Fourth Quarter Review and Outlook

January 2019

Much has changed since we last wrote to investors on the day after Christmas (A Lump of Coal for Investors This Christmas?). At that time, most equity market indices—including the S&P 500—had breached bear market territory (customarily defined as a 20% decline from recent peak). We then argued that uncertainty over pending trade disputes had taken hold of market sentiment, and that perhaps the negativity was disconnected from the underlying realities of global economic growth and corporate profitability. As if on cue, equity markets began to rally on the very day we released our letter. The S&P 500 gained over 5% in the last week of December to close down just 4.5% for the year. It has climbed over 3.6% in just the first two weeks of 2019—an impressive rally.

Period Returns

	Oct. 1st - Dec. 24th	Dec. 25th - Year-End	2017	2018	2017 - 2018 Avg. Annl.
Global Equity	-16%	4%	24%	-9%	6%
US Large Cap	-19%	7%	22%	-5%	8%
US Small Cap	-25%	6%	14%	-11%	1%
Devl. Intl.	-13%	1%	25%	-14%	4%
Emerging Mkts.	-9%	2%	37%	-15%	8%
US Bonds	1%	0%	4%	0%	2%
High Yield	-5%	1%	8%	-2%	3%
US Corporate	0%	0%	6%	-3%	2%
Long Term	4%	0%	9%	-2%	3%
Real Assets					
Commodities	-9%	-1%	2%	-11%	-5%
Real Estate	-10%	4%	10%	-4%	3%
Hedge Funds	-7%	1%	6%	-7%	-1%
Managed Futures	-2%	0%	3%	-3%	0%
Equity Hedge	-11%	2%	10%	-9%	0%
Market Neutral	-3%	0%	2%	-3%	-1%
Global 60/40	-9%	3%	16%	-6%	6%
CPI	0%	0%	2%	2%	2%
Real Return	-10%	3%	14%	-8%	4%

While we'd like to believe that global capital markets responded forcefully to our December letter, we know that many of the challenges and opportunities identified in our letter continue. In this edition, we provide a brief wrap-up of 2018 before shifting attention to our intermediate-term outlook.

2018 Retrospective

Most market movements in 2018 can be traced to growing trade uncertainty. Stocks started the year with a bang. We felt that strong equity market gains in the U.S. were justified following a major, permanent corporate tax cut that was sure to positively impact profits. Congress then passed a mammoth spending bill that also promised to support growth. Mindful that the U.S. serves as an economic engine to much of the world, we anticipated that these forms of fiscal stimulus would bleed over to other markets in a positive way.

Unfortunately, trade uncertainty and other frictions between the U.S. and China reverberated across global markets throughout the year. The U.S. initially benefited from this trend as U.S. net exports are typically low compared to many of our trading partners. Those countries most exposed to trade were hit first and hit hardest. Emerging market stocks and currencies led markets downward, followed by developed international stocks. Investors were also disappointed with the U.S. Federal Reserve's determination to continue raising interest rates as it strives to reach the so called "neutral rate." The latter factor led to an unusual case where both stocks and bonds generated losses simultaneously. Though bonds managed to rally in December as investors sought safety, fixed income investments ended the year at only a break-even level.

With 2018 in the books, it is ironic to observe that the economic growth and corporate profitability gains that we had anticipated were fully realized, despite calendar year losses in nearly every asset class.

Below we offer a few brief retrospective observations to set the stage for the outlook that follows:

1. **Returns are "OK".** Most diversified portfolios generated adequate real returns (investment return net of inflation) across the most recent two-year period. Nevertheless, many investors may be licking their 2018 wounds and feel as if something has been lost, but periods of loss are inherent in investing and higher than expected long-term returns go hand-in-hand with deeper losses during market declines.

2. **A useful stress test.** The "baby bear" market of 2018 did not last long but it serves as a live-fire test of risk tolerance. Those who were distressed by the 2018 market gyrations might wish to discuss their current portfolio structure with their advisors to assure proper alignment of risk and return expectations. We also remind investors that market pullbacks are a normal part of investing, even in very positive years, which we discussed in our October piece on Market Volatility.

3. **The low-return environment has arrived.** Low bond returns and high starting-point equity valuations coupled with slowing global growth are expected to lead to more meager portfolio returns over the intermediate-term. This is a widely-held view. Absent an exogenous shock to the upside (such as we saw in the dot-com era), returns will be lower than investors have come to expect from prior experience. One silver lining in this cloud is that inflation is expected to remain contained at about 2%. Thus, nominal returns may be lower but real (after-inflation) wealth creation will be less impacted. Investors should keep this in mind when evaluating success. Though this period will not last forever, investors must adopt attitudes and strategies appropriate for the era to remain content and to allow their portfolio designs to work over time.

4. **Dangers of timing/tactical investing.** Investment performance by asset class in 2018 nearly mirrored that of 2017, underscoring the pitfalls of becoming too tactical. While it is tempting to swing the portfolio aggressively toward perceived opportunities and away from risks, it is more likely that such actions will impair capital and thus erode wealth. Rather, consistency and strategic investing are most often rewarded.

OUTLOOK

No one has a reliable crystal ball, but we can examine history, past trends, current valuations and other data to develop reasonable market expectations. While we seek to maintain a consistent (strategic) allocation across years, we make adjustments based on the collective weight of empirical evidence. Below we list several expectations that we anticipate will impact capital markets in the near-term. These expectations may not be fully realized in just one calendar year.

1. **Recession fears will prove to be overblown.** Growth in the U.S. and China may be slowing but *slowing* is not *declining* (i.e., not a recession). Recession probability indicators suggest only a 25% chance of a recession this year and the indicator usually hovers around 20%. The U.S. will eventually see a period of negative growth, but it is unlikely to occur in 2019. Similar observations apply across much of the globe. China has shown a willingness and need to stimulate if economic growth slows below target. We know that markets are always looking ahead and increasing recession risks in future years may impact equities at any time, but the near-term outlook for the economy remains positive.

2. **Low valuations will boost stocks.** Investors have come to realize that company profits grew significantly over 2018, while prices fell. Using the forward price-earnings ratio as a guide, stocks are now priced at 2012 levels. Starting-point valuations should allow stocks to register meaningful gains over a volatile year even as earnings growth *and* global GDP decelerate.

3. **Beware the "trade" trade.** It may be frustrating to observe that the primary market driver over the past nine months is not something that we believe is wise to work into an investment thesis going forward. Should trade disagreements persist for a long period, equites across the globe are likely to be negatively and materially impacted, while the opposite can also be true. Yet a decision to invest based on one's expected outcome is nothing more than a gamble. The political nature of such discussions makes the outcomes unpredictable. Moreover, the complexity of today's supply chains makes trade-based forecasting outcomes for companies—or even regions—nearly impossible to diagnose. Investment decision-making must therefore proceed without making the prediction of trade and tariff outcomes the fulcrum for success.

4. **Volatility will remain high—perhaps much higher than in the recent past.** In an environment characterized by high uncertainty, new information can have a material and immediate impact on market movements. An unusual number of high-impact triggers are poised to move markets, up or down, over 2019. Moreover, programmatic trading has increased and much of it is momentum-based. Such trading can be expected to exaggerate near-term trends. We expect investors to have to contend with the twin deplorables of low overall returns coupled with high volatility. The good news is that volatility can be exploited to an investor's advantage through specific investments such as structured notes and put-write strategies.

5. **Active management will outperform in fixed income.** The U.S. 10-year treasury yield plunged over fourth quarter 2018, moving from 3.2% to about 2.7%. This was primarily driven by fear. We expect that move to unwind over 2019. Given that bond yields are very low, if yields retrace that 50-basis point drop over 2019, it will be mathematically impossible for bonds to generate a positive return.

    - In such an environment, investors may wish to skip the typical intermediate-duration bond allocation and simply hold short-term bonds to weather a period of rising rates. Yields on short-term bonds are above 2% following multiple increases in the Fed Funds Rate.
    - We continue to favor conservative, low-volatility alternative investments (e.g., hedge funds) in lieu of bonds for a *portion* of the diversifier allocation in portfolios—a strategy that we have employed over the past several years with better returns than bonds.
    - It is a little-known fact that active bond managers tend to outperform the Barclays Aggregate Bond Index, and while this was true over much of 2018, a powerful late-year

bond rally represented a departure from that tendency. We expect active fixed income managers to resume their outperformance versus the bond index in 2019 and beyond.

6. **<u>Long-dated stock trends should reverse</u>.** Investors typically demand a premium for investing in smaller companies as evidenced by the fact that small company stocks, on average, outperform large company stocks over time. Similarly, while growth companies may outperform for a time, long-term results favor those who invest in underpriced stocks (i.e., *value* stocks). In recent years, both small company stocks and value-oriented stocks have woefully underperformed. These performance patterns tend to run in multi-year cycles, and both are now long in the tooth. We anticipate a reversion to the mean with small cap and value stocks outperforming in a long-awaited return to a focus on company fundamentals.

7. **<u>The appeal of private market investments will return</u>.** Over the course of the recovery from the Great Recession, equity and bond performance dwarfed that of hedge funds, which has taken the shine off private market investments overall. However, it has long been known that the private equity asset class reliably outperforms public market stock portfolios despite the attendant liquidity challenges. Additionally, some hedge funds offer attractive investment strategies that are simply not available in mutual funds or ETFs, such as direct lending, distressed debt and real estate. Lastly, product innovations and technology have made these asset classes more accessible with lower minimum investment amounts. In a low-return environment where investors may be increasingly willing to endure some illiquidity to produce more acceptable returns, private market investments will gain appeal.

In closing, we remain ever mindful of the investor angst that increased market volatility and political instability can create, but looking ahead we see as many opportunities as threats and we are taking action to exploit the former. As always, we stand ready to discuss your thoughts and concerns. We appreciate the trust and confidence you place in us and continuously strive to remain worthy of that trust.

With best wishes for a happy and prosperous 2019,

Sean Cook
Managing Partner and Chief Investment Officer