Market Review

Fourth Quarter 2018

Volatility spiked dramatically in the fourth quarter, erasing equities' prior gains. Large-cap stocks (as measured by the S&P 500 Index) declined 13.5%, and small-cap stocks (as measured by the Russell 2000 Index) fell 20.2%. The rotation out of expensive (as measured by price-to-earnings ratio) Technology stocks continued, with growth underperforming value, as the Russell 1000 Growth Index dropped 15.9% versus an 11.7% decline for the Russell 1000 Value Index. More specifically, investors gravitated towards defensive stocks in Utilities, Real Estate, and Healthcare sectors which have traditionally held up better during recessionary periods. Accordingly, the Russell 1000 Defensive Index (down 9.1%) fell less than half as much as the Russell 1000 Dynamic Index (down 18.5%).

On balance, economic and political developments during the quarter led to increased uncertainty and diminished investors' appetite for stocks. On the political front, differences between the President and Congress over an appropriations bill led to a partial government shutdown. Turning to international trade, markets initially rallied following a constructive meeting at the Group of 20 Summit in Argentina between President Trump and China's President Xi. The immediate benefit will be to delay a planned increase in tariffs on $200 billion in Chinese goods from 10% to 25% to March 2019. China also agreed to cut auto tariffs and increase purchases of soybeans from the U.S. Although touted by President Trump as a "big leap forward," the two sides set a tight timeline of three months to hammer out a long-term proposal. Such negotiations may be complicated by long-term balance-of-power considerations, and by the fact that China is now experiencing slower economic growth.

The trade war was cited by survey participants as a factor behind slowing manufacturing activity. The Institute for Supply Management's Purchasing Managers Index rebounded from its October decline, rising 1.6% to 59.3% in November, but then decreased to 54.1% in December. Mirroring the fluctuating manufacturing activity, the labor picture ebbed and flowed during the quarter. U.S. employers added just 155,000 workers to their payrolls in November, but then greatly exceeded expectations by adding 312,000 jobs in December.

In December, the Federal Reserve raised interest rates for the fourth time in 2018. While the decision itself was not a huge surprise, comments from Chairman Jerome Powell during a news conference indicated that while growth is softening, the Fed's course has not fundamentally changed. Such color was not well received, with the Dow Jones Industrial Average declining over 500 points. However, Fed officials indicated that the need to raise interest rates going forward is less likely than it was three months ago. Accordingly, futures data from CME Group at year-end indicated that the likelihood that the Fed raises rates at least once in 2019 is about 13%, versus 71% a month ago. Moreover, the possibility of *lowering* rates in 2019 has ticked up to 15%, up from 4% at the end of November. The Fed's actions in 2018 seem to have tempered some economic activity, as sales of

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new homes fell 8.9% to a seasonally adjusted annual rate of 544,000 in October, according to the Commerce Department. A separate survey of confidence in home builders revealed a similar sentiment, with the National Association of Home Builders Index dropping to its lowest level in two years. Importantly, more dovish comments from Chairman Powell in early January indicated that the Fed may moderate its stance going forward.

Oil prices fell by 38% in 4Q18, with West Texas Intermediate crude dipping below $50 a barrel. Increased production in the U.S., Saudi Arabia, and Russia, along with greater-than-expected waivers of sanctions against Iran, all contributed to a supply glut. The rising dollar, which tends to move in the opposite direction, may have also contributed to falling oil prices. The decline could have mixed effects, acting as a tax-cut for consumers of oil, but depressing earnings for the energy sector.

Beyond macro level data, the earnings picture doesn't look as rosy as before, and not just because one-time gains from tax cuts are expected to fade. According to FactSet, analysts cut S&P 500 2019 full-year earnings estimates to 7.8% growth, down from the 10.1% estimate reported at the end of September.

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Reviewing the year in full, 2018 proved challenging as investors were whipsawed by a series of reversals which were largely macro-driven. The S&P declined 4.4%, while the Russell 2000 Index fell 11.0%. Despite getting pummeled in 4Q18, the magnitude of growth indices' outperformance through 3Q18 allowed these stocks to finish ahead for the 12 months ended December 31, 2018 (Russell 1000 Growth -1.5% vs. Russell 1000 Value -8.3%).

As prior tax cuts fueled earnings growth, for the first half of the year, the market's mantra was "growth at any price," with valuation largely ignored. In the second half of the year, the market seemed to wake up to the idea that investors had been overly optimistic about stocks' growth prospects. However, even as market leadership shifted away from Technology and small-cap stocks, it tended to punish higher-valued stocks more than it rewarded lower-valued securities. Rather than focusing on lower multiples in cyclical sectors such as Industrials and Materials, concerns over interest rates, protectionism, and a possible recession led investors to instead favor defensive sectors such as Healthcare and Utilities, once again ignoring valuation.

In the fourth quarter, this paradigm shift effectively became a rout, with some observers pointing to electronic trading—computer models, high-frequency traders, passive funds, and market makers—as being responsible for selling without regard for stock-specific fundamentals. Forced selling by mutual funds and exchange-traded funds (ETFs) also led to a vicious cycle, as Investment Company Institute data showed that equity fund investors withdrew nearly $50 billion during the three weeks ended December 26th. In short, 2018 was a challenging year for fundamentally-driven investors.

As often is the case, volatility may beget further volatility. However, the combination of a healthy employment picture and manufacturing data that is still expansionary reduce the near-term risk of recession. After trading above 18 times forward earnings in 2017, as of January 4th, the S&P 500 now trades at just 14.1 times forward earnings despite still-low interest rates by historical standards, and below its 10-year average of 14.6x, according to FactSet. A silver lining to the market's recent sell-off and diminished outlook for corporate earnings is that they could provide fertile ground for our bottom-up approach, given our emphasis on stocks with attractive relative valuations and the ability to exceed expectations.

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