Fourth Quarter 2018 Market Newsletter Summary

- Stocks and credit sensitive bonds sold off in the fourth quarter of 2018 capping off the worst December since 1931.

- The US economy is moderating but is still strong.

- Soft data (Optimism and confidence) has been falling faster than hard data and the risk is that geopolitical uncertainties could further affect soft data resulting in a self-fulfilling loop.

- Corporate earnings and stock valuation should support stocks.

- US companies have taken on a lot of debt. This could hurt them in the future. Investors should avoid stocks of companies with excessive leverage.

- European economies are slowing but stock valuations there are compelling.

- Emerging economies are growing and stocks there are cheap. Low interest rates and weaker US dollar could help these stocks.

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Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	-13.52%	-4.38%	-4.38%	9.26%	8.49%
S&P Mid Cap 400	-17.28%	-11.08%	-11.08%	7.66%	6.03%
S&P Small Cap 600	-20.10%	-8.48%	-8.48%	9.46%	6.34%
MSCI Emerging Markets	-7.4%	-14.25%	-14.25%	9.65%	2.03%
MSCI EAFE	-12.50%	-13.36%	-13.36%	3.38%	1.00%
Investment Grade Credit (C0A0)	-0.04%	-2.24%	-2.24%	3.32%	3.34%
Non-Investment Grade Credit (H0A0)	-4.63%	-2.25%	-2.25%	7.27%	3.82%
Bloomberg Commodity Index Total Return	-9.41%	-11.25%	-11.25%	0.30%	-8.80%
Dollar Index (DXY)	1.09%	4.39%	4.39%	-0.84%	3.70%
Vanguard Total Bond Market Index (VBMFX)	1.59%	-0.11%	-0.11%	1.93%	2.35%
10 Yr Rate	2.69% 12/31/2018	2.40% 12/31/2017	2.40% 12/31/2017	2.27% 12/31/2015	3.03% 012/31/2013

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 1/7/2019			
	Latest Release	Recent Trend	Notes
Non Farm Employment	312,000	Positive	Non farm employment in December was very strong and even November's number was revised higher by over 20,000 jobs. Hourly earnings rose by 0.4% raising concerns about inflation. Unemployment rate edged higher to 3.9% because a lot more people started looking for jobs.
Weekly Claims for Unemployment Insurance	231,000	Positive	Weekly claims increased recently, but is still at a very low level reflecting a strong jobs market.
ISM Manufacturing Index (Number over 50 points to growth)	54.1	Negative	Manufacturing activity has slowed significantly and the index is at its November 2016 level. The silver lining is that the index is over 50, reflecting a continuing growth in manufacturing

Source:

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	Latest Release	Recent Trend	Notes
ISM Non Manufacturing Index (Over 50 points to growth)	57.6	Negative	Non manufacturing activity has been moderating but is still growing as evidenced by the index being over 50. New orders were the second highest in eight years.
Consumer Prices (Month over month change)	0%	Positive	Energy and apparel held CPI down. Year over year, CPI was up 2.2% both headline and excluding food and energy.
Producer Prices (Month over month change)	0.1%	Positive	Producer prices have fallen from the highs of over 3% set in May to 2.5% year over year. Core producer prices are up 2.7% from last year.
Retail Sales (Month over month change)	0.2%	Flat	Gasoline and autos dragged retail sales which was strong otherwise. Early estimates point to a very strong holiday sales which augurs well for January's release.
Consumer Confidence (Conference Board)	128.1	Positive	Consumer confidence fell sharply from the previous month, but is still at a high level. The recent drop was because of expectations for the future.
Durable Goods (Month over month change)	0.8%	Flat	Aircraft sales helped the headline number. Core capital goods actually fell by 0.8%. The silver lining is that October's number was revised up by a significant 0.5%.
Industrial Production (Month over month change)	0.6%	Positive	Strong utilities and mining offset weak manufacturing.
Capacity Utilization	78.5	Positive	Capacity utilization has been inching up to its long term average of 80.
Housing Starts	1.256MM	Negative	After months of weak numbers housing starts and permits showed strength in November.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.4%	Negative	Home prices improved a bit in November however the year over year growth fell to 5%.
GDP (Real, Annualized)	3.4%	Positive	The third estimate for 3Q GDP was a tad weaker held down by weakness in retail spending and construction. Despite this, 3Q GDP growth was quite strong.

Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

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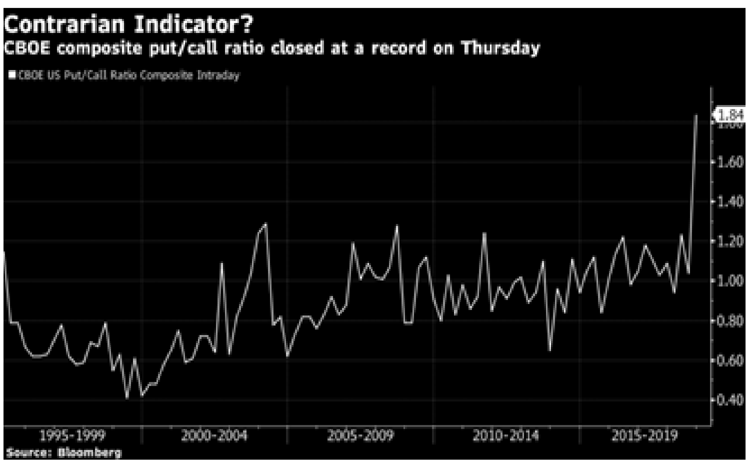
All risk assets (Stocks and credit sensitive bonds) fell precipitously around the world in the fourth quarter, making it the worst since 2011. In December, which is usually a good month for stocks, US stocks fell by over 9% making it the worst December since 1931. After underperforming US stocks for most of the year, non-US stocks outperformed, especially Emerging market stocks, which fell *only* 7.4% in the quarter. A flight to safety led US treasury and the US dollar to deliver positive returns. For all the talk about a bond bear market throughout the year, the US 10-year rate ended the year at 2.69%, below the level it was at 5 years ago. (Bonds rally when rates fall all else being equal)

The reasons for the market drop were several- the Federal Reserve (Fed) raising interest rates, slowing world economic growth, geopolitical events such as Brexit, US Government shutdown and the trade wars between the US and China. Although all these reasons were known all through the year, the market just decided to take notice in the fourth quarter. By the end of December there was record bearishness in the markets as evidenced by the Put/Call ratio that jumped up to 1.84, the highest level since 1995. (Fig 1). The put call ratio can sometimes be a contrarian signal, with high levels indicating that stocks could rally in the future.

Fig 1: Put Call ratio showed record bearishness in December



Source: Bloomberg

Fig 2: Soft data and hard data versus expectations

Source: Charles Schwab

As can be seen in the table above, the US economy is moderating from very strong levels set earlier in 2018 but is still quite strong. US companies are hiring at a record level with both, the manufacturing and the non-manufacturing sector growing. As we have mentioned before, the latter is especially significant because a majority (More than 80%) of the real US GDP is made up of non-manufacturing sectors such as services (As per calculations by the St Louis Fed). The US consumer is also reasonably strong and record hiring with wage growth could support consumer spending. Early estimates of retail sales during the holiday season seem to confirm this with Mastercard reporting that it was the best season in six years. The risk to the economy is that business and consumer sentiment may get dented because of the uncertainties surrounding the trade wars and a volatile stock market could lead to a self-fulfilling loop. Already we are seeing some moderation soft data such as small business optimism and consumer confidence (Fig 2), though both are still high. (Fig 3 and Fig 4).

Trade discussions between the US and China seem to be progressing. After the November meeting between Presidents Donald Trump and Xi Jinping at the G-20 summit in Argentina, both sides declared truce and the US suspended further increase in tariffs on Chinese imports for 90 days. Subsequently, both sides have been engaged in negotiations and giving out positive sound bites. Although we remain skeptical that any meaningful progress will be made, especially on the issue of technology transfer and intellectual property, both sides seem eager to avoid further pain to their respective economies and markets. A positive announcement on trade could remove a big cause for anxiety for the stock markets.

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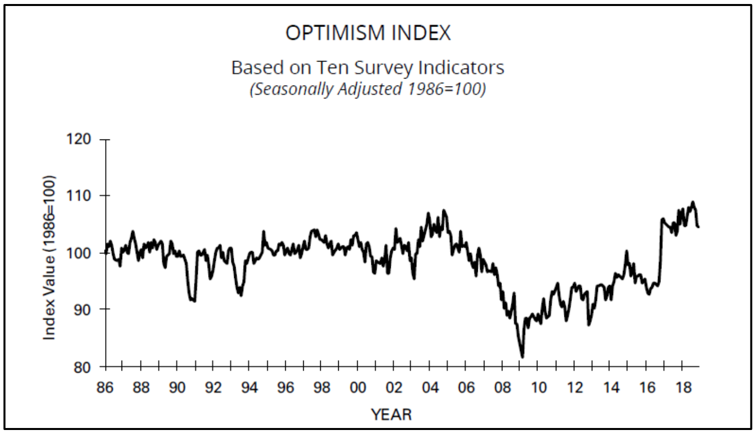
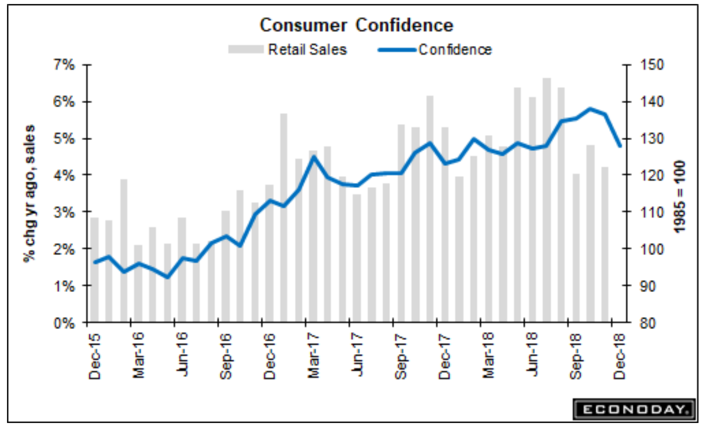
Fig 3: NFIB small business optimism index



Source: NFIB Association

Fig 4: Conference board consumer confidence index



Source: The Conference Board, Econoday

The Fed has raised interest rates nine times since December 2015 and has also been engaged in unwinding its balance sheet (i.e. reducing its massive bond portfolio that was acquired in order to stabilize the financial markets during the credit crisis of 2008-2009). It can be argued that both these actions are unwarranted to such an extent especially when the economy is moderating and there is no sign of excessive inflation. The Fed's favorite indicator to measure inflation (PCE index) is below the 2% threshold. At its December meeting, the Fed increased interest rate by 25 basis points (100 basis points are equal to 1%) and during the press conference afterwards, Fed Chairman Jerome Powell was perceived as being hawkish. This led to the markets selling off precipitously. However, in recent interviews and speeches, Fed officials have tried to convey to the markets that they are not on a pre-set path to increase interest rates and would be data dependent.

US corporate earnings were robust in 2018. As per Factset, based on estimates for 4th quarter earnings growth, the full year earnings growth could be as much as 21% and revenue growth could be almost 9%, the highest levels since 2010 and 2011 respectively. Tax cuts and stable oil prices helped considerably. Tax cuts is estimated to have added 7-8% to earnings growth last year. Earnings of Energy companies grew by over 100% as compared to the next two highest growth recorded by companies in the Materials and Financials sector at 30.5% and 20.6% respectively. Both these tailwinds will be absent in 2019. However, FactSet estimates that earnings will grow by 8%- not as stellar as in 2018 but still reasonably strong.

US stock valuations have fallen significantly after the recent sell off. As per Standards and Poor's, the 12-month forward price earnings ratio for US stocks is about 15 (Using operating earnings) down from a 5 year high of about 19. Additionally, US treasury rates have dropped significantly. The difference in the earnings yield of US stocks (Inverse of P/E ratio- earnings yield is a measure of how many dollars of earnings one is getting for every 100 dollars in stocks) and the 10-year US treasury rate has shot up to 4% from 2% at the end of the third quarter of 2018. This could be a tailwind for stocks as they are better relative value than bonds.

Stock returns are comprised of three parts- the initial dividend yield, earnings growth and multiple (P/E) expansion. The dividend yield for the S&P 500 is currently 2.15%. If earnings grow by 8% in 2019 as estimated by Factset, these two factors could result in stocks rising by about 10%. The wildcard is the P/E multiple. Last year, even as earnings grew, the P/E multiples fell resulting in stocks falling 6%. Currently the P/E for US stocks is below its 25-year average (Fig 5) and if the uncertainties weighing on stocks subside, P/E multiple expansion could help stock performance.

A risk factor that could have significant implications for stocks in the future is the large amount of debt that companies took on when interest rates were at historically low levels. US non-financial corporations collectively have over 6 trillion dollars of debt on their balance sheet. Many of these corporations used the proceeds of the debt to buy back stock rather than to invest in profitable projects. The increase in earnings has not kept pace with the increase in leverage (66% versus over

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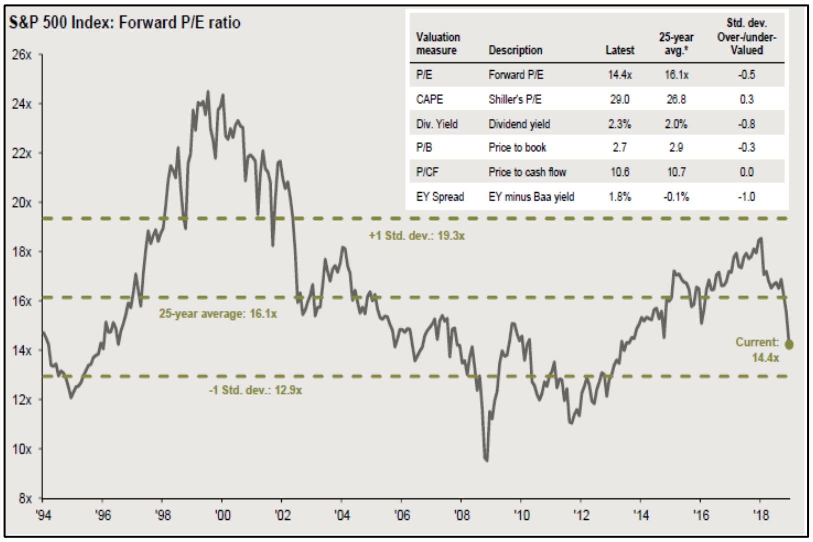
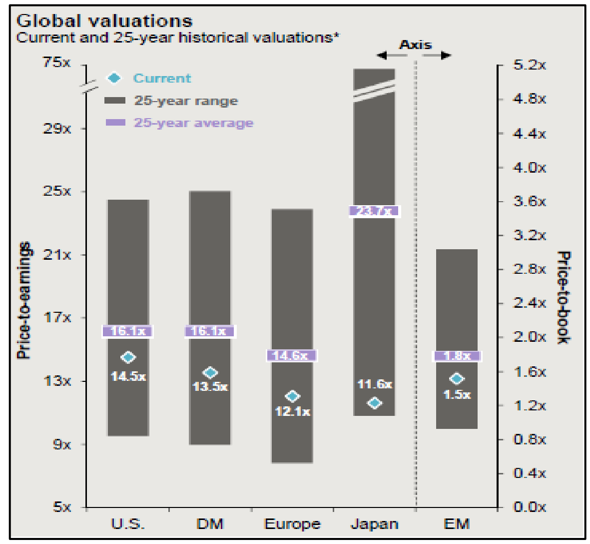
100% since the financial crisis as per calculations by the Federal Reserve) and a significant portion of the earnings per share growth was a result of the buybacks. If interest rates continue to rise and/or if there is a recession, these companies may find it difficult to service the debt. It is difficult to pin point when that may happen, and rising debt levels is not a new phenomenon. However, investors would do well to steer clear of investing in stocks of companies that have excessive debt and stick to quality companies with strong balance sheets.

Fig 5: P/E ratio for US stocks is below 25-year average



Source: JP Morgan

Fig 6: P/E ratios for global stocks



Source: JP Morgan

In Europe, economic indicators are reflecting weakness. Germany, which is the engine of growth in Europe is dependent on exports, which has been adversely affected by the slowdown in China and the trade wars. Last year, the German economy grew by 1.5%, the slowest since 2013. The German and European purchasing manager's indices (PMI) are just above 50, which means manufacturing is growing but barely so. Adding to the gloom in Europe are political uncertainties in the UK (Because of Brexit discussions), Italy (New Government navigating debt deficit discussions with the EU) and France (Yellow vests strike). Looking forward, there are several events that could affect the European markets such as the European parliamentary elections, German elections and the selection of a new ECB President. The upside to investing in European equities is the low valuation (Fig 6) currently with some sectors such as Autos close to the lows set during the financial crisis. Low interest rates in Europe (The ECB has kept interest rates at 0%) could also be conducive to stock performance.

As in Europe, Emerging market equities are trading at depressed levels and attractive valuation (Fig 6). Price earnings ratios for Emerging market equities are near the levels set in 2008. These countries have favorable demographics and structural improvements that could support economic growth. If interest rates remain low as expected and the US dollar depreciates, it could further support emerging market equities.

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