Dillon Capital Management
Economic & Capital Markets Strategy 4Q-2018

Highlights

- US Stocks dropped 20% from September Highs
- Expansion continues at a lower rate
- Fed hikes short term rates to 2.50%

Economy

The US economy continues to expand despite the reversal in stock markets, but the forecast for 2019 suggests a slower rate of growth.

It was only October when we reported that key US economic measures, Institute of Supply Management (ISM) and Leading Economic Indicators (LEI), had hit 12 and 14-year highs. But subsequent monthly reports late in the 4th quarter came in below expectations, indicating that 2019 will not be as good as 2018.

However, the results do not forecast a recession; just that economic growth may slow, and current conditions remain strong.

The Federal Reserve raised short-term interest rates again in December, to 2.50%, an effort to cool inflation fears and get back to the elusive "neutral" level for interest rates. The fed has caused liquidity to evaporate around the world by allowing its balance sheet of government bonds and mortgage securities to mature to the tune of about $50 billion per month. This was exacerbated by a strong US dollar, increasing the cost of trade funding.

European economic activity slowed further, and politics remain the headlines. Conditions are similar in the UK but they blame it on BREXIT negotiations internally and with the EU.

It's clear that China is slowing, and it's not just because of tariffs imposed by the US.

Capital Markets

The S&P 500 hit a new all-time high of 2,930 on September 20 and dropped to 2,347 on December 26 – a 19.9% decline.

Higher interest rates, trade wars, and a 10-year bull market make business leaders reflect on their next move. Fed Chairman Powell's stoic resolve to raise rates into 2019 seemed more like an excuse to leave the party, but when tariff threats were not resolved as expected, and corporations started guiding profits lower in advance of earnings reports, fears increased.

Add the memory investors have of recent recessions and, in retrospect, its easy to see why markets sold off, despite the lack of an obvious bubble, like housing problems in 2007 or the dot-com excitement of 2001.

Major Indexes	4Q-2018	2018
Short-term Treas. (1-3 Yr.)	1.3%	1.6%
Barclay's Aggregate Bond	1.6%	0.0%
S&P 500 Index	-13.5%	-4.4%
Russell 2000 (Small Cap)	-20.2%	-11.0%
MSCI EAFE (International)	-12.5%	-13.8%
MSCI Emerging Mkts.	-7.4%	-14.3%
Bloomberg Commodity	-9.4%	-11.3%

Stocks prices follow earnings, or in the case of technology's FAANG stocks, the expectation for future earnings. So, when the likes of Facebook, Amazon and Google get called in front of Congress, expectations begin to slide. The impact is magnified when these cohorts are trading at lofty valuations and are among the largest constituents of the major indexes – when they go down, the indexes go down.

Growth stocks had a big run the past 5-years, leading stock market indexes to record highs on momentum, but momentum stopped, and prices dropped.

Every major equity index declined by a double-digit percentage in 4Q, pushing the full year's returns into negative territory.

Riskier segments were the worst: small caps cliff-dived in mid-summer from 12-month returns of over 20% to end the year down 11%. Growth stocks (Russell 1000 Growth Index) dropped 16% in the quarter but declined only 1.5% for the year because of a great 1st half.

From a sector perspective, Utilities proved a safe harbor, if an expensive one, and the only S&P sector with a positive return for 4Q, gaining 1.4%. The energy, tech and industrial sectors all fared worse than the S&P 500 (-13.5%).

International markets were just as bad, so I'll spare you the commentary; only India (+3%) and Brazil (+14%) gained in the quarter.

As signs pointed to a slowdown and the possibility the fed might slow its rate hikes, investment grade bonds rallied. Treasuries were the best, gaining 2.6% on average.

Short maturities were in positive territory most of the year, long-maturities turned positive late in the quarter when yields declined; prices stabilized, and coupon income was collected.

The fearless high-yield market dropped (-4.5%) in the final quarter on concerns that economic weakness increases the risk of default.

Investment Strategy

The S&P 500 has gained 13.1%, on average, for the 10-year period ending 12/31/2018, <u>above</u> the long-run average of 10.5%. Bonds returned 3.5% over the same period, but only 2.1% for the last 3-years, <u>below</u> the long-run average. We expect a reversion to mean in the future.

I guess we *were* at the "…as good as it gets stage" (see our 3Q-2018 Strategy section) in 3Q.

Low interest rates and the 2018 tax cuts boosted corporate profit growth to over 20% for 2018 – that's abnormal. It's time to reset expectations. We expect 5-7% growth in 2019.

At this point, with the price-to-earnings ratio (P/E) on the S&P 500 at about 14x 2019's earnings, the market has priced in a slowdown. Foreign equity market valuations are even lower. With the US dollar sentiment index at cycle highs, it should decline from these levels in conjunction with the fed getting softer about interest rate hikes, this could provide the basis for outperformance in Europe.

As news headlines fade, the markets will stabilize. We'll seek to re-allocate cash to the US, international and emerging equity markets, gradually. We'll remain cautious about "growth" stocks in favor of quality and dividend paying stocks. We still favor a shorter duration (lower interest rate risk exposure) for bonds but will use these reserves to reinvest at slightly higher yields.

G. Foley – January 2019

Please call or email with questions or comments!