

NOTES FROM THE NORTH: MARKET OUTLOOK

January, 2019

One year ago, the opening paragraph from our January 2018 “Notes from the North” included the following, “2018 begins with the best outlook for economic growth we have had in ten years. Tax cuts will indeed help many U.S. firms; Credit Suisse recently raised their 2018 earnings growth expectations for the S&P 500 to +17%, adding that tax changes will account for about half of the earnings gains. Additionally, both business and consumer confidence are high. Most recent economic reports have exceeded estimates. Capital spending and wage growth are expected to accelerate.” Not blinded by the rosy outlook we also asked, “How much of this good news is already priced into the market? We think the chances are good that much of it is.”

In many ways both statements were accurate. There was, indeed, good reason for economic optimism. With the benefit of hindsight, 2018 witnessed accelerating GDP growth, falling unemployment, rising wages, high business and consumer confidence and ~+20% corporate earnings growth. Despite that healthy backdrop, equity markets – specifically the S&P 500 – did something it has done only three other times since 1960, it lost value in a year when earnings grew more than +10%.

So, what happened? Certainly, the markets got off to a great start in 2018. In what would prove the best month of the year, the S&P 500 Index returned +5.7% in January. However, when conditions appear too good to be true, they often are. Following the unprecedented calm of 2017 where every month posted positive returns, 2018 quickly reverted to “normal” volatility. Across the first three quarters of the year markets seesawed higher, despite near consensus around the prospect for decelerating earnings growth in 2019 and concerns that the Federal Reserve’s efforts to engineer a soft landing may prove difficult. However, by late September a shift was afoot. Early in the fourth quarter investors became increasingly unsettled as they focused on 1.) the Federal Reserve raising short-term interest rates and reducing its balance sheet, thereby reducing systemic liquidity; 2.) the likelihood of decelerating 2019 corporate earnings growth paired with stretched equity market valuations, and 3.) falling growth estimates for Europe and China, with trade and tariff uncertainty that may further impair growth if the current impasse is not resolved.

Spurred by programmatic, momentum-based trading platforms the fourth quarter turned into a rout with the S&P 500 plunging -13.5%. December punctuated fears with the S&P falling -9.0% for the ignominious title of “the worst December since 1931.”

When the dust settled there had been few places of refuge for investors. For the first time in more than 15 years, cash was king, returning +1.8% for the year. Bonds were essentially flat, with the Bloomberg Barclays US Aggregate Bond Index returning +0.01% for calendar 2018. The fourth quarter equity decline left the median U.S. stock down roughly -14% for the year. The S&P 500 index was helped by a strong performance from a few stocks, but it too lost -4.4% for the year. Small company stocks (as measured by the Russell 2000) were down -11.0% and foreign stocks (as measured by the MSCI All World ex-US Index) fared no better, falling by -13.8%.

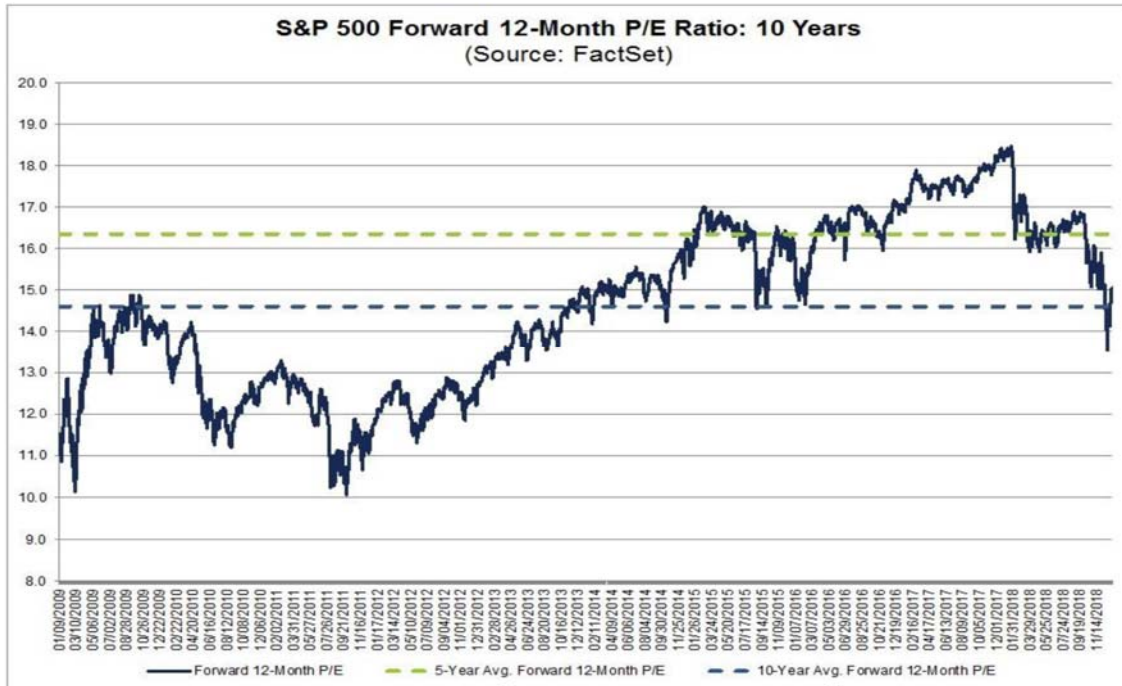
So where does that leave us? In early 2019 the markets appear to be finding a footing. One important truth is inescapable, when earnings grow by roughly +20% and the median stock ends the year -14% lower... multiples contract. To that end, in late December BCA’s Chief Global Strategist, Peter Berezin, encouraged investors to increase equity exposures. In his note Berezin wrote, “We downgraded global equities this summer based on lofty valuations, overly bullish sentiment, and the prospect of slowing global growth. Since then, valuations have improved, sentiment has turned more cautious, and while global growth will continue to decelerate in the first half of 2019, asset markets have largely discounted this outcome.”

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The FactSet chart below corroborates Berezin's point, showing that in late 2018, based on expected earnings, the S&P 500 earnings multiples reached levels not seen since 2013. After its fourth quarter retreat, the index valuation is now in line with long-term averages. Stocks broadly (and in some cases indiscriminately) now sit with more attractive valuations, creating new opportunities to buy great companies at fair prices.

We closed our "Notes" a year ago with the following, "Faced with the dilemma of a rising (*or falling*) market, investing basics always help: asset allocation, diversification, security selection. The strongest tool in our tool box is an awareness of the strengths and weaknesses of our own approach to investing. Whether at a market top or a market bottom, a melt-up or a melt-down, an unemotional approach has always served us well, especially when others become consumed with fear or greed."

Had anyone been presented with a crystal ball with perfect information about 2018's general overall economic strength, they surely would not have predicted negative returns across virtually all asset classes. It is a good reminder that market-timing is rarely successful. Across the past decades, a steady and consistent approach to dispassionately building diversified, value oriented, balanced portfolios has served our clients well. To that end, we will endeavor to stay the course of maintaining a thoughtful awareness of the dynamic markets, use the recent market weakness to upgrade positions where possible, and maintain a balance suitable for the predictably unpredictable days ahead.



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