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GROUP

Investment and Financial Consultants

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2018 REVIEW AND OUTLOOK FOR 2019

The fourth quarter of 2018 was the most volatile period for the financial markets in many years. After a sharp stock market correction early in the year, a second global stock market decline began in October due to worries that Federal Reserve Board interest rate increases and global trade tariffs would lead to a decline in domestic economic activity and corporate earnings. Also, investors have become worried that the strong U.S. dollar is harming U.S. corporate profits. These concerns and uncertainty surrounding the slowing global economy are causing traders to sell stocks. Consequently, the S&P 500 Index ended the year down 6.24%, while the Dow Jones Industrial Average lost 5.63%. Bonds did not offer much of an opportunity for gains in 2018 either as the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index increased only 0.88% during 2018.

While the declines in the major U.S. stock market indices were limited to single digits last year, the damage to many stocks was much worse. For example, the MSCI EAFE Index of foreign stocks was down 16.14% last year and the Russell 2000 Index of small company stocks was down 12.18%. Almost 30% of stocks in the S&P 500 finished 2018 down 20% or more in 2018. *

Although the U.S. economy is expected to remain strong in the near term, the fact that the rate of corporate profit growth is expected to slow is concerning to investors. Stock prices generally reflect the underlying profits of corporations. Therefore, expectations for slowing future corporate profit growth led to lower stock prices last year.

One reason corporate earnings growth is expected to slow is because the Federal Reserve Board has continued to raise interest rates to prevent inflation. When the Fed raises interest rates, it can harm corporate profits because it increases the cost of borrowing for corporations and individuals. For example, rising interest rates make it more expensive for consumers to borrow to buy large items such as autos and homes, which could weigh on profits of companies in those and related industries. It also increases the interest rate that consumers have to pay on home equity loans, credit cards, car loans, and student loans, thereby eroding consumer purchasing power. Rising interest rates can also make fixed-income investments look more attractive to investors, resulting in money moving out of stocks to bonds and other fixed-income securities.

The Fed is concerned about rising inflation due to the recent tariffs imposed on imports from countries like China. Tariffs increase the cost of products and raw materials. Placing tariffs on goods imported from other countries could also lead to retaliation from those countries who refuse to import goods produced by large U.S. corporations, thereby harming their profits. These trade wars could eventually lead to slower economic growth if they go on for a long time or escalate further. Another reason the Fed is concerned about future inflation is due to the tight U.S. labor market. This can lead to rising wages, which is another cause of inflation.

A result of rising interest rates and a stronger economy in the United States compared to the rest of the world has been a rise in the U.S. dollar compared to most foreign currencies. As the U.S. dollar strengthens, foreign investors generally invest more money in the United States in hopes of benefiting from the stronger currency. However, when the dollar becomes too strong, it can act as a headwind for U.S. corporate profits because corporations that sell their products overseas receive fewer U.S. dollars when they translate their foreign revenues back to the United States. Foreign consumers also favor non-U.S. products that may be cheaper.

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While the Fed has been raising short-term interest rates, foreign investors have been buying long-term U.S. Treasury bonds due to the strong U.S. dollar and because Treasuries are considered a safe-haven investment in times of geopolitical uncertainty. This demand for long-term Treasuries has led to an increase in bond prices, and therefore a decrease in long-term interest rates. The combination of rising short-term rates controlled by the Fed and declining long-term rates resulting from foreign investment is leading to concerns about an inverted Yield Curve. The Yield Curve illustrates the relationship between yields on bonds over different time periods and it typically indicates that short-term bonds pay lower interest rates than long-term bonds. However, an inverted Yield Curve means that short-term bonds are paying higher yields than long-term bonds. In the past, inverted Yield Curves have been a precursor to recessions, and this has investors concerned. However, we do not believe that fears of an inverted Yield Curve are signaling an imminent recession. Any inversion of the Yield Curve in this existing environment is likely due to temporary and extraordinary conditions that we do not believe are sustainable.

Because the recent stock market decline is mainly due to fears that the rate of corporate profit growth and economic growth will slow, and because the U.S. economic backdrop is still strong, our base case is that the stock market will regain its footing this year and not recede into a long-term bear market like those that occurred between 2000-2002 and from 2007-2009. The worst bear markets are typically accompanied by major structural problems with the U.S. economy and there are no indications of fundamental problems in the U.S. economy at this time.

We continue to prefer large company stocks over small company stocks and U.S. stocks over foreign stocks. The U.S. economy is stronger than most foreign economies and emerging market economies are at an even greater risk if interest rates continue to rise and trade issues persist. We also continue to prefer short-term bonds over long-term bonds as the Fed continues to raise short-term interest rates.

In the meantime, please contact us if you are concerned about the recent market volatility or if you have any questions regarding your investments or the financial markets in general.

** Index returns and other statistics were obtained from the Wall St. Journal, Bloomberg Barclays, MSCI, and Morningstar on January 1, 2019.*

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