in 2019. The probability of any rate hikes in 2019 has been falling, and there is even a remote possibility of a rate decrease in 2019. We expect that the Fed will raise rates at least once in 2019, but we also believe that they will take a pause during the first part of the year and wait until the second half of the year so as to not scare the markets. More important to the market from a Fed perspective is the change in policy around reducing the balance sheet. If the Fed continues to target $50 billion per month in balance sheet reductions, then the market will continue to be volatile. The market, however, is pricing in the likelihood of a reduction in the current runoff, an accommodative measure that would be bullish for the markets.

March 1 marks the deadline for a resolution of the ongoing trade war between the U.S. and China before President Trump increases the current tariffs. Given the complexity of the situation and the relatively short time period, it is doubtful that a complete agreement will be secured. If an agreement in principal is not made, or at the very least very close, we fully expect President Trump to increase the tariffs in an effort to put more pressure on China to make a deal. The current tariffs have put pressure on the Chinese economy so we believe China won't have the flexibility to delay a solution until the next Presidential election; this suggests an agreement will be made this year. Virtually any agreement that President Trump accepts will be good for the markets.

Democrats take control of the House of Representatives in January for the first time in eight years, while Republicans remain in control of the Senate. The split Congress only adds to the dysfunction of Washington and increases the risk that the government shutdown, which carried over from 2018, will continue. Ending the shutdown will be the first order of business, but President Trump is not moving from his position of wanting to build a wall on the southern border and the Democrats continue to claim that there will be no more money for the wall. The Democrats have an outlined agenda which includes reducing corruption, cutting drug prices and shoring up Obamacare, improving U.S. infrastructure and addressing climate change. The corruption focus is a political message, with nothing expected to come from it. President Trump may be open to cutting drug costs by allowing Medicare to negotiate prices, but the Obamacare piece will see very little Republican support. Both parties agree that U.S. infrastructure needs upgrades, but it will be a challenge to get the two sides to agree on where to focus the attention. The Democrats aim to fight climate change and formed a Select Committee on the Climate Crisis, but even Democrats are divided on how to tackle the initiative; furthermore, the President and Republicans are unlikely to support any meaningful climate related legislature.

Corporate earnings of companies in the S&P 500 are expected to be strong for the fourth quarter but not as strong as the previous three quarters in 2018. Current estimates from FactSet expect earnings growth of about 11.4 percent; when accounting for expected earnings upside surprises, the actual earnings growth rate is expected to be above 15 percent. This is above long term trends but lower than the 25 percent or more growth rates seen in the previous three quarters.

While corporate earnings remain strong there have been some recent economic indicators that are either beginning to worsen or improve less quickly. Consumer confidence has increased long with the stock market over recent years, but after peaking in October the indicator has fallen as the market has fallen. Despite the drop in consumer confidence, retail sales remained strong over the holidays; however, a lower stock market would pressure confidence lower and eventually bleed over to consumer spending. The housing sector had been weak for much of 2018 and this will most likely continue. The cost of purchasing a home has increased both because of the increased cost of raw materials and manufacturing as well as the Fed's action to raise interest rates, pushing mortgage rates higher as well. The most recent manufacturing data, which provides an indication of future business activity, continued to expand; however, the most recent December reading was the lowest reading in two years. Another closely monitored report is the orders of nondefense capital goods excluding aircraft. The data is a proxy for business spending plans and has been declining since it hit its peak in July. This is only a short-term blip, but continued weakness will hit economic growth.

The U.S. dollar strengthened through much of 2018 when the Fed was expected to raise rates at a more rapid pace, but the dollar weakened recently amid the volatility and we expect the weakening to continue in 2019. If the dollar weakens, we believe that will provide an opportunity for international stocks. International stocks in general are attractive from a valuation perspective and a weakening dollar would bolster the returns of U.S.-based investors. It should be noted, though, that low valuations, especially in Europe and Japan, may be justified due to structural issues and slowing growth. Emerging markets, on the other hand, are more likely to have a good year.

In last quarter's commentary we ended with a note of caution to those investors who were frustrated with the lackluster returns of their fixed income investments. At the time, riskier equity asset classes were up by double digits for the year and most fixed income was negative. The importance of sticking with your fixed income was demonstrated in the fourth quarter as stocks fell, along with interest rates, thus pushing fixed income prices higher. As we end our fourth quarter commentary we will reissue a similar cautionary note: resist the urge to sell out of your equities after this recent market turbulence. If you work with ACG, equities are in your portfolio for a reason and were added with the understanding that periods of volatility happen from time to time. Remain focused on your long term goals.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

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