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2018 Fourth Quarter Review

"Santa Claus Rally from Christmas Crash?"

The fourth quarter was a brutal one for stocks. The combination of rising interest rates, a shrinking Federal Reserve balance sheet, political drama, and increased tariffs and trade tensions finally took its toll on investor confidence. From a high point reached near the end of September, all of the major indexes fell as much as 20% in a decline that extended until the Christmas Eve trading session. In the last few trading days of the year, stocks had posted the worst performance for the month of December since 1931. All told, the entire quarter was the worst for stocks in almost 10 years, since the dark days of the economic crisis of 2008.

For the first time since 1901, 90% of asset classes of all kinds posted losses for the year. The S&P Commodity Indexed Trust was down 14% by year's end. Bonds fell as interest rates rose. By the end of October, treasury bonds as represented by the iShares Barclay 20 year Treasury ETF had fallen more than 11%. Bonds then rallied, but then closed down over 4% for the year. In stocks, the S&P Index fell 6.24% (dividends would have reduced the loss to about 5%). Smaller company stocks were hammered with the Russell 2000 index falling over 12%. International stocks provided no safe-haven as the Vanguard Total World ETF fell by 12%, the MSCI Emerging Markets Index fell 14%, and the Euro Stoxx 50 index lost 16%. Most spectacular of them all was the fall of the once shining Bitcoin, which lost over 73% of its value from its high near the end of 2017. A bitcoin bought for nearly $20,000 a little over a year ago came to be worth only $3,880 by New Year's Eve.

Last quarter we mentioned that the Fed's actions raising interest rates and withdrawing liquidity (through balance sheet reductions, i.e. selling bonds) would be one of, if not *the* most important factor to watch. The stock and bond markets had declined somewhat going into the Fed meeting in December where the board raised rates again, as expected. It was Fed Chairman Jay Powell's comments *after* the meeting that really unnerved investors. When asked whether the Fed would back off in the face of weakening economic conditions, Chairman Powell reiterated that they were on track for more rate hikes in 2019 and that the balance sheet reductions were "on autopilot." Within seconds, the markets fell further and continued to do so until hitting a low on Christmas Eve. Fortunately, Santa Claus may have worked his magic once again as stocks have rallied since then. The more recent, more accommodative comments by Fed Chairman Powell in early January seemed to say, "We get it! We won't keep tightening and run the economy off a cliff." After the drubbing that stocks took last quarter, investors seemed relieved and bid stocks up again into early January. As things have turned out, we did in fact see the often-mentioned "Santa Claus Rally," but only after a fairly painful "Christmas Crash."

Much of the fourth quarter felt like investing in a field of quicksand peppered with land mines. Most stocks were sinking, but there were more than a few blowups. Apple announced disappointing numbers and the stock fell almost 40% from its peak in October to its recent low. Market stalwart like Johnson & Johnson fell over 12% in one day over worries of asbestos in their baby powder. Federal Express dropped 10% in a day after giving lowered earnings guidance due to expected slowing traffic from trade tariffs. More recently Bristol Myers dropped 14% the day they announced plans to acquire leading biotech company Celgene. Suffice it to say that there has been enough drama in the markets without even mentioning the government shutdown.

Although the economy has remained strong, some signs are troubling. Leading economic indicators, manufacturing indexes, and housing data have declined and are causing concern that a slowing of growth may be upon us. Whether this will constitute a recession is not yet clear. On the positive side, unemployment is low and wages appear set to rise. This along with still-positive consumer confidence may mean that recession is not imminent. But growth may be slowing and expectations for corporate earnings may be too high for 2019.

We will need to continue to monitor the changes in interest rates, as continued Fed tightening could lead to recession and a negative investing environment. Perhaps most importantly, we should bear in mind that both government and corporate levels of debt have continued to expand even during this almost-10-year economic expansion. Partially due to the recent tax cut, the US government budget deficit has exploded while corporate borrowing has broken records. In previous economic cycles, debts were paid down during good times and a buffer was created to weather bad times. The opposite has happened during this cycle. This has caused alarm among those who wonder how severe the consequences might be in any future economic downturns.

There at least two silver linings in this recent sell-off in stocks and increase in interest rates. One is that stocks have gotten cheaper based on their earnings, and bargains are beginning to appear in greater numbers than we've seen in quite a while. The second is that cash reserves are now earning well over 2.25%, up from almost zero a few years ago. This reduces the penalty for playing defense by keeping ample cash reserves. Schwab changed their method of automatically managing cash reserves in October. You should have received multiple notices from them regarding this change. However, it may still be confusing. I urge you to read the attached "Important Updates" page where I try to make it more understandable as to what Schwab changed and why. The upshot is that your cash is invested in a combination of bank deposits and manually purchased money market funds. Whenever you need cash in addition to your "bank sweep" amount, just let us know and we will sell enough of the money market to make sure that the cash will be available to you.

Your 2018 year-end reports and statements are enclosed. Please review them at your convenience and let me know if you have any questions, comments, or suggestions. It is a privilege to work with you on your investments and we will continue to work to do our best for you in the coming year.

Sincerely,

Claude R. Carmichael CFA