VERITAS
INVESTMENT & WEALTH ADVISORY

Fourth Quarter Market Review and Comment
January 2019

Updated Market Performance

Returns	4th Quarter 2018	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-13.52%**	**-4.38%**	**9.26%**	**8.49%**	**13.12%**
DJIA	**-11.31%**	**-3.48%**	**12.94%**	**9.70%**	**13.16%**

Performance: The S&P 500 reversed course in the 4th Quarter posting the worst quarter since 2011, the worst December since 1931, and ended the year negative.

After posting the best returns since 2013 in the 3rd quarter 2018, the S&P 500 (SP500) posted a -13.52% return in the 4th quarter that just ended on December 31, 2018. The Dow Jones Industrial Average (DJIA) bested (Second Loser) the SP500, posting -11.31% over the same period. For the previous twelve months the SP500 has returned -4.38%, underperforming the DJIA which returned -3.48% over the same period. The annualized three-year returns are better than near term returns, with the SP500 posting 9.26%, while the DJIA is running at 12.94%. Over the last five years the annualized returns are running below historical norms (around 10%), with the SP500 returning 8.49% and the DJIA posting 9.70%. The ten-year annualized numbers are running above long-term averages (around 10.00%); the S&P500 posted 13.12% vs the DJIA which turned in 13.16%.

Breaking down the returns for the Q4 2018, we note that there were seven outperforming sectors and four underperformers. **The best sectors (Can we say Defense) were Utilities (1.36%), Real Estate (-3.83%) and Consumer Staples (-5.21%)**. **The losers during the quarter were Energy (-23.78%), Information Technology (-17.34%) and Industrials (-17.29%).** Over the past year the growth sectors have continued to dominate their value counterparts, but in the 4th quarter value did outperform growth. The clear winners the last twelve months were Healthcare (6.47%), Utilities (4.11%) and Consumer Discretionary (0.83%). Bringing up the rear were Energy (-18.10%), Materials (-14.70%) and Industrials (-13.29%).

The DJIA tanked in the 4th quarter as trade tensions, tightening monetary policy, and slowing global economic growth led to negative sentiment as well as negative returns. Trade tensions continue to be visible and slowing global growth leave the blue-chip index vulnerable to further volatility. More than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Economy: The worry of slowing growth has begun to come into the conversation.

The third estimate of 3rd quarter Gross Domestic Product (GDP) is 3.4% according to the report released at the end of December by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter decelerated by ~0.8% compared to the 2nd quarter 2018 when GDP was running at a rate of 4.2%. Overall, the economic recovery continued in 2018 following growth of 2.3% in 2017 and 1.5% in 2016. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future although it is beginning to show some chinks in its armor. By comparison, China says their GDP grew at 6.5% in the 3rd quarter of 2018. The lowest growth rate since 2009 during the global financial crisis, due to the continued tariff dispute with the US and off balance sheet borrowings by local governments. Growth rates for the European Union (EU) and the Euro Area beat expectations in 2017 to reach a 10-year high of 2.4%. Growth rates for the 3rd quarter were 1.8% for the EU. The Euro Area economy grew 0.2 percent in the quarter ended September 2018. This is the weakest growth rate since the 2nd quarter of 2014. Driven mostly by a negative contribution from external demand.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, December unemployment rose 0.2% to 3.9% from 3.7% in November, the last time the unemployment rate maintained an average of 4.0% or lower was in the late 1960s. Job growth occurred from healthcare, food services and drinking places, construction, manufacturing and retail trade.

Inflation decreased so far in the fourth quarter. After averaging 2.63% in the 3rd quarter, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 2.35% in the 4th quarter though November. The average rate of inflation for 2018 through November was 2.5% and continues to be subdued by historical standards (2.64% over last 30 years).

Consumption continues to be an important driver of the economy as it represented 68% of third quarter nominal GDP. The U.S. Census Bureau announced in December that retail sales for November 2018 were up 0.2% compared to October but were up 4.2% above November of 2017. Gasoline stations and Non-store Retailers were up 8.2% and 10.8% respectfully from June 2017.

Manufacturing economy had growth in manufacturing for the 28th consecutive month. Economic activity in the **manufacturing sector** grew for the twenty eighth consecutive month in December, with the Purchasing Managers Index (PMI®) registering 54.1, a substantial decrease from November's reading of 59.3. This was led by a continued expansion in new orders, production, employment, net export orders, and imports. Although they are continuing to grow, they are do so at a slower pace. Customer inventories continue to struggle to maintain expansion levels as a result of supplier deliveries slowing further. The **overall economy** grew for the 116th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*.

Home prices continue to rise, but at a slowing rate since the peak in 2017. According to the S&P Case-Shiller Home Price Indices home prices rose in October with the S&P CoreLogic Case-Shiller National Home Price Index rising 5.5% over the last 12 months. Western cities continued to lead price increases with Las Vegas, San Francisco and Phoenix having the largest price increases of 12.8%, 7.9% and 7.7% respectively. The favorable economy has continued to support recent gains in housing. However, recent increases in mortgage rates and reduced affordability have led to slowing sales in both new and existing homes. There continues to be a low supply of homes on the market.

Markets: After muted volatility in 2017 we experienced our first 1 day 1,000 point move in the DJIA. First 1,000 (-1,175.21) point drop occurred on February 5th, second 1,000 (-1032.89) point drop followed soon after on February 8th and after the worst Christmas eve on record we came back from the holiday only to rally for our first 1,000 (1,086.24) point gain.

- **Earnings growth for the SP500 is expected to come in at double digits for the 4th quarter. If actual growth comes in as estimated, it will be the fifth straight quarter of double-digit growth for the index.** According to FACTSET, of the SP500 companies that have reported earnings as of 4 January (Approximately 20), 89% reported earnings above the mean estimate and 67% have reported sales above the mean estimate. **Earnings guidance has been skewed to the**

downside with 72 companies issuing negative EPS (Earnings per Share) guidance and 33 issuing positive EPS guidance. Currently companies are seeing an impact from tariffs and a decrease in global growth. The estimated earnings growth rate for the S&P 500 for Q4 2018 of 11.4% is below the original earnings growth rate of 16.7% at the beginning of the 4th quarter. All eleven sectors have a recorded a decrease in expected earnings growth due to downward revisions to earnings estimates, with Energy, Utilities, and Materials sectors having the largest declines.

- **Stocks are fairly valued.** The current 12-month forward Price Earnings (PE) multiple on stocks is 14.4. The long term (20 Year Average) PE for stocks is 15.8, so we do not see much evidence of a bubble in stock prices. After the decrease in value during the fourth quarter we are starting to see more opportunities. There is a little room for PE expansion now, but to get meaningful appreciation we will need an increase in earnings and widening profit margins.
- **Global trade tensions still exist.** Trade tensions continue to be present. This has cast a cloud of uncertainty on the market. With trade concerns in the news often, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures continue to be present. We are starting to see a flow through of the impacts of tariffs globally as it is starting to hit corporate profits.

- **Rising interest rates.** The Federal Reserve raised the target range for the federal funds rate by a quarter of a percentage point to a range of between 2.25% and 2.50% during its December meeting. The increase predicated by the continued strength of the labor market and strong economic activity. Fed officials expect further gradual increases in the target range for the federal funds rate that will be consistent with their assessment of realized and expected economic conditions. Risks to the economy currently appear roughly balanced. The most recent release of Fed minutes indicates a much more Dovish tone taken by the Chair Jerome Powell. The market is currently underpricing the chance for rate hikes in 2019. With the potential for continued fiscal stimulus, rising wages, higher than expected growth, we believe the Fed will end up raising rates more than is currently priced into the market.

- **Its back! Say hello to Volatility.** There were 69 trading sessions when the DJIA increased or decreased by 1% or greater in 2018. Since 1940, the average is 49. Volatility was muted in 2017 as we only had 10 trading sessions with a move of 1% or greater. As mentioned above we had our first ever 1,000 point decline in a single session and our first ever 1,000 point gain in a single session. Don’t be surprised if this is the new normal.

Forecast: A forgettable 4th Quarter has led to increased prospects for equities to outperform.

Continued growth, low unemployment, and low inflation. Lower corporate tax rates added to profit margins translating into higher earnings. However, this is being offset by tariffs and slowing global growth. The majority of fiscal stimulus will soon be in the rearview mirror, interest rates will continue to rise, and the impact of tariffs will continue be seen. Economic growth will continue to moderate. Unemployment has reached lows not seen since the 1960s. Inflation continues to run below average, but we are starting to see some meaningful wage growth.

Earnings Growth & Maintained/Increasing Profit Margins. This is what is still needed to get the market out of its current negative sentiment. Ever since hitting a market low on Christmas Eve the market has started to regain some of the losses it incurred in December. Strong earnings and revenue growth could be enough to reverse our current negative momentum and lead us back to test the high reached in October.

What risks are out there that might disrupt the recovery?

- **Negative earnings guidance and negative earnings surprises**. There have already been negative earnings revisions from SP 500 companies for their current earnings reports due to tariffs and slowing global growth impacting earnings. If earnings come in worse than expected or forward guidance is disappointing, stocks will continue to have downside pressure. There is not currently a compelling reason to sell based on valuations being too rich. The probability of this scenario is medium but could increase if we see a meaningful increase in negative earnings guidance.

- **Continued Fed Tightening**. Given the recent low inflation, low unemployment and stable economic growth, we think the risk of rate increases by the Fed are medium. The fed made 4 .25% increases in 2018. Amid recent volatility in the financial markets and slower global growth the Fed has lowered expectations for interest rate increases in 2019. **Nine of the last eleven recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**

- **Global trade tensions.** We are continuing to see trade tensions which will continue to hold back business and consumer spending, leading to slower economic growth.

We think the biggest threat to the stock market is the uncertainty presented by slowing economic growth as well as a potential misstep by the Fed. This uncertainty will persist until there is clarity over what the final resolution will be on the trade front. It will also depend on the amount of economic stimulus injected globally to spur growth. Rates on the long end of the yield curve have retreated recently, as prospects for global growth have deteriorated. It has not taken much pessimism and fear to get the market to head to the downside. We think the SP500 will end the first quarter between 2,600 and 2,700. At this juncture, we venture a guess that stocks will end up somewhere between 10%-12.0% for the year.

For the next six months, the Federal Funds rate should remain near its current range of 2.25%-2.50%. **The 10-year Treasury which is currently priced at 2.68% may rise back toward 3.00-3.25% before the end of the 1st quarter.** By year end we should see the rate between 3.25%-3.50% assuming the FOMC (Federal Open Market Committee) continues its dovish tone, inflation increases, and global growth expands.

Happy New Year! We look forward to another great year.

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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