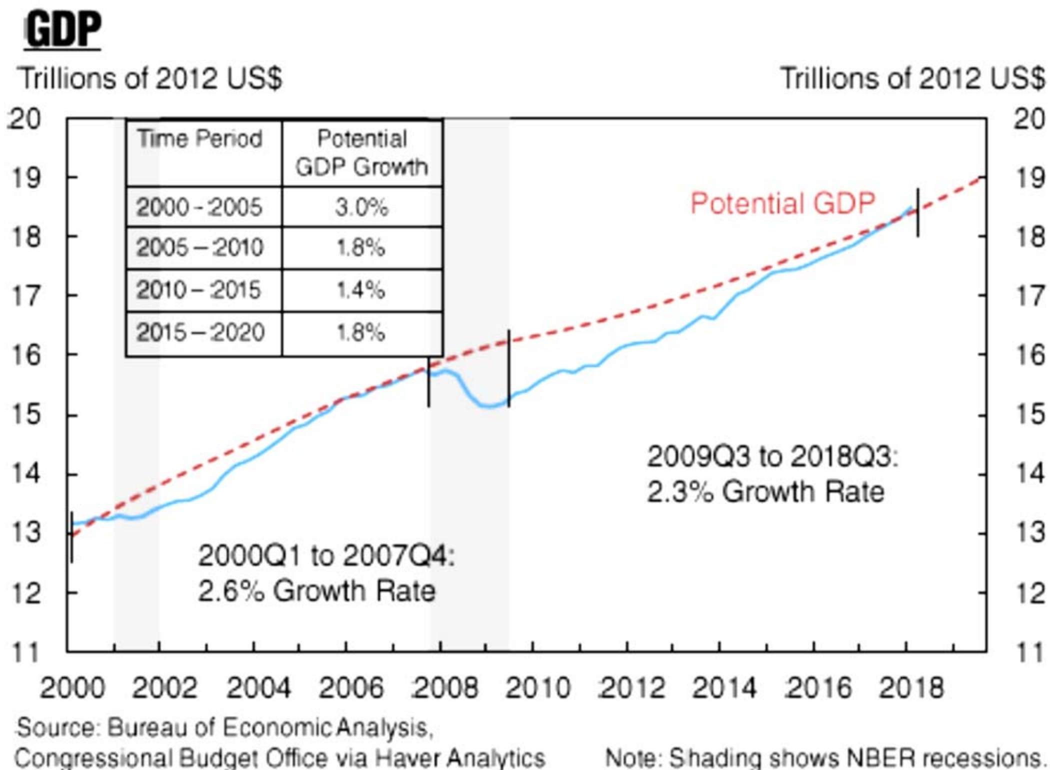
ECONOMIC REVIEW AND OUTLOOK

U.S. Economy will slow in 2019

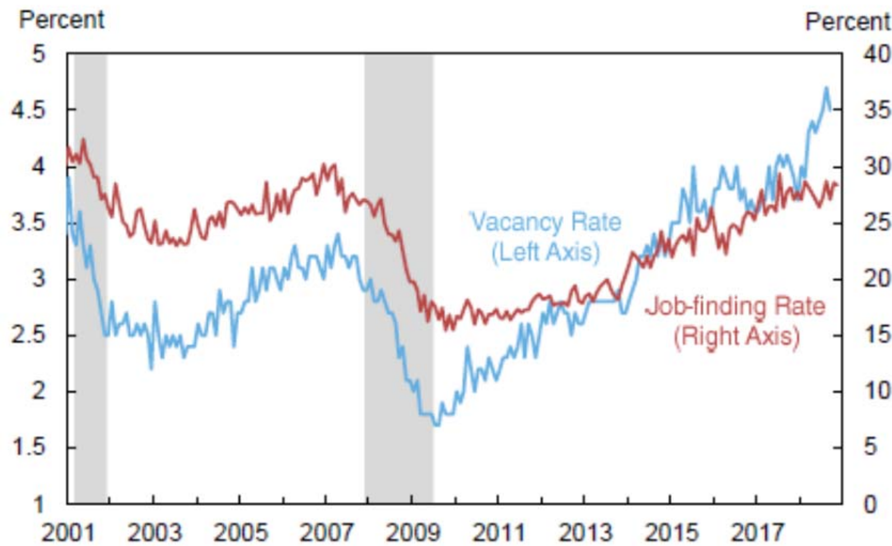
The US economy's rate of growth will slow along with other economies, according to most forecasters. The NFIB Small Business Trends summary writes, "There are a number of reasons, primarily structural, for a slowdown, including a lack of qualified workers to fill open positions and a low rate of labor force growth. The Congressional Budget Office calculates our potential GDP and its prospective growth path annually. In simple terms, potential growth (with no inflation) is determined by labor force growth and productivity growth. The dramatic decline in investment and labor force growth in 2008 and in the following years significantly altered the potential growth of the economy and its potential growth path."



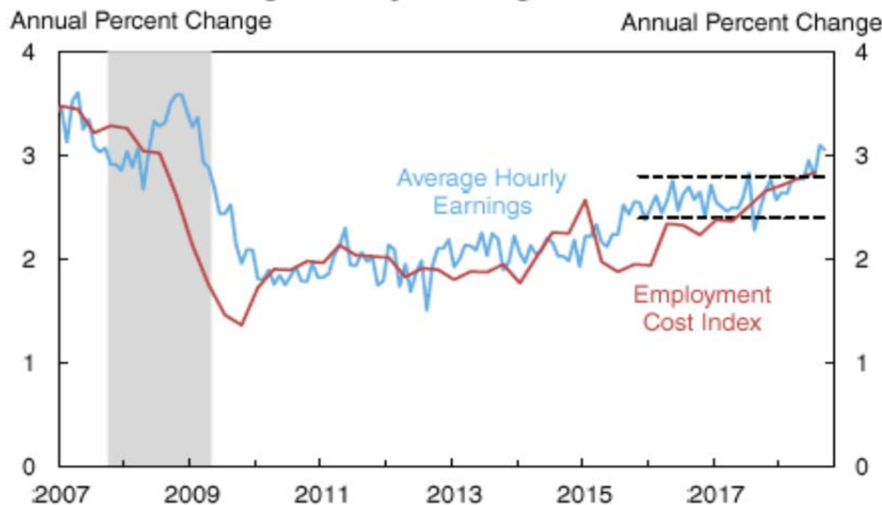
Steady albeit slow growth has resulted in low unemployment levels and has eliminated over-capacity. Thus, continued spending will put pressure on capacity and prices, which is the Federal Reserve's primary focus; therefore, they will continue raising rates, unless price pressures abate.

The labor market has fully recovered

A year ago, we noted that the unemployment rate reached 4.1%, which was a 17 year low. Unemployment reached a low of 3.7% last year before bumping up to 3.9%. Job openings have climbed, as illustrated below. Indeed, the ratio of job vacancies to unemployed reached a high in September.



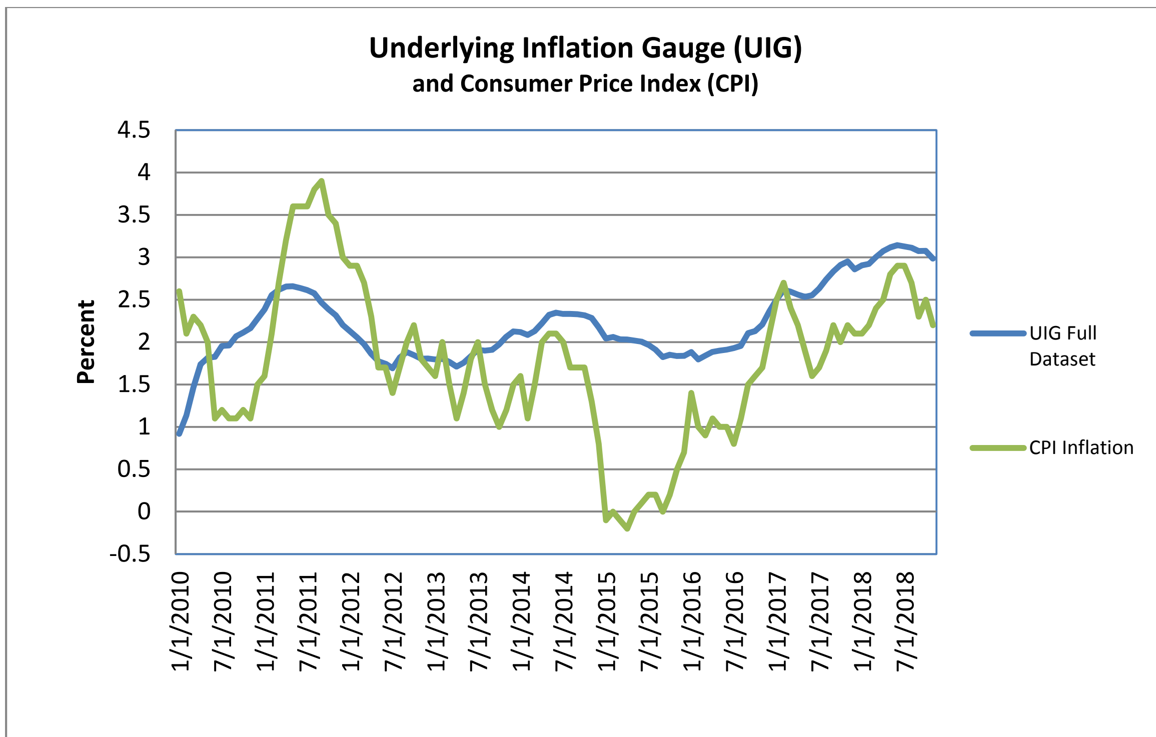
The result is a very tight labor market that has resulted in meaningful wage gains.



The inflation rate is above the Federal Reserve's 2% target

The consumer price index (CPI) will probably be closer to 2% this year because of lower energy prices. However, the Federal Reserve does not focus on this measure, despite its popularity. We have focused on the underlying inflation gauge (UIG) because it provides a better indication of the direction and broader trend of inflation. Furthermore, the UIG is a product of Federal Reserve research, adding to its policy significance.

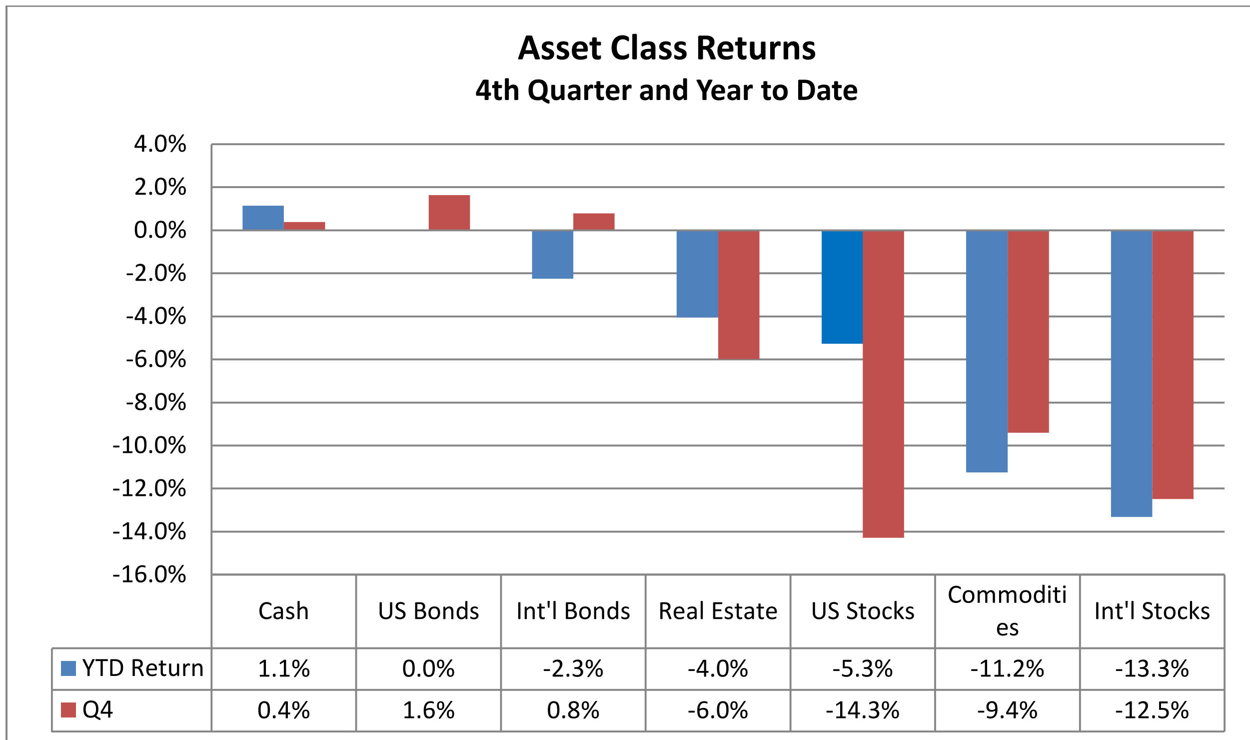
As illustrated in the chart below, inflation trends are closer to 3% than 2% suggesting that Federal Reserve policy will continue to be restrictive in order to rein in inflation.



CAPITAL MARKET REVIEW

Asset Class Performance

After reaching all-time highs in the 3rd quarter, US stocks declined by almost 20%, high to low, in the 4th quarter. Domestic stocks joined international markets that had already been under pressure from earlier in the year. Bonds, which had declined in value from the beginning of the year, rallied as investors sought out safe havens from the unrelenting selling in stocks. Commodities also sold off as oversupply in oil crashed the price of oil, and concerns about growth took down industrial metals.

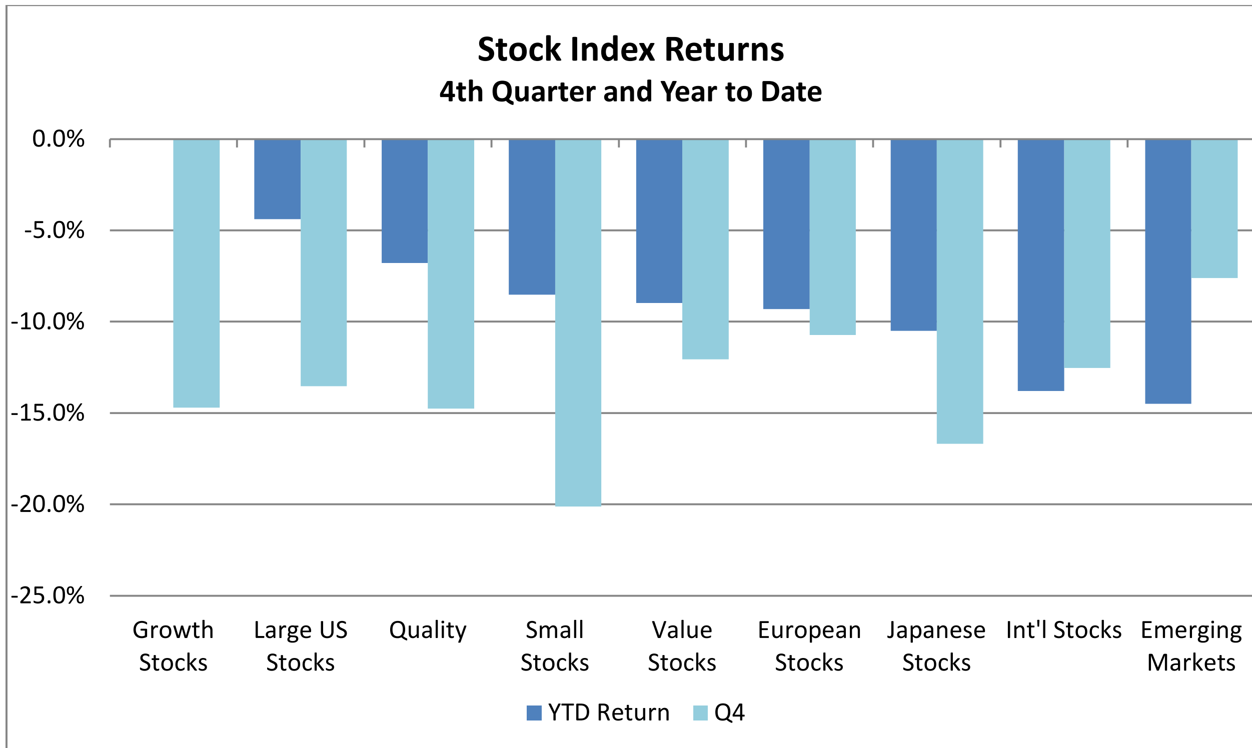


	Cash	US Bonds	Int'l Bonds	Real Estate	US Stocks	Commodities	Int'l Stocks
YTD Return	1.1%	0.0%	-2.3%	-4.0%	-5.3%	-11.2%	-13.3%
Q4	0.4%	1.6%	0.8%	-6.0%	-14.3%	-9.4%	-12.5%

CAPITAL MARKET REVIEW
(continued)

Stock Market Performance

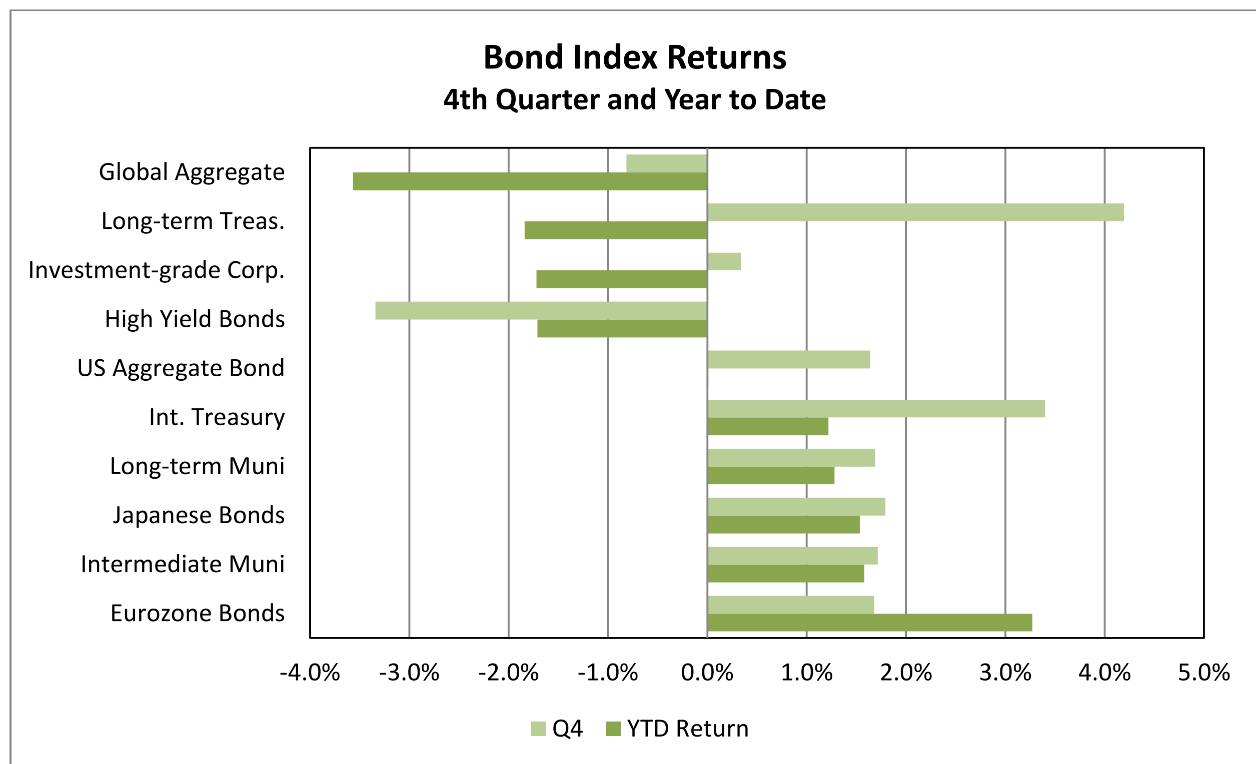
As you can see below, stock markets and strategies were down across the board. In the 4th quarter, strategies that had lagged earlier in the year fell less, while the strategies that had led the recent bull market fell more. The lower chart illustrates not only the severity of the 4th quarter decline but also the pattern of the recovery from the beginning of the year correction.



CAPITAL MARKET REVIEW
(continued)

Bond Market Performance

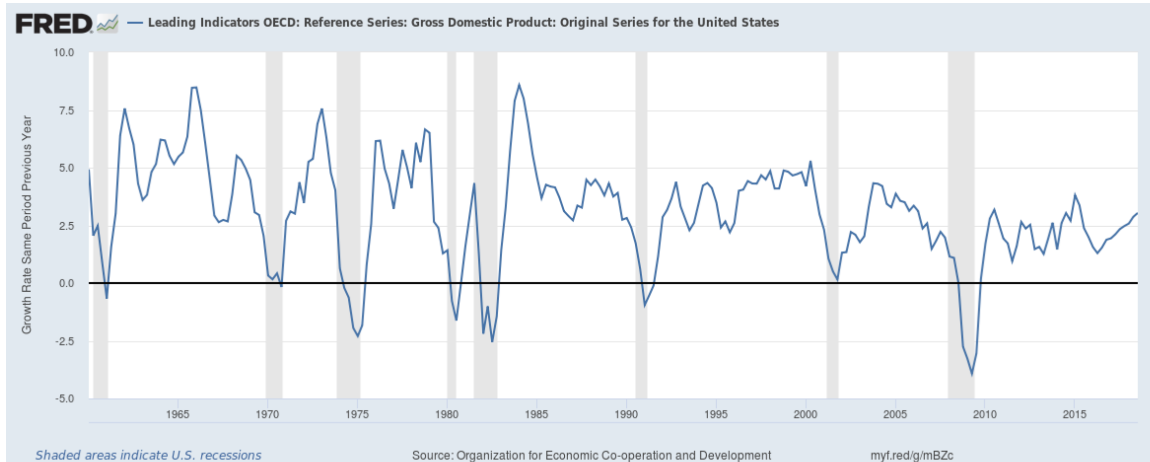
As noted earlier, bonds traced out a pattern opposite from stocks, falling earlier in the year, when stocks rallied, and then recovering, at least partially, when stocks sold off in the 4th quarter. Long-term Treasuries, which are most sensitive to interest rates, illustrate this reversal: the 4th quarter return was over 4% but losses from rising rates for the first 9 months resulted in a 2% loss for the year. By contrast, municipal bonds and bonds in the bottom half of the graph had much smaller losses through September, so the 4th quarter gains pulled the year to date return into positive territory.



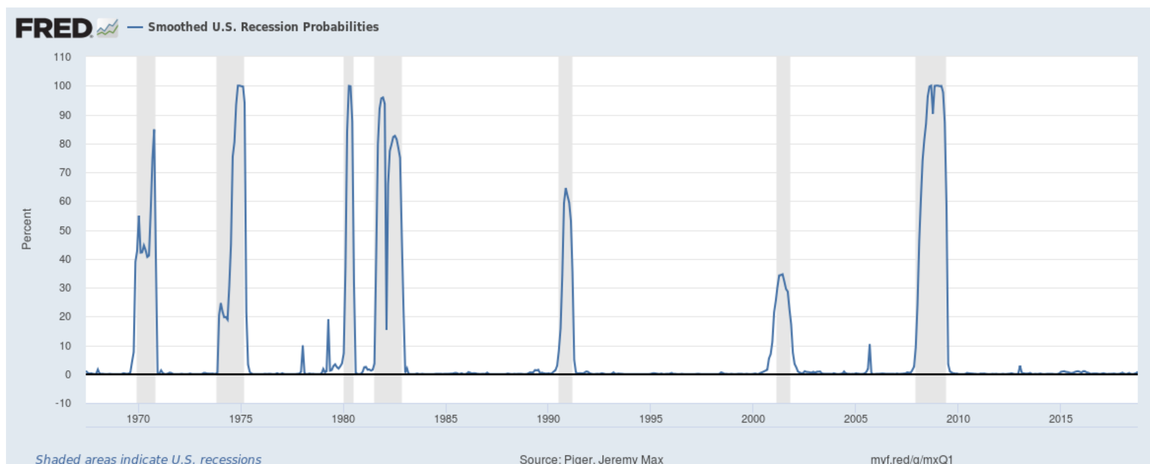
INVESTMENT STRATEGY THEMES

<u>The US Economy is slowing and while some recession signals are flashing a warning the chances of a recession are low.</u>

The history of the index of leading indicators, illustrated below, suggests that most of the time, the indicator is declining before the start of a recession. Therefore, an iminent recession is not reflected in this indicator.



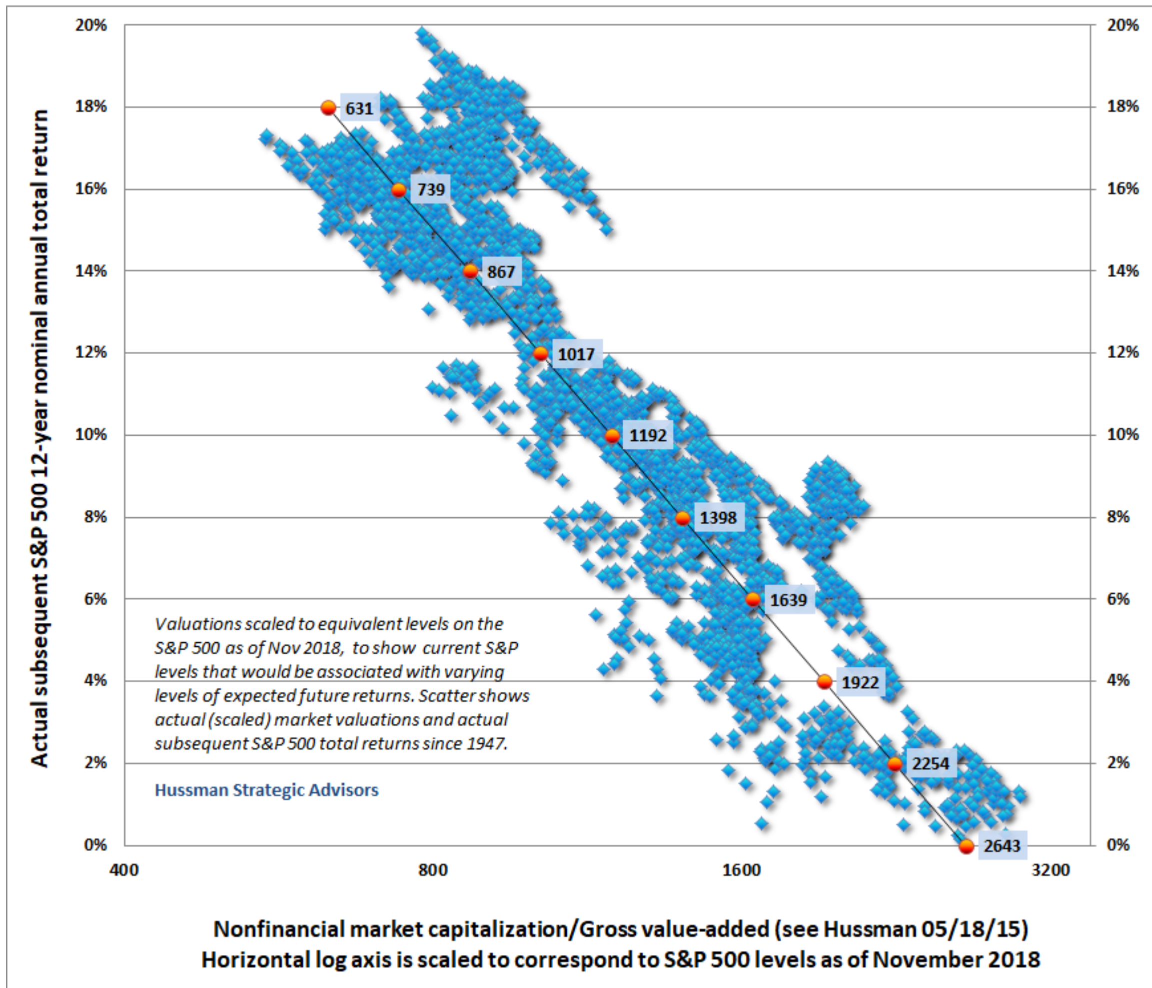
Consistent with the leading indicator index, recession probabilities are very low.



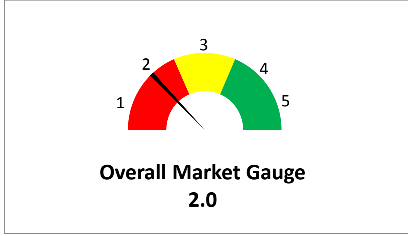
Implications: Near term fears may be overblown. Economic pressures on rates (i.e., wage increases) will not abate significantly. Thus, stocks and interest rates have reason to rally.

Defensive Allocation - Stocks

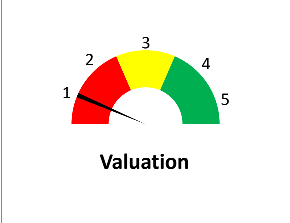
We have a defensive positioning relative to both stocks and bonds. With respect to stocks, our stock market gauge shifted to a sell signal at the end of November. The gauge's reading at year-end is on the following page. Importantly, despite the sell-off in the 4th quarter, valuations suggest that prospective returns will be low over an extended period of time and the downside is still significant. The graph below (which details the relationship between valuations and future returns) shows that much lower levels of the S&P 500 will be required to have returns above cash. The year-end level of the S&P 500 was 2500, just above the red dot at the bottom of the graph.



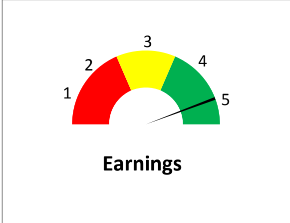
STOCK MARKET DASHBOARD - December 31, 2018



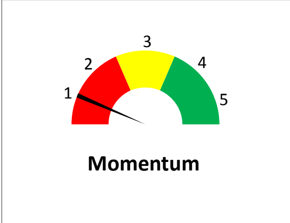
Overall Market Gauge
2.0



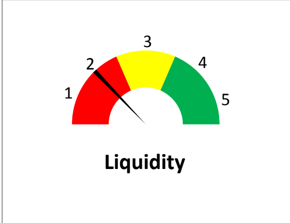
Valuation



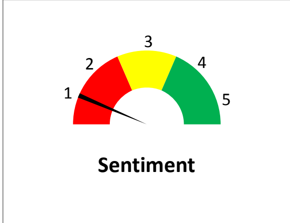
Earnings



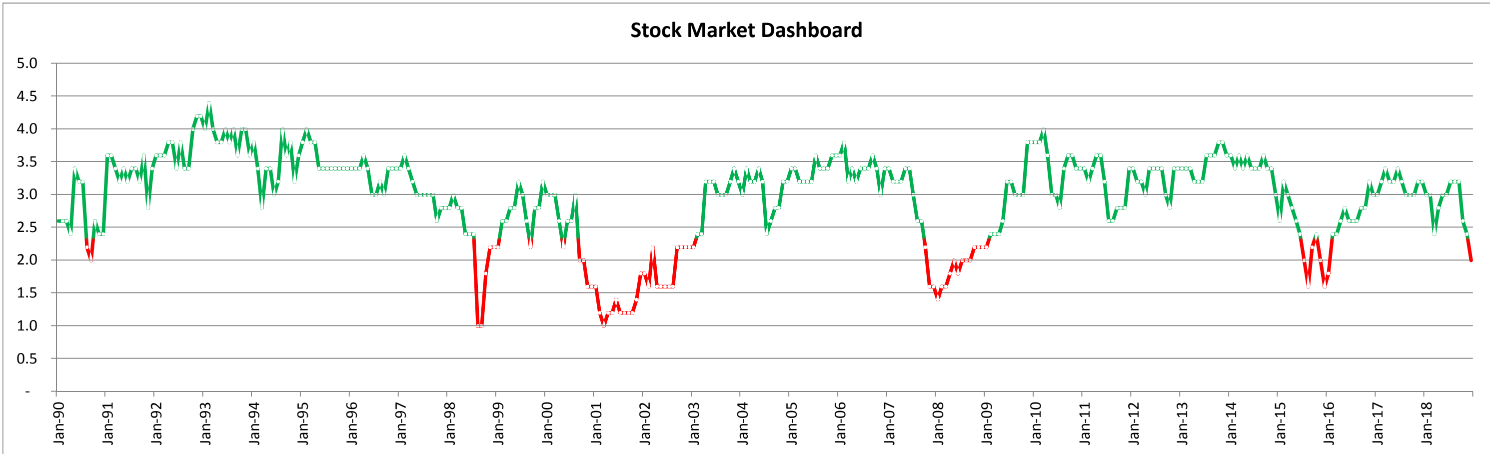
Momentum



Liquidity

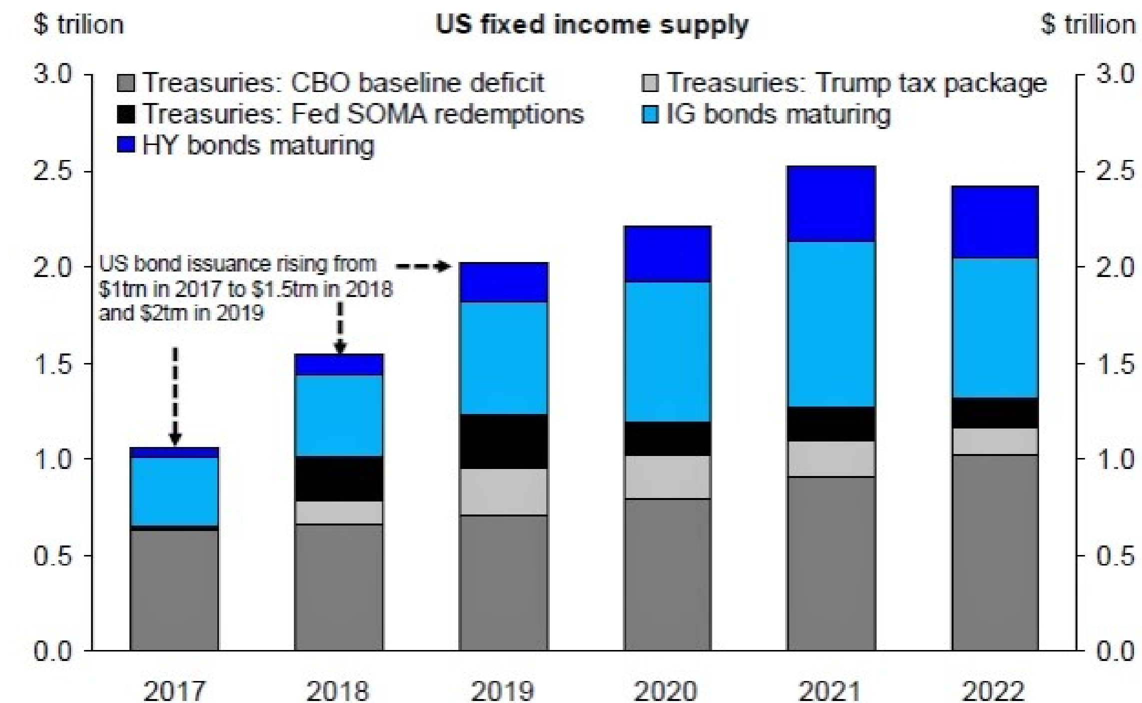


Sentiment



Defensive Allocation – Bonds

Several factors support our under-weighting of bonds. First, value is thin. For example, 10 year bonds yield under 3%, presently, while inflation appears to be moving from 2% to 3%; thus the real return above inflation is small compared to an historical real return closer to 2 percent. Also cash is now yielding over 2%, providing a yield close to that of intermediate bonds without the principal risk associated with rate increases. Second, the Federal Reserve still plans to increase interest rates, as continued growth in the face of a tight labor market pressures inflation. Third, the supply of new Treasury bonds is set to increase significantly because of new borrowing to finance the ballooning US deficit (projected at $1.1 trillion); US Treasury issuance will increase 20% in 2019.

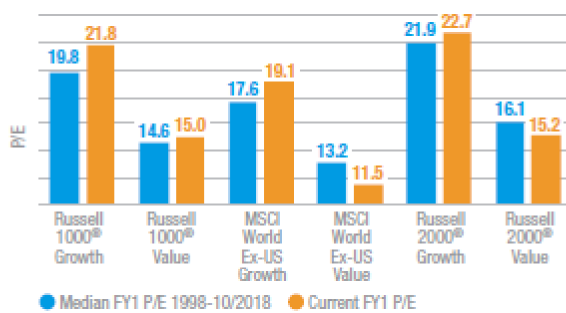


Value Stocks

Value stocks represent stocks that have below average price to book ratios, when one refers to the value indices. More active strategies consider price to earnings ratios and other factors that provide a more robust definition of value. Over the long-term, measured in decades, value stocks have out-performed the broad stock market as well as growth stocks. Why does "value" work? The process begins when investors develop an expectation that certain companies or sectors will decline or grow at a depressed rate in the future. These companies' earnings are then priced at a discount, turning them into "value stocks." Over time many of these companies resume normal growth, and subsequently, their valuations are re-rated higher, resulting in above average returns. The fact that on average value stock returns are above average indicates that the market overreacts or is biased against companies that have growth challenges.

Value stocks have under-performed growth stocks for a number of years by a large amount. The reason is the popularity of growth stocks, especially stocks like Facebook, Amazon, Netflix and Google and the relative antipathy towards value stocks, in particular, the banks.

The charts below illustrate that long-term growth expectations have increased dramatically since 2016 and investors are putting a higher price earnings multiple on those higher earnings expectations.



Regarding value stocks, over the last 5 years with the benefit of hindsight, we know that the value stocks with the highest growth rates under-performed. Thus, the market appears to be unduly penalizing value stocks. However, this situation is not unique to the recent period, having occurred in the late 1990's and late 1980's.

Quality Stocks

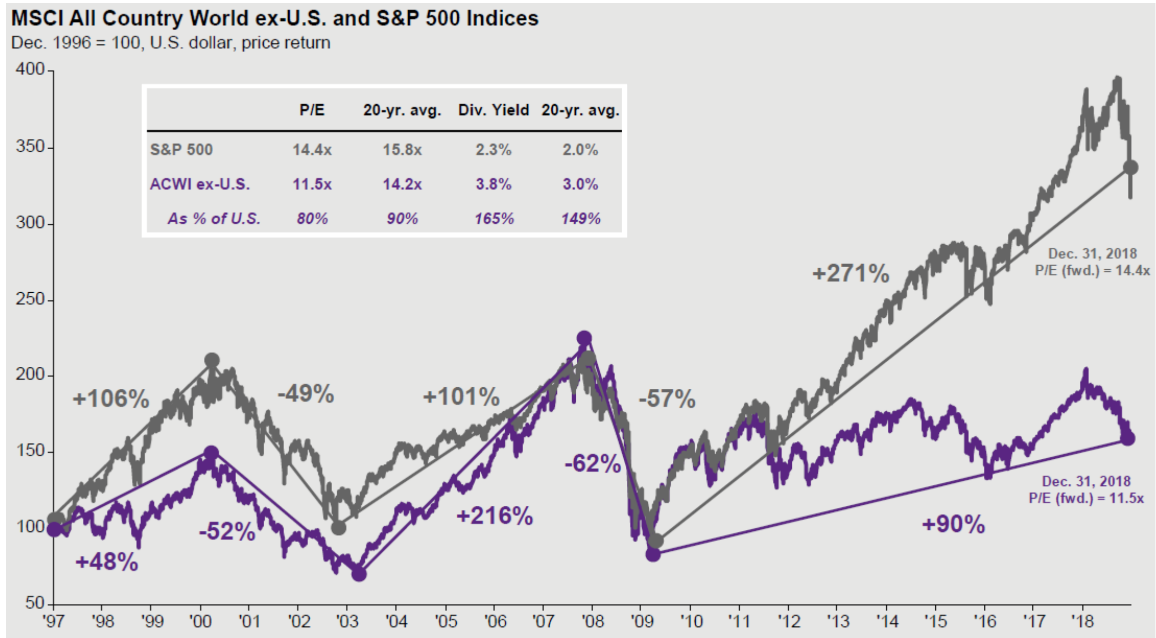
Quality stocks represent ballast in your stock portfolio. The table below illustrates how quality stocks have performed in the last two bear and bull markets in terms of the total return for the period.

Market Condition	S&P 500 Index	S&P 500 Quality Index
Bear 3/31/2000 – 9/30/2002	-43.8%	-12.8%
Bull 9/30/2002 – 9/30/2007	105.0%	123.8%
Bear 9/30/2007 – 3/31/2009	-45.8%	-37.3%
Bull 9/30/2009 – 3/31/2018	313.5%	306.2%

While quality stocks have out-performed for most of the current bull market, they did not prove defensive in the 4th quarter sell-off. The S&P Quality Index has almost 40% invested in growth and technology stocks; thus, the fund is somewhat riskier and more expensive than a more conventional quality portfolio that includes dividend paying as part of the definition of quality. Therefore, we are shifting to stocks and funds that emphasize dividends as well as strong balance sheets in our quality strategy.

International Stocks

As we have noted in past reports, international stocks and domestic stocks tend to alternate long periods of out-performance, as illustrated below.



Generally, international stocks out-perform when the Dollar weakens. Currently, the consensus expects that the Dollar will weaken, which would be supportive of international stocks. The catalyst for such a reversal could be a pause in Federal Reserve rate increases or widening of US deficits.