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Investment Commentary

January 9, 2019

Pop quiz: How would stocks perform in a year when:

- GDP rises above 3%
- S&P 500 earnings rise over 20%
- corporate taxes are slashed
- personal income is up over 4%
- the unemployment rate falls to a 50-year low
- and inflation is contained and under 2%?

One could be forgiven for a bullish answer. Stocks rose nicely for the first three quarters of 2018 only to go into bear market, ending down 4.5% for 2018. Foreign markets fared worse, down double digits on average; Chinese stocks were down by almost a third.[1]

Uncertainty and fear are growing for many reasons. Most are related to—or directly caused by—Donald Trump: An escalating and costly trade war with China, an increasingly dysfunctional government, 17 open investigations between Robert Mueller and two U.S. Attorney districts, impeachment odds, rising deficits, and more. Trump's trade war in particular has negated much of the "supply-side effects" and gains in confidence from last year's tax cuts and regulatory roll-back.

The Federal Reserve also contributed to lower stock prices in December with an increase in interest rates and a forecast for two more in 2019. This was surprising to many given the weakening stock market and souring global economic growth picture. After nine interest rate hikes in three years, markets are increasingly worried the Fed will go too far in tightening the money supply and put the economy in recession.

While fully aware that uncertainty very often does *not* translate to risk, we do believe overall risk is rising, especially given the higher number of threats to markets. There seem to be too many 50/50 propositions (like trade) where the bad side could be quite damaging. We've pared back a lot of equity exposure in client accounts while adding high-quality bonds and Treasury bills. We even added a small amount of gold for additional hedging and diversification.

[1] To be sure, when it comes to short term forecasts like this, the real answer is almost always some form of: "It depends." "I don't know" might be even better.

Views into 2019

We think it's increasingly important to err on the side of conservatism and humility. Visibility is low, but we have some weakly-held views and assumptions, including:

- Market direction in the near term will mostly be a function of trade war's developments with China. Our guess is that both sides will realize how damaging the war is becoming (especially for China) and agree to a deal where each can save face. However, even if the odds of the trade war worsening are low, the impact of a worsening scenario is likely very *high*. Thus, one shouldn't bet based just on probability alone; impact has to be discounted.[2]

- Concerns about the Fed are overblown at the moment. It's clear the Fed would *like* to raise rates, but that doesn't mean it feels it *must*. Since the Fed's last rate hike in December, Chairman Jerome Powell and other Fed governors have made efforts to reassure markets that monetary policy has no preset course and the Fed will be data driven moving forward. We believe them. Growth is slowing globally, including in the U.S, and inflation looks to be settling under 2%. There is no overheating the Fed needs to remedy.

- Our sanguine inflation view means that, on the margin, high quality bonds are a better value than they have been in recent years. Bonds should still hedge somewhat against the risk of deflation, which has increased with a slowing economy and numerous threats. We are concerned with deflation largely because of the world's debt problem, which has only grown worse since the financial crisis. The Institute of International Finance reported global debts reached a record $247 trillion in the first quarter of 2018. As a share of GDP, global debt rose from 248% in 2003 to 318%. While debt has grown faster abroad, debt is also soaring in the U.S. across all levels of government and among corporations. U.S. corporate debt has climbed to a record high of 46% of GDP.[3] How much is too much, we can't know for sure. The data nonetheless signals a higher level of overall risk.

- The debt picture also suggests monetary and fiscal policy makers must thread the needle and get things right. Otherwise the next recession could be truly severe.

- The dollar has had quite a run versus foreign currency, and for good reason. We now have no concrete view on the dollar but feel it might be prudent to think about hedging dollar weakness going forward. But because we see no attractive foreign currencies, and because a future debt-crisis would inevitably lead to money printing and lower confidence in governments everywhere, we think it is time again to consider gold as a distant hedge. We invested a small amount, as our conviction level is still low. At under $1,300 an ounce, gold is still down some 33% from its all-time high set over seven years ago.

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[2] An extreme example of this is Russian roulette: the odds of a "bad" scenario might be just one out of six, but you still should not play for any amount of money.

[3] "Corporate Debt Is Reaching Record Levels" by Sam Goldfarb and Rachel Louise Ensign, *The Wall Street Journal,* December 29, 2018.

- Macro factors notwithstanding, stocks overall don't strike us as overly expensive nor very cheap. Companies' earnings reports in 2019 will be telling. After a big corporate tax cut and some one-time adjustments impacting earnings reports in 2018, we should get a clearer picture shortly of organic growth and profitability.

<u>Notable Trades</u>

The following summarizes major buys and sells placed during the past quarter in our Core strategies (conservative, asset allocation-driven and absolute return-focused portfolios representing a majority of our clientele). Note that not all clients or portfolios participate in every trade idea due to clients' circumstances, account size, or other factors. Some portfolios are managed primarily, or exclusively, with exchange traded funds.

New buys:

During the further quarter we re-established positions in **Amgen Inc. (Ticker: AMGN)** and **Intel Corporation (Ticker: INTC)** and increased our holdings in **Stryker Corporation (Ticker: SYK)**.

We also established a small position in long term Treasury bonds through an exchange trade fund: **iShares 20+ Year Treasury Bond ETF (Ticker: TLT)**.

Sells:

We lowered positions in **Johnson & Johnson (Ticker: JNJ)** and **Microsoft Corporation (Ticker: MSFT)** and exited **SPDR S&P Bank ETF (Ticker: KBE)**, **Apple Inc. (Ticker: AAPL)**, **Lockheed Martin Corporation (Ticker: LMT)**, **Kansas City Southern (Ticker: KSU)**, **General Dynamics Corporation (Ticker: GD)**, **3M Company (Ticker: MMM)**, **Northrop Grumman Corporation (Ticker: NOC)**, **Amazon.com, Inc. (Ticker: AMZN)**, and **iShares Core S&P Mid-Cap ETF (Ticker: IJH)**.

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