Independence Asset Advisors

MarketMatters

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"The most important thing is to stay the course – not to get shaken out of the market during a difficult time."
John W. Rogers, Jr.
Ariel Capital Management

Fourth Quarter at a Glance

The final quarter of 2018 was a challenging period for nearly every global asset class. Key themes persisted, volatility remained elevated, and investors generally shifted away from "risk assets" in favor of "safe havens" that have historically offered better principal protection when markets are heavily pressured.

For the quarter, U.S. equities lost roughly 14% and foreign equities fell roughly 12% on the aggregate, with emerging markets equities only losing 7%. Bond markets fared better on a relative basis, but ended the quarter broadly lower on an absolute basis.

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2018 Market Overview & Key Themes

2018 will be remembered more for its ending than its beginning or middle. Through the first three quarters, global market returns were generally positive despite mounting headwinds that culminated in a sharp fourth quarter sell-off.

During the year we witnessed the Fed implement a steady monetary tightening agenda, raising short-term interest rates in four incremental 0.25% hikes. The rate increases lifted the central bank's benchmark interest rate to 2.4% by year-end, its highest rate since the first quarter of 2008.

The decision to "normalize" policy was generally considered appropriate, despite a relatively low rate of inflation. However, markets began to react with less enthusiasm as it increased borrowing costs and slower corporate earnings growth became quantifiable.

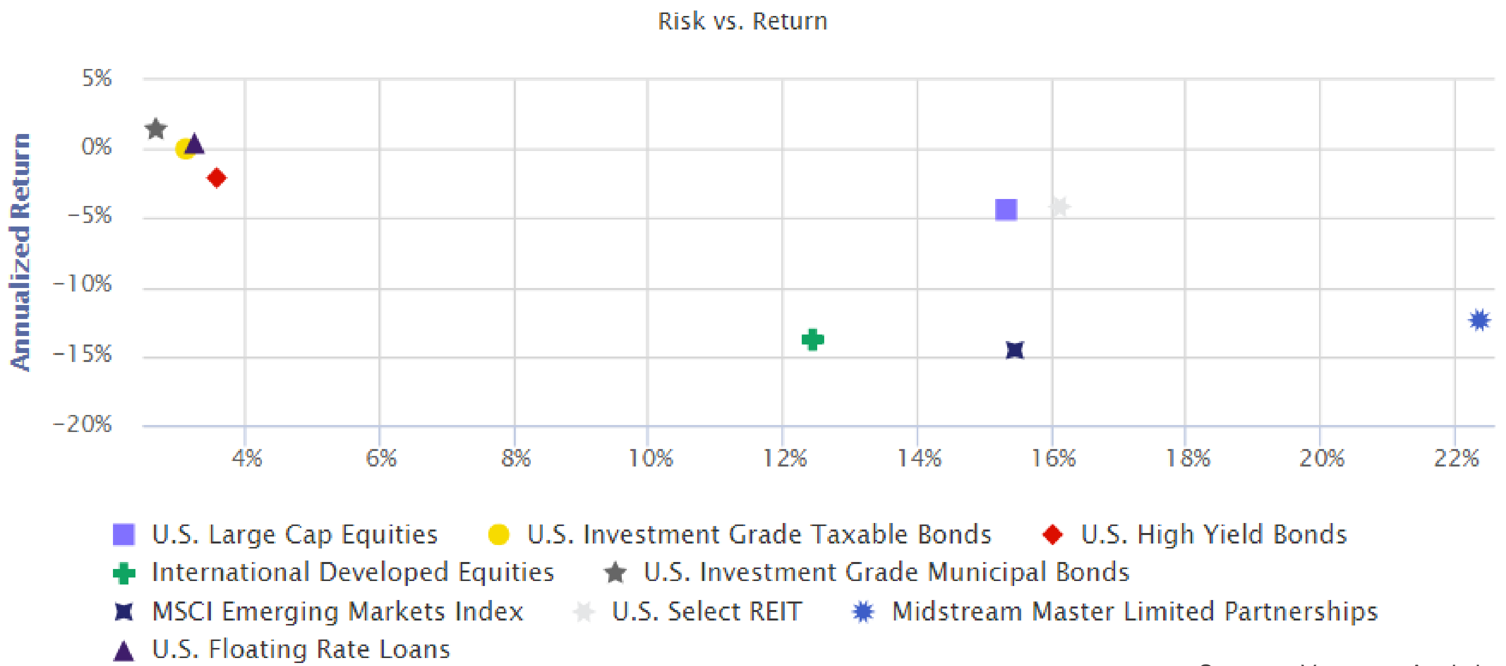
As of this writing, nearly 80% of the market is pricing in zero rate increases in 2019, with a consensus that the Fed will wait until June before considering another rate increase.

Compounding the effects of the Fed's tightening program was the ongoing challenge of global trade negotiations. The U.S. restructured the trade agreement with Mexico and Canada, forming the new moniker "USMCA," but the more significant agreement between the U.S and China, the world's two largest economies, remained unresolved at year-end.

Pressure peaked in early December when the 3-year and 5-year U.S. Treasury yields briefly inverted. A yield curve inversion has historically served as a reliable recession indicator. This inversion, combined with a sell-off in the tech-heavy NASDAQ composite, resulted in the second market correction of 2018. Oil prices were also extremely volatile throughout the year, ranging from a high of $76 to a low of $42. The U.S. dollar exhibited unexpected strength throughout 2018, which eroded foreign market returns.

Please refer to page four where we address mounting concerns over the possibility of a 2019 recession amid a forecasted slowdown in fourth quarter GDP growth.

2018 Global Benchmark Results



Source: eVestment Analytics

U.S. fixed income outperformed U.S. and foreign equities in 2018 with meaningfully lower relative risk following the fourth quarter equity sell-off. Investment grade fixed income returns were muted throughout the year, with yields barely high enough to offset the negative price returns associated with the incremental rise in short-term interest rates, but absolute returns were still positive.

High yield bond returns were slightly negative relative to investment grade bonds due to their higher correlation to U.S. equities, while floating rate loans performed exceptionally well throughout the year until December, when the asset class experienced a reset.

The tables to the right show global equity valuations and characteristics (top) and fixed income prices relative to $100 par (bottom) at December 31, 2018.

We do not see sufficient evidence to support a recession in 2019, making the fourth quarter repricing an attractive opportunity to rebalance to long-term targets.

Equity Indexes*	P/E	High	Low	Average
U.S. Large Cap	14.4	18.3	10.3	14.6
U.S. LC Growth	17.6	21.4	11.7	16.5
U.S. LC Value	12.4	16.6	9.3	13.5
Midstream MLP	10.0	14.0	9.0	11.5
U.S. REITs	15.7	20.5	6.7	16.6
MSCI World	13.5	17.1	10.1	14.2
Int'l Developed	11.9	15.8	9.4	13.2
Emerging Markets	10.5	13.6	8.6	11.0

Notes: P/E represents "Current Next 12-Months"
MLPs = EV/EBITDA & REITs = P/FFO

Fixed Income Index*	Price	Yield to Worst	Duration
U.S. IG Corporates	$99	4.2%	7.1
U.S. IG Municipals	$107	2.7%	6.2
U.S. High Yield	$92	8.0%	4.2
Bank Loans	$93	7.2%	N/A
Global ex-U.S.	$109	0.9%	7.9

Understanding Standard Deviation

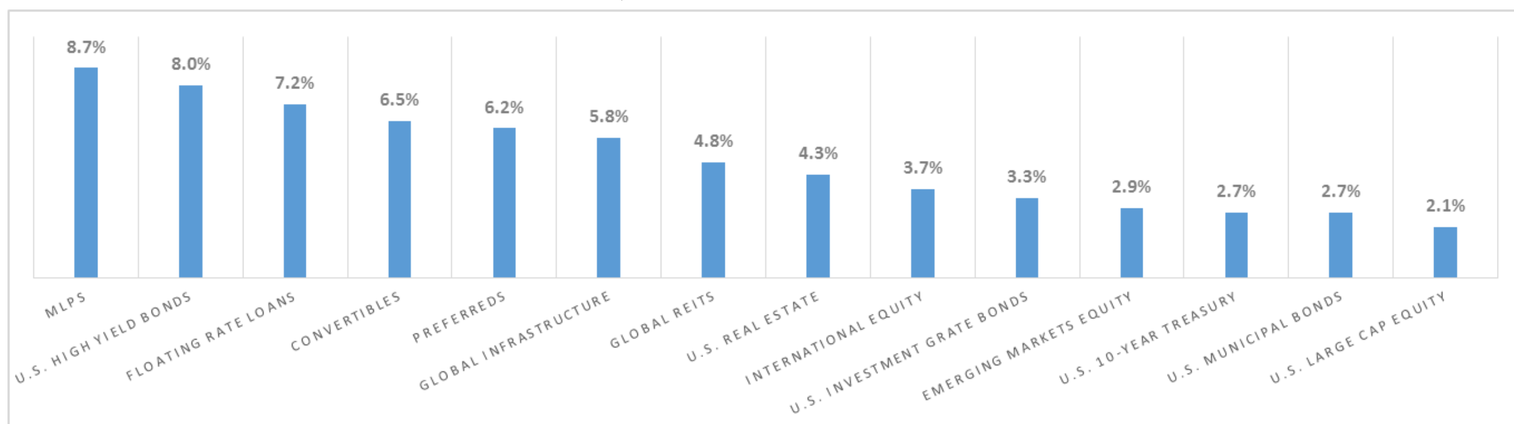
Standard deviation is a measure of volatility. A higher standard deviation represents a greater dispersion of returns around mean returns, which indicates higher risk. The more a portfolio's returns vary from the average, the higher the standard deviation.

In the chart at the top of this page, we provide a comparison of the return and risk (standard deviation) for ten broad global equity and fixed income benchmarks. The upper left quadrant represents the best ratio of return and the dispersion of actual return over the 1-year time period. The bottom right quadrant represents the worst ratio of return and volatility over the same period.

*Source: eVestment Analytics

2018 Global Asset Class Review

Global Asset Class Yields at December 31, 2018*



U.S. Equities

Domestic equities fared better than foreign equities in 2018, but still ended the year down 4.4%. The fourth quarter was particularly challenging for stocks, and a positive 10.6% return through September was eliminated by a negative 13.5% return in the fourth quarter. The sell-off in December was significant, but not entirely unexpected, and is being looked at as a healthy price reset. The forward P/E ratio for stocks at year-end was a more attractive 14.4x and the dividend yield was 2.3%.

Midstream MLPs

Energy infrastructure investments were pressured throughout the year by domestic regulation, tax hurdles and volatile oil prices. The Alerian MLP Index fell 12.4% for the year, but remains attractively priced with good upside potential. The underlying companies are stronger now than ever before, with lower debt and better coverage ratios. MLPs offer a compelling 8.9% dividend yield for long-term investors.

U.S. REITs

The Dow Jones U.S. Select REIT Index, which tracks the performance of publically traded REIT securities, provides a proxy for direct real estate investment. This Index fared relatively well in 2018, falling 4.2% after losing less than half the return of U.S. stocks in the fourth quarter. REIT equities are now somewhat expensive relative to U.S. stocks, but offer a higher rate of income at 3.8%.

International Developed Equities

International developed equities diverged from emerging markets equities in April, performing slightly better since then, but still ending the year unfavorable relative to U.S. equities. International developed equities were fairly resilient in the face of monetary policy and geopolitical uncertainties over the past 12-months, but the combination of an unresolved BREXIT deal, U.S. tariffs, strong U.S. dollar, and less favorable fundamentals resulted in a negative 13.8% return for the year.

Emerging Markets Equities

Emerging markets equities struggled against the same headwinds as international developed equities in 2018, but were more susceptible to the strong U.S. dollar. In local currency terms, the MSCI EM Index fell 7.9%. The U.S. currency effect detracted another 6.8% from the total return for U.S. investors, resulting in a negative 14.6% return for the year.

Preferred Securities

These assets tend to produce higher yield than other asset classes, making them a good source of current income. They have also demonstrated low correlations to traditional asset classes like common stocks and bonds. However, preferreds have also demonstrated tremendous volatility, as demonstrated in 2008. In 2018, the S&P U.S. Preferred Stock Index declined 4.3%.

U.S. Investment Grade Bonds

The Barclays U.S. Aggregate Bond Index was neutral in 2018, having fallen as much as 1.2% in January and gained as much as 1.8% in December. These bond are better priced now relative to a year ago and higher yielding.

U.S. Municipal Bonds

U.S. tax-exempt bonds experienced a similar pattern of monthly returns compared to their taxable peers, but ended the year 1.3% higher. Municipals are slightly expensive, but default rates are low, issuance and demand are balanced, and the taxable equivalent yield favors these issues.

U.S. High Yield Bonds

High yield bond spreads tightened in 2018 as a result of incredibly strong retail demand. The asset class experienced a repricing similar to U.S. equities in December, and are now more attractive. Note the default rate remains well below historical averages.

U.S. Leveraged Loans

Bank loans performed well in 2018, leading most global asset classes through September. However, strong retail outflows resulted in a risk repricing and the asset class lost 3.5% in the fourth quarter. Bank loans are still attractive, but should be viewed as a floating rate non-investment grade sector with the downside risk of high yield bonds.

Credit Limited Partnerships

This asset class, which can be described as a higher yielding alternative to investment grade credit, gained 6.0% in 2018 with less than a 2% standard deviation.

*Sources: JP Morgan Guide to the Markets & Eaton Vance Monthly Market Monitor

2019 Global Market Outlook

We have a cautiously optimistic outlook for 2019 and do not see enough evidence to support a recession forecast this year.

This outlook could be considered contrarian, especially considering the heightened volatility and subsequent selloff that occurred during the fourth quarter of 2018. However, we see a number of favorable catalysts that could further support global growth and extend gains despite a number of meaningful headwinds. Perhaps most importantly, we see no imminent threat to the four primary cyclical sectors of the U.S. economy, which contribute +70% of U.S. GDP volatility.

Domestically, we see high employment and growing wages as a catalyst for sustained consumption. While stocks dropped precipitously in December, retailers were reporting +5% holiday period sales growth. We also witnessed a meaningful, and healthy, correction to mortgage and auto loan rates as a result of the flight to quality fueled Treasury yield decline (the 10-year U.S. Treasury yield declined 0.33% in December to 2.69%).

U.S. equities, at 14.4x bottom-up earnings estimates for 2019, appear attractive relative to history. Bullish estimates suggest corporate profits could advance another 7% in 2019, but we think this aggressive considering a weaker demand from China and Europe, which accounts for nearly one-third of S&P 500 Index company revenues. A more realistic fair value estimate implies a 5-6% stock market advance in 2019, which is supported by a conservative 35% payout ratio. However, we see opportunity for the S&P 500 Index dividend yield to increase above its current average rate of 2.1%.

For U.S. bond markets, we expect less volatility in 2019 as the Fed slows its tightening pace. Bond holders will appreciate higher current yields as maturing bonds are reinvested at higher yields. Further, a lower forecasted tightening agenda should alleviate some of the negative price returns that muted gains in 2018. Investment grade taxable and municipal bonds are better priced now than they were in September, and should experience lower volatility compared to high yield bonds. Bank loans are expected to recover from the December selloff, but should be considered subject to increased headline risk as regulation intensifies.

International developed and emerging markets equities provide a good opportunity to investors seeking higher long-term total returns, as these asset classes are attractively priced relative to history, and offer higher dividend yields relative to U.S. large cap equities. However, over the short-to-intermediate term, we expect these asset classes will continue to contend with more of the same monetary policies and geopolitical issues that resulted in double-digit losses in 2018.

FINAL THOUGHTS

While we are cautiously optimistic about U.S. equity and bond markets in 2019, we are cognizant that a multitude of factors could derail any positive growth momentum and send indexes lower. Domestically, we will be watching the Fed closely and monitoring political issues including the recent government shutdown, trade disputes and immigration reform. We will also be monitoring the U.S. dollar and commodity price movements. Internationally, we will watch for opportunities to strategically rebalance to take advantage of increasingly attractive equity entry points.

Disclaimer:
The views and opinions in this newsletter are solely those of Independence Asset Advisors (IAA).
IAA has made every attempt to ensure the accuracy and reliability of the information provided, but it cannot be guaranteed.
Past performance is no guarantee of future returns.

What is a Recession?

A recession occurs when the value of goods and services produced in a country, known as the gross domestic product, declines for two consecutive quarters, or half year.

According the National Bureau of Economic Research, a recession is more broadly categorized as “a significant decline in economic activity” that is widespread and lasts several months. This would include shrinking GDP, but also declining household income, higher unemployment, muted industrial production and lower retail sales.

A recession is considered to be over when growth returns.

We do not see enough evidence to support a case for a 2019 recession. There is always the possibility of a one-off recession-triggering event such as a war or natural disaster, but historically recessions have more frequently been caused by a financial crisis or aggressive monitory tightening.

Looking at the economy, we see GDP growth in the third quarter of 2018 at 3.0%. Guidance on fourth quarter GDP growth is only 2.0%-2.3% (GDP forecast for 2019 is ~2.0%), leading investors to question if a recession is forthcoming.

While growth is expected to slow modestly, when we consider the cyclical sectors, the U.S. economy appears fundamentally strong. Homebuilding, business investment spending, autos and inventory changes account for less than 20% of nominal GDP, but as much as +70% of the volatility in GDP. We do not see a risk to any of these cyclical sectors currently, therefore we see minimal support for a recession this year.