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Market Update: December 2018

U.S. stocks plummeted over 9% in December and ended down 14% for the quarter. The daily volatility during the quarter was nothing short of remarkable. Market leverage and quantitative trading strategies apparently exacerbated the situation. We saw the worst Christmas Eve decline on record, and it was followed up with the largest one-day point gain in the history of the Dow Industrials.

> **Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.**
>
> **Warren Buffet**

From the September peak to the December 24 low, the S&P 500 fell 19.8% … just shy of the 20% decline that defines a bear market. From the December 24 low, the blue-chip measure rallied 6.7% to close out the year. Still, it was the first time since 1948 that the S&P 500 finished the year down after being up for the first three quarters.

The record books will show that domestic stocks finished down just over 5% for calendar 2018 … a decline that is still *relatively insignificant* from a historical perspective.

> **All the pain came in the final quarter and most of it in the final month … Ultimately, 2018 ended with a very different feeling than it began.**
>
> **Alex Eule – Barron's 12/31/18**

With the U.S. economy still on cruise control, it would appear that market performance is not in sync with the economic fundamentals. It's actually the global economy that is struggling. China's economy has hit a rough patch, while Germany's economy is coming off a third quarter contraction. Let's not forget concerns over the pending Brexit deadline, problems with the Italian banking system, and antigovernment protests in France.

> **For the rest of the world there seems to be some air coming out of the balloon and that, I think, will come back also and affect the U.S.**
>
> **Maurice Obstfeld, International Monetary Fund – WSJ 12/14/18**

Foreign stocks, like their U.S. counterparts, had a rough quarter. They were down nearly 5% in December and over 11% for past three months. For the calendar year, foreign stocks recorded declines of just over 14% … which is *relatively significant* from a historical perspective.

> **The world's weakness is not a disaster for the U.S. Is it enough to put you in recession? No. But if the car was driving at 70 miles per hour, this gets you down to 55, and nobody likes to drive at 55 miles per hour anymore.**
>
> **Jay Bryson, Wells Fargo Securities – WSJ 12/14/18**

U.S. crude oil prices ended the year down 25% due to concerns over falling demand and a potential supply glut. Prices plummeted 38% for the quarter after hitting multiyear highs in October.

The Federal Reserve raised interest rates in December for the fourth time this year, and they anticipate making 2 or 3 more *quarter-point* increases in 2019. The Fed's upbeat view of the economy was not shared by investors, who were hoping the Fed might pause in response to market volatility.

> **When you take away the punchbowl and raise the rate, asset prices have to adjust. Financial market turbulence is not irrelevant, and they know that, but it's also the case that monetary policy normalization is likely to cause turbulence.**
>
> **Catherine Mann, Citigroup – 12/20/18**

While many investors (along with President Trump) were not happy with the Fed's actions and communications, some economists applauded Fed Chair Jerome Powell's resolve. They blame our current economic woes on previous Fed actions that eased aggressively during times of stress, while condoning excess during upswings.

> **From bubble to bubble, from crisis to crisis, there were increasingly compelling reasons to question the Fed's stewardship of the U.S. economy.**
>
> **Stephen S. Roach, Yale University – Project Syndicate 12/24/18**

Remember that the Fed is also in the process of reducing its balance sheet, otherwise known as quantitative tightening (QT). QT has the effect of draining liquidity from the financial system. Also, the European Central Bank is ending its quantitative easing (asset purchase) program and may actually start initiating rate hikes sometime during 2019.

> **That means the Eurozone is about to lose a monetary drug on which it has grown highly dependent.**
>
> **John Mauldin, Mauldin Economics – 12/7/18**

The yield on the 10-year U.S. Treasury note ended 2018 at 2.68% … up from 2.41% at the end of 2017. The yield climbed higher for most of the year and hit multiyear highs in November before declining sharply to end the year. The yield gap between the 10-year and 2-year Treasury, which contracted to less than 0.10 percentage points during December, ended the year at about 0.19 percentage points. Historically, when the gap inverts (meaning the 10-year yields less than the 2-year) a recession generally follows in the next 6 to 18 months.

China's growth strategy is to dominate high-tech markets by subsidizing state-owned companies and supplementing research with stolen technologies from the Western world. The FBI recently told Congress that Chinese theft of technology has become the greatest threat to national security. With all the focus on tariffs and the potential for a trade war, everyone should be aware of the bigger picture.

> **The purpose of the tariffs is not to reduce the bilateral trade deficit but to counter Chinese technology theft and forced transfer. The U.S. should not let these outrageous practices continue.**
>
> **Martin Feldstein, Harvard University – WSJ 12/27/18**

Global debt levels continue to surge. Without question, our world is awash in debt. It is the economy's 800 pound gorilla. I find it interesting that the **WSJ's Year-End Review** insert had no less than seven articles focused on debt concerns. These problems are massive and have the potential to create tremendous disruption to the global economy down the road. When will we reach the tipping point? It could be 15 years or 15 months. At this point, it is anyone's guess.

Currently, the markets are fixated on four major concerns: slowing global growth, tightening monetary policy, declining corporate earnings growth, and political uncertainty. This is not exactly breaking news, as we've been talking about these same issues for quite some time.

We started the year knowing that the economy was in the late innings of this expansion … obviously now it is even later. Everyone is predicting a late stage slowdown in economic growth for 2019. That is still a far cry from recession, and by the way, there are practically no economists warning of a pending recession.

> **As the global economy enters into its tenth year of expansion following the global financial crisis, concerns are growing that a recession may be imminent. In short, economic growth should shift down, but not out.**
>
> **Vanguard, Market Outlook – 12/2018**

Sure, monetary policy is tightening, but the Fed's moves have been generally well choreographed. Also, everyone knows that corporate profits for 2018 were *juiced* by tax cuts, and the *sugar high* would soon fade. Again, this is old news. As for political uncertainty … well when has anything political ever been certain?

> **The market seems to be pricing in more of a slowdown than the fundamentals would suggest …**
>
> **David Lebovitz, J.P. Morgan Asset Management – 12/28/18**

Remember, the most probable scenario for 2019 is for slower (positive) global growth, a more "dovish" Federal Reserve, and 8% corporate profit growth. This is hardly a recipe for disaster. Stock valuations have come down. According to J.P. Morgan Asset Management, the forward looking price/earnings ratio for the S&P 500 is now below its long-term average. So, if you liked the market back in September, you should love it now.

Rebalancing and tax loss harvesting are strategies to help take advantage of market volatility. As always, we will rebalance at the same time we make adjustments to our model portfolios for 2019.

I hope you all have a happy and healthy New Year!

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