Lowe, Brockenbrough & Company

Fourth Quarter 2018

Commentary

Adjustment Period

2018 was a trying, occasionally unnerving ride - the first down year in the U.S. equity markets since the Great Recession. For nearly a decade, investors had reflexively bought into market weakness, but in the last quarter they frequently went on strike, resulting in unsettling downdrafts. Traders like to say: "the market climbs a wall of worry." Apparently, the wall got too high. But why now? (And please be assured, all wall references in this piece are purely anecdotal.) Recession, interest rates, debt, economic growth, Europe, China, Brexit, politics, trade wars: most of these worries, other than trade wars, aren't new. You could have tuned into CNBC or Bloomberg at any time, day or night, after March of 2009 and you wouldn't have had to wait long before some doom-minded pundit would come on and confidently predict pain, but they were always wrong until now. Is the trade skirmish really the proverbial last straw? Global growth was already slowing in response to central bank tightening here and abroad, so it's hard to tease out the trade war impact. So far, at least from where we sit, there's scant evidence of any great harm. The December jobs report - the freshest of economic data - was good. We're hopeful, but only time will tell.

It's been a remarkable decade since the depths of the Great Recession. Ten years passing does much to dull the memory of the visceral panic as the global financial system nearly choked to death on real estate lending (principally) run amuck. But one thing is impossible to forget: most everyone thought the ensuing decade would be hard or worse. But that's not how it panned out. Slowly, haltingly at times, the economy recovered and grew. In fact, things turned out surprisingly well, especially for U.S. investors. And the key here, in our opinion, was the extraordinary recovery and growth in corporate profits. S&P 500 profits regained their old peak less than two years after the Great Recession and have been on a remarkable run ever since thanks to modest economic growth, low interest rates, declining tax rates and the offshoring of manufacturing to lower cost locales. And it wasn't just the old economy kicking into gear, a whole new world-beating leadership (FAANG and friends) would emerge: social media (Facebook), smart phones (Apple), The Cloud and e-retail (Amazon), streaming (Netflix), on-line advertising (Google), and others like Tesla, Salesforce, and Booking.

So, generally speaking, investors were braced (positioned) for an unappetizing decade and instead got something closer to chocolate cake, with a fat corporate tax cut in 2017 to ice it all off. Note: nothing gets investors quite as excited as a really long run of progressively better news. So back to that original question: Why now? With the fed raising rates, the tax

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Commentary

Adjustment Period *(continued)*

cut in the rearview mirror, Trump attacking trade and offshoring, global economic growth slowing, and a couple of the FAANGs getting hit for real fundamental reasons (Apple's iPhone sales and Facebook's privacy issues), every driver of the remarkable profits advance has suddenly gotten squeezed in one way or another, shocking a bullish and complacent investor base. An adjustment period seems quite reasonable - roughly akin to mourning the loss of something special.

In fact, you may recall that in our Q4 commentaries in both 2016 and 2017, we cautioned that prospective equity returns would be lower but acceptable. You won't recall us saying that 2017 would be up 22% and 2018 would be down 4% - we never said it or even thought it, actually. Where the market might go in any year is a mystery to us. We reasoned that profit tailwinds could ebb. We worried that a speculative frenzy was building in some elements of FAANG and friends. 24 months later and the two-year returns are lower. Ours is a frustratingly inexact profession.

And that brings us to 2019. Some have interpreted the flattish yield curve and the equity swoon as strong recession signals. While we can't rule it out, it seems unlikely given the available data. As we stated earlier, the labor market is healthy. By all accounts holiday sales were fine. Housing does have affordability challenges, but with 10-year Treasury rates pulling back below 3%, mortgage rates have eased and that should help. We do believe that U.S. economic growth will be slower this year than last, but that's no reason to panic. And earnings won't have the benefit of lower taxes or interest rates, but a growing economy is generally good enough. Frankly, the pull-back has created an equity landscape of attractive value and sentiment (overly bearish is good), two conditions that usually produce gains. While we don't know how long investors will mourn the loss of the perfect environment, if we had to guess, it'll be measured in months, not quarters, and will coincide with proof that the economy is ok.

As for trade, a real wild-card, we're sticking with our view that Trump would rather have a second term than a recession. Unfortunately (or fortunately depending on your mood after reading all this), there isn't much more to say on the subject, and that goes for Brexit, too.

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The Financial Markets

- Despite signs that economic fundamentals remain solid, volatility returned to the equity markets in the fourth quarter – following the midterm elections and a run-up in bond yields.
- During the fourth quarter, the S&P 500 Index declined -13.5%. The Dow Jones Industrial Average dropped -11.3% and the Nasdaq Index fell -17.3%. Meanwhile, the Russell Mid Cap and Small Cap Indices declined -15.4% and -20.2%, respectively.
- The Utilities sector was the only positive sector for the fourth quarter, while Energy, Technology and Industrials were the worst performers.
- The MSCI All World ex-US Index of developed markets fell -12.8% during the quarter while the MSCI Emerging Markets Index declined -7.5%. There were a handful of countries that had positive returns in the fourth quarter – notably Brazil (+13.6%), Indonesia (+9.8%) and India (+2.5%). Most countries saw declines though, including Mexico (-18.7%), Germany (-15.5%), Japan (-14.2%), United Kingdom (-11.8%) and China (-10.7%).
- The Bloomberg Commodity Index fell -10% during the quarter. Oil prices plunged, with Brent Crude and West Texas Crude both down at least -36% as OPEC's plan to reduce output failed to assuage fears of oversupply. Gold, a haven in times of crisis, rose nearly 7.5%.
- The CBOE Volatility Index, or VIX (a popular measure of the stock market's expectation of volatility), rose from 13.9 at the beginning of October to a high of 25.9 on Christmas Eve before ending December at 23.1.
- As expected, the Federal Reserve raised the Fed Funds target rate another 0.25% in December, lifting short-term rates to a range of 2.25% to 2.50%. This marked the fourth rate hike of 2018 and the ninth increase since Dec. 2015.
- The yield on the U.S. Treasury 10-year Note reached 3.24% in early November, then fell to 2.68% by year-end as stock prices tumbled and flight-to-safety buoyed demand for bonds.
- Yield curve flattening continued, as the 2yr/10yr Treasury yield spread narrowed to 20 basis points at quarter-end. Market participants worry that short-term yields will climb above long-term yields if the central bank were to hike interest rates further. An inverted yield curve preceded each of the past seven recessions with varying lead times.
- Corporate bonds underperformed Treasury debt during the quarter, as credit spreads widened while equity prices were under pressure.

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The Economy

- Real gross domestic product (GDP) increased at a robust annualized rate of 3.4% in the third quarter. Fourth quarter GDP growth is expected to be around 2.7%.
- Labor markets were quite strong through the end of 2018. Nonfarm payrolls increased by 312,000 in December and 2.6 million for the year. The unemployment rate ticked up to 3.9% in December due to an increase in the participation rate. Wage growth accelerated as average hourly earnings rose 3.2% year-on-year.
- Housing markets have experienced weakness. Pending Home Sales declined -0.7% in November. The year-over-year change in November was -7.7%, the eleventh consecutive monthly decline.
- Home price appreciation has moderated as borrowing costs have climbed. The average rate on a 30-year conforming mortgage was 4.75% in the most recent MBA report, up from 4.0% a year ago.
- The ISM Non-Manufacturing Index (NMI) fell 3 points to 57.6 in December from the November level of 60.6. The ISM Manufacturing Index also slowed in December to 54.1 from November's reading of 59.3. Levels above 50 indicate economic expansion. The two major manufacturing indices in China fell below 50 in December for the first time in nearly three years.
- Some high profile companies such as Apple and Tesla have announced weakness in sales in China that is dampening revenue expectations for those companies and their suppliers.

Outlook

- Interest Rates: The recent decline in government bond yields is bullish for stock prices. Interest rates remain low by historical standards although real yields are no longer negative in the U.S. The bond market is now pricing in no further interest rate hikes by the Federal Reserve in 2019.
- Sentiment: After a significant swoon in December, market sentiment has recovered some, yet remains more cautious. Sentiment is a contrarian indicator, with a low reading typically indicating a more attractive opportunity for stock returns.
- Valuation: The equity market sell-off together with the continued growth in corporate profits has lowered P/E ratios. On 2019 earnings, the S&P 500 is now trading at a P/E ratio of 15x, below the 25-year average of approximately 16x.
- Macro-Economic: The outlook remains for a moderation in U.S. and global economic growth in 2019. We do not forecast an economic recession in the next six months, although risks are rising that prolonged trade disputes will negatively affect global growth.

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