Investment Tally & Perspective

Fourth Quarter 2018 Review

The first three pages provide a summary of financial markets and economic activity in the fourth quarter and 2018 calendar year; our Investment Outlook & Strategy follows on page four.

MAJOR ASSET CLASS RETURNS

	4th Qtr. 2018	1-Year	3-Year	5-Year
Equities				
S&P 500	-13.5%	-4.4%	9.3%	8.5%
MSCI EAFE	-12.5%	-13.8%	2.9%	0.5%
MSCI Emerging Markets	-7.5%	-14.6%	9.2%	1.6%
Fixed Income				
Barclays Capital US Aggregate	1.6%	0.0%	2.1%	2.5%
Barclays Capital US Corp. Inv. Grade	-0.2%	-2.5%	3.3%	3.3%
Barclays Capital Emerging Market	-0.2%	-2.5%	5.1%	4.2%
Other Assets				
MSCI US Reit Index	-6.7%	-4.6%	2.9%	7.8%
S&P GSCI	-22.9%	-13.8%	0.5%	-14.5%
ICE WTI Crude Oil	-38.0%	-24.8%	7.0%	-14.3%
Comex Gold	7.1%	-2.1%	6.5%	1.3%

Source: Capital IQ — All returns greater than one year are annualized

Market Activity

Higher risk assets, including U.S. stocks, had a rough quarter. What started out as a reaction to rising interest rates quickly morphed into global growth concerns. The S&P 500 declined 13.5% during the quarter while developed international equities were down 12.5%, and emerging market stocks were down a more modest 7.5%. Small cap stocks were down 20.2% during the fourth quarter, and value outperformed growth in the quarter though not in December.

Bonds posted mixed results in 4Q2018 as U.S. Treasury's, which represent a growing proportion of the Barclays Aggregate Bond Index, performed well with growth scares pressuring interest rates lower and pushing bond prices higher. In contrast, corporate credit was unsettled as growth worries stirred expected default probabilities, as well as the risk premium investors demand for assuming commensurate risk. Investment grade corporate bonds were down 0.2% and high yield bonds were down 4.5%. Leveraged loans, a popular asset class in recent years, were down 4.7% (using the BKLN ETF as a proxy).

Other assets showed similar dynamics with commodities in general working lower. Crude oil collapsed on growth worries and perceived excess supply as inventory positions once again moved past five-year averages in developed countries. Gold displayed its safe-haven status and posted a 7.1% return.

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The U.S. - Before diving into the details, it is important to view the U.S. economy in proper perspective. With annualized GDP (Gross Domestic Product) of $20.6 trillion, the U.S. economy is the largest contributor to global GDP of $88.1 trillion (IMF). Economic activity (GDP) is categorized as follows: personal consumption expenditures, residential investment, non-residential investment, government spending, and net exports. The diagram below shows the contributions to GDP of these categories:

Personal Consumption Expenditures	68%
Government	17%
Non Residential Investment	14%
Residential Investment	4%
Change in Inventory	0%
Exports-Imports	-3%
Total	100%

Source: BEA.gov

The U.S. economy grew at annualized rates of 2.2%, 4.2%, and 3.4% during the first three quarters of 2018, and the Atlanta Fed GDP Now Model pegs fourth quarter growth at 2.7%, not meaningfully different than the estimate in October. Fourth quarter personal consumption expenditures, the biggest factor in U.S. GDP, continued to gather strength as the fourth quarter progressed.

Hard data points to Consumer health:

- Unemployment is at a level not seen since 1969
- The 2018 holiday shopping season was the strongest in six years, with sales up 5.1%
- Average hourly earnings were up 3.2% from a year earlier in December, the highest level since 2009
- Average weekly hours worked have been relatively flat
- Debt service ratios are at multi-decade lows, while debt to income ratios are at levels seen in the early 2000's

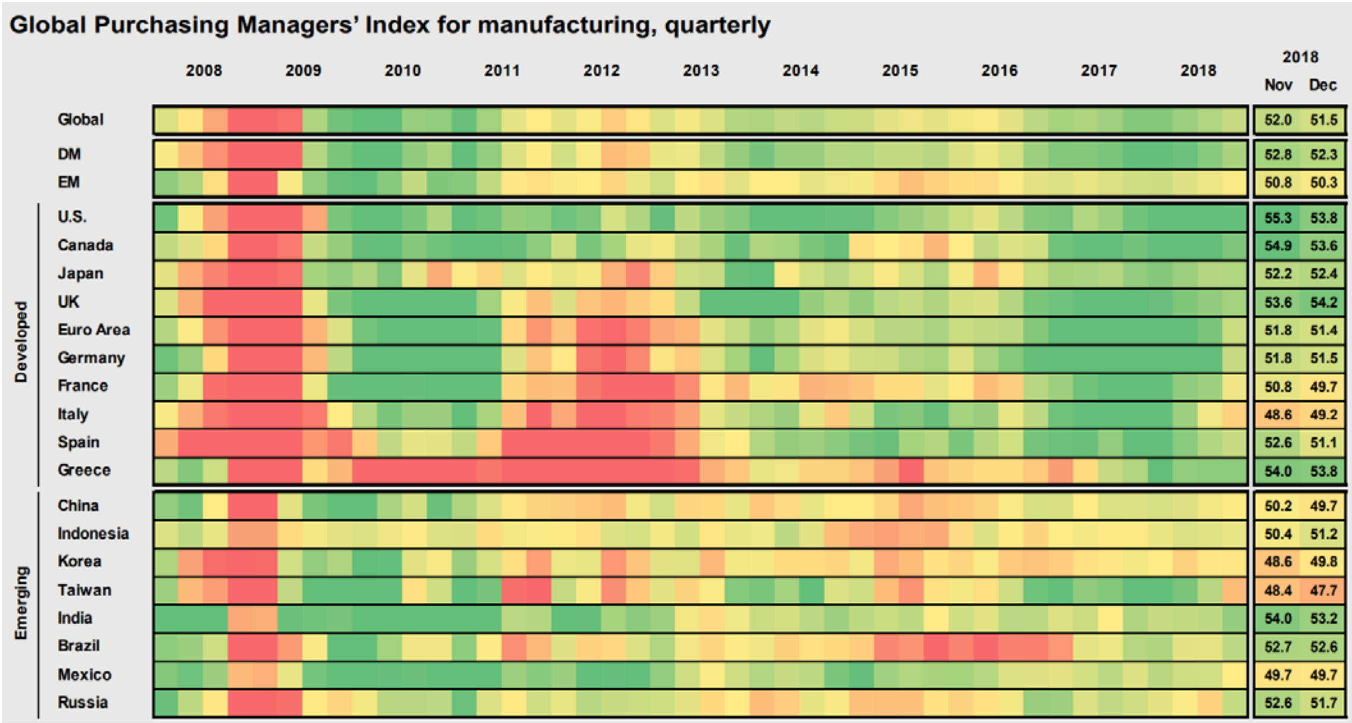
Confidence data

- University of Michigan Consumer Confidence index is up 2.5% from last year, while expectations of the future were up 3.2% from the prior year (but down from November)
- The Conference Board reported a decline in Consumer Confidence in December from November, with the biggest decline coming from expectations

On the business side, after posting strong spending growth in the first two quarters, business investment cooled in Q3, and it appears Q4 will be at a similar level. Non-defense capital goods orders ex-aircraft (a capital expenditure proxy) are at recovery highs though, like the consumer, the data is starting to weaken. The NFIB Small Business Optimism index is down to its lowest level in seven months. Further, over 50% of CFO's surveyed by Duke University in December expect to be in a recession in 2019. Lastly, state and local government finances should be in decent shape, as income, sales, and property taxes are solid.

Global Growth-

The following diagram from JP Morgan shows a purchasing managers survey for multiple countries. A reading above 50 signals expansion, while a reading below 50 signals contraction:



Source: Markit, J.P. Morgan Asset Management.

PMI's (purchasing managers index) are an important indicator, as they are usually one of the first to signal improvement or decline. As can be seen in the chart above, France, Italy, China, Korea, Taiwan, and Mexico are signaling a slowdown. These economies represent 26% of global GDP.

In Europe, the biggest concerns are France, Germany and the U.K. The U.K. is in a stand-off with the EU regarding Brexit. The breakup deal agreed to by Theresa May and EU leaders must now be voted on in the U.K. Parliament which will be no easy task. This process has already driven cabinet resignations and a no confidence vote. In order to avoid crashing out of the EU with no deal in place, something will need to be done and agreed to by the end of March. Germany and France are seeing growth strains. Germany reported a decline in Q3 GDP, but this was due mainly to changes in auto emission testing standards.

China continues to see growth recede. As can be seen above, PMI surveys have moved into contraction territory. Industrial production posted its slowest growth since early 2016 in November, while retail sales grew 8.1%, the slowest pace since 2003.

Monetary Developments

Outside of the U.S., monetary policy didn't register material surprises. The December Fed meeting was widely considered to be of importance as it occurred during a severe market drawdown. The Fed hiked rates, as expected, and lowered its projection for 2019 rate hikes and economic growth. The Fed now anticipates two hikes by the end of next year. The market, as implied by fed funds futures, sees an extremely high likelihood that there won't be any more rates hikes in this cycle.

How these two expectations converge in 2019 will be a critical factor in asset performance. In our view, it is likely the Fed, as part of its plan to "normalize" interest rates and its balance sheet, slows down the pace of rate increases and becomes more data dependent, though no hikes through 2019 would be a remarkable change in Fed policy and communications.

Valuation & Investor Sentiment

The sharp and deep fourth quarter decline in stocks has made equity valuations much more appealing. The P/E multiple fell from 17.5x in October to around 14.0x in late December (presently around 15.0x). EPS growth estimates for 2019 have moved lower, declining from 9.66% in late September to around 7.04% today. Today's P/E multiple is approximately average relative to the past five years. Other measures of valuation like the Shiller PE ratio (aka Cape Ratio) is 16% off its high, but still elevated relative to the average seen since 2002.

Sentiment has turned remarkably bearish (note: keep in mind that sentiment surveys are contrary indicators). Looking at the American Association of Individual Investors survey, during the week ending 12/27/2018, 50.3% of respondents said they were bearish. Using the averages and standard deviation seen in the survey since 1987, this is more than 2 standard deviations from the long-run average. Looking at the 1,642 weeks of the survey, 54 had a bearish reading above the latest reading of 50.3%. Just looking at those, the subsequent three-year returns were negative 10 times. Looking at all the 54 instances, the average annualized three-year return after posting a bearish reading above 50.3% was 10.6%.

Investment Outlook & Strategy

The Fourth Quarter of 2018 – A Stealth Bear Market: At the end of last September we were looking for a modest market pullback, perhaps 4% to 6%, in the broad stock market. Though stocks had covered a lot of ground during the upward advance in the prior decade and valuations were extended, generally they were not at extreme levels. Experience told us this long, strong rally (bull market) was not yet over, even given the late stages of the economic cycle and the market cycle. With recession being more likely post-2019, a large market decline was deemed unlikely. Well, surprise, surprise. Stocks declined more than our expectations as the broad stock market entered bear territory with the low level being reached on the 24th. of December.

The Road Ahead: Three of the most prominent concerns facing investors follow with our brief view on each:

(1) The U.S. – China Trade Talks: Likely result will be an agreement by March 1st that satisfies some of the concerns and issues sought by both sides, leaving unresolved issues for future negotiations
(2) Government Shutdown: Either a compromise will be reached at zero hour after contentious negotiations produce high levels of stress, or President Trump will find alternative sources of financing and ends the shutdown
(3) Fed Actions and Interest Rates: We expect rates will rise from current levels (hopefully based on supply and demand without central bank manipulation), and we doubt the Fed would intentionally invert the yield curve in the near term. Further out, the Fed may become more restrictive if there were clear signs that the economy was over-heating or there were bubbles or excesses that warranted being purged or offset.

In closing, we continue to manage bond portfolios with emphasis on shorter duration and high-quality securities. For stock portfolios, the fourth quarter decline, while being unpleasant, largely removed excess valuations resulting in a more attractive risk/reward and potential returns. While we cannot rule out a testing of the recent lows, we expect attractive returns from current levels in the years ahead.

The Lincoln Capital Team