



Dear Clients and Friends,

Well, that was exciting! Most trends that had been in place for a number of months (or in some cases years) came to an abrupt halt at the beginning of the fourth quarter. Many commentators have attributed the reversals to the speech by Federal Reserve Chairman Powell on October 3rd in which he laid out a path of multiple more interest rate increases to get to the still distant “normal rate.” Regardless of the catalyst, markets and participants were ill-prepared for the change in markets. The S&P 500 declined 13.5% in the fourth quarter which brought its total return for the year to -4.4%. Virtually all other risk assets saw similar or even worse performances. Emerging markets (as measured by the MSCI Emerging Market exchanged traded fund) declined 7.6% in the fourth quarter and 15.3% for the full year. The S&P Goldman Sachs Commodity Index dropped 22.9% in the quarter on the back of a virtual collapse in energy markets. This brought the full year performance of the index to -13.8%. Safe haven assets finally provided some negative correlation as the U.S. bond market (as measured by the Bloomberg Barclays US Aggregate Bond Index) returned 1.4% in the quarter resulting in a nearly flat 2018 as a whole and the gold price rallied 7.5% in the quarter.

Market Outlook

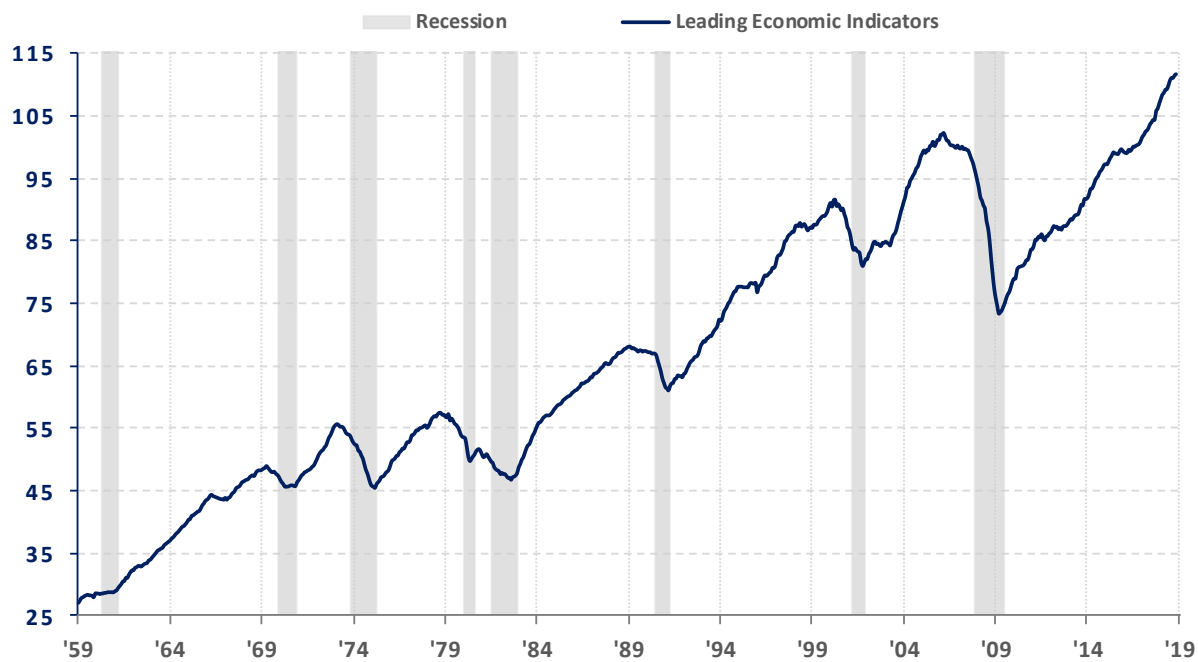
We had been arguing since the middle of last year that the U.S. stock market and economy were in the late innings of the current expansion, but we were challenged to know whether it was the top of the 7th or the bottom of the 9th. We now have our answer at least in terms of the stock market! With a 20% decline already having been registered, the question now is whether this is a correction or a more significant bear market. For a number of reasons, we believe that it is likely the former and that the odds favor that we have already experienced most of the damage:

- 1.) Current market valuations are generally constructive. The S&P 500 is now trading at 14.6 times this year’s earnings estimate; this compares to about 18.2 at this time last year. This places the current P/E multiple at the lowest level since 2013.
- 2.) Sentiment among market participants has reached levels often associated with major market lows. A record amount of money, \$94.3 billion, was pulled out of equity funds and ETFs in December. A majority of newsletter writers were bearish at yearend for the first time since the last major low in early 2016. Small traders/investors bought more puts at the recent market low than they had since late-2008 and late-2002.
- 3.) The monetary policy backdrop has gotten more accommodative. The yield on the U.S. 10-year Treasury note has declined to about 2.65% from 3.25% three months ago. The stance of the Federal Reserve appears to have shifted last week in response to the market turbulence as Fed Chair Jerome Powell expressed his willingness to be patient on future interest rate increases and flexibility in responding to market and economic developments including the pace of the Fed’s balance sheet shrinkage.
- 4.) The odds of a recession for the U.S. economy in 2019 still appear to be remote. Monetary tightening has certainly had an adverse impact on interest rate sensitive sectors such as housing and auto, but the index of



leading indicators is still pointing towards expansion (**Chart 1**). In past cycles, this indicator has turned down several quarters before the economy.

Chart 1: Commerce Board’s Index of Leading Economic Indicators with Recessions



This is not to say that there are not risks to the outlook. The U.S. stock market is still at historically rich levels on some longer-term measures, albeit not as rich as it was a few months ago. **Chart 2** shows the updated CAPE price earnings multiple relative to the last 100 years of history. This measure attempts to account for inflation and compares current prices to a multi-year measure of earnings. Corporate debt levels and profit margins are at very high levels and would seem to have very limited room for further expansion (**Charts 3 and 4**). Finally, the outlook for trade and domestic politics leaves more than a little room for concern.



Chart 2: Long-term Historical Cyclically Adjusted PE Ratio with Recessions

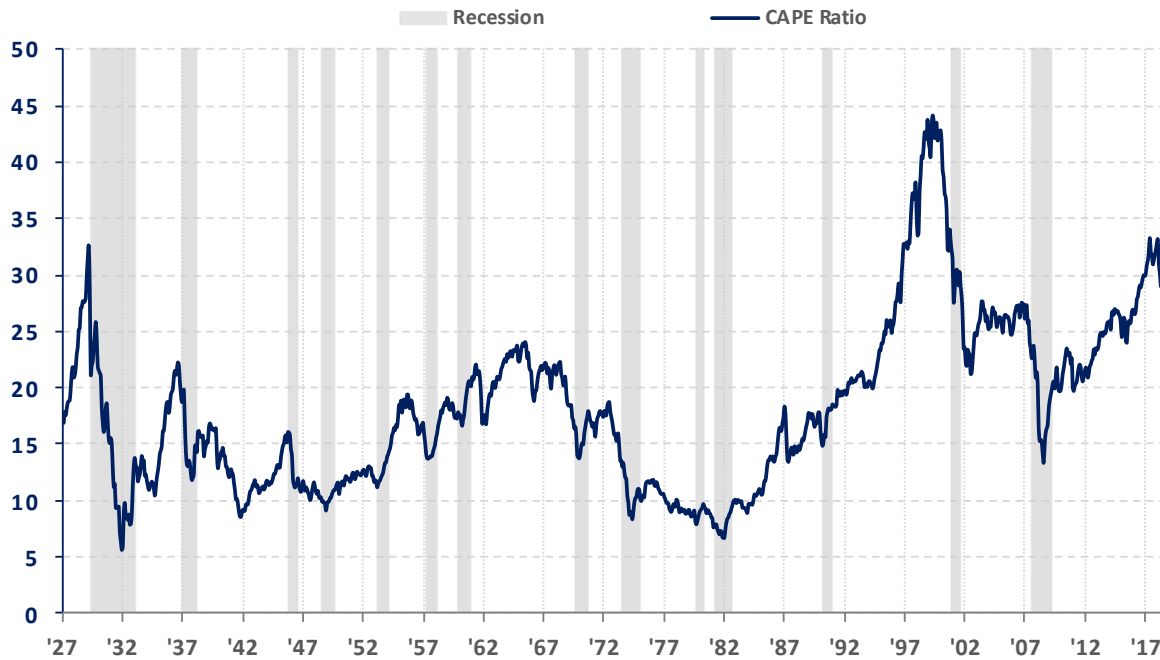
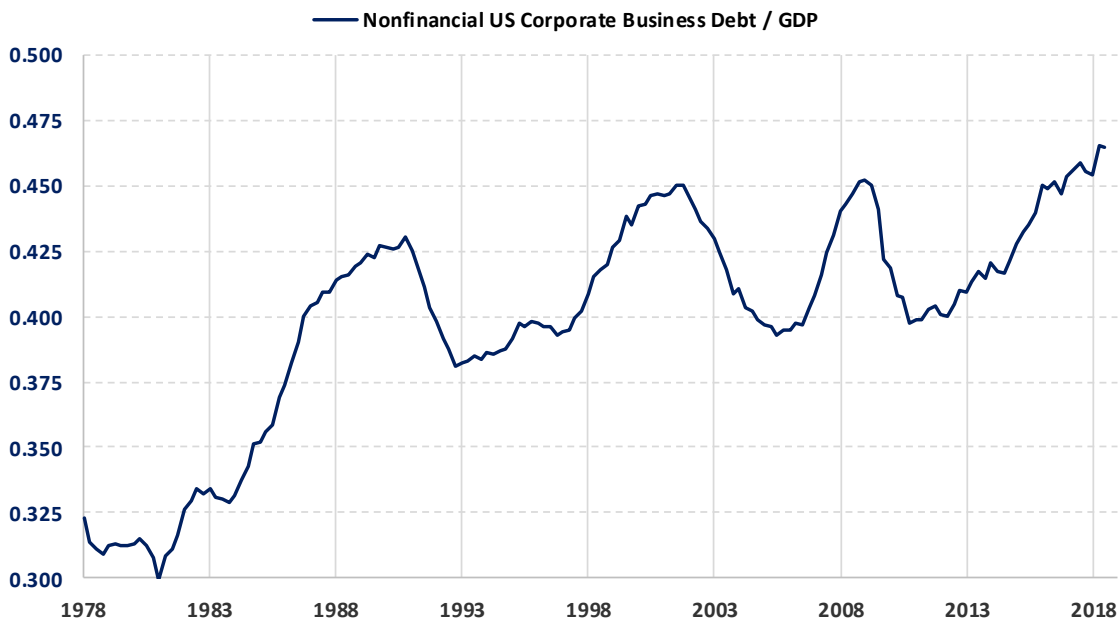
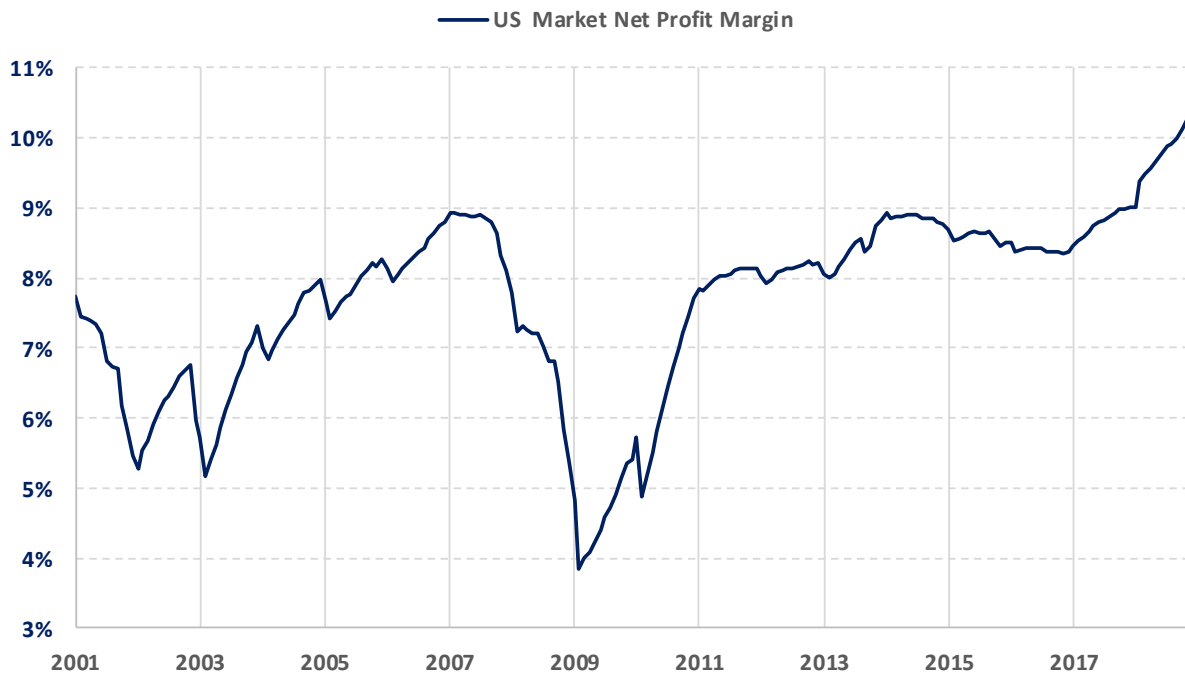


Chart 3: Nonfinancial US Corporate Business Debt / Gross Domestic Product



**Chart 4:** US Stock Market's Net Income Divided by Revenue

However, our strongest held view is that the stock market will be much higher over the long term and will provide far superior returns than cash or the fixed income market. The “price” that an investor pays for those long-term returns is greater volatility in returns such as what we just experienced over the last year. How we react to volatile periods in the markets teaches us something about our tolerance for risk. Human nature and emotion being what they are, most people want more exposure to stocks the higher they climb and want less exposure the lower they fall. Part of our job as wealth managers is to protect our clients from those emotions so they do not make significant allocation changes at the wrong time. Buying high and selling low is not a winning investment strategy. If you are feeling stressed about recent market movements, please call us so we can discuss your current asset allocation to ensure you are taking enough risk to achieve your goals, but not so much that you feel overly uncomfortable during corrections in the markets. You should be relatively comfortable with your allocation in all market environments.

Current Portfolio Themes

We have been unusually active in our portfolios in recent months as we worked to position them for the downturn we feared was coming. In equities, we reduced our exposure to cyclical industries such as Energy, Materials, and Industrials, preferring stable areas such as Consumer Staples and cash. In fixed income, we eliminated exposures to high-yield and lower-quality investment grade corporate bonds in favor of Treasuries

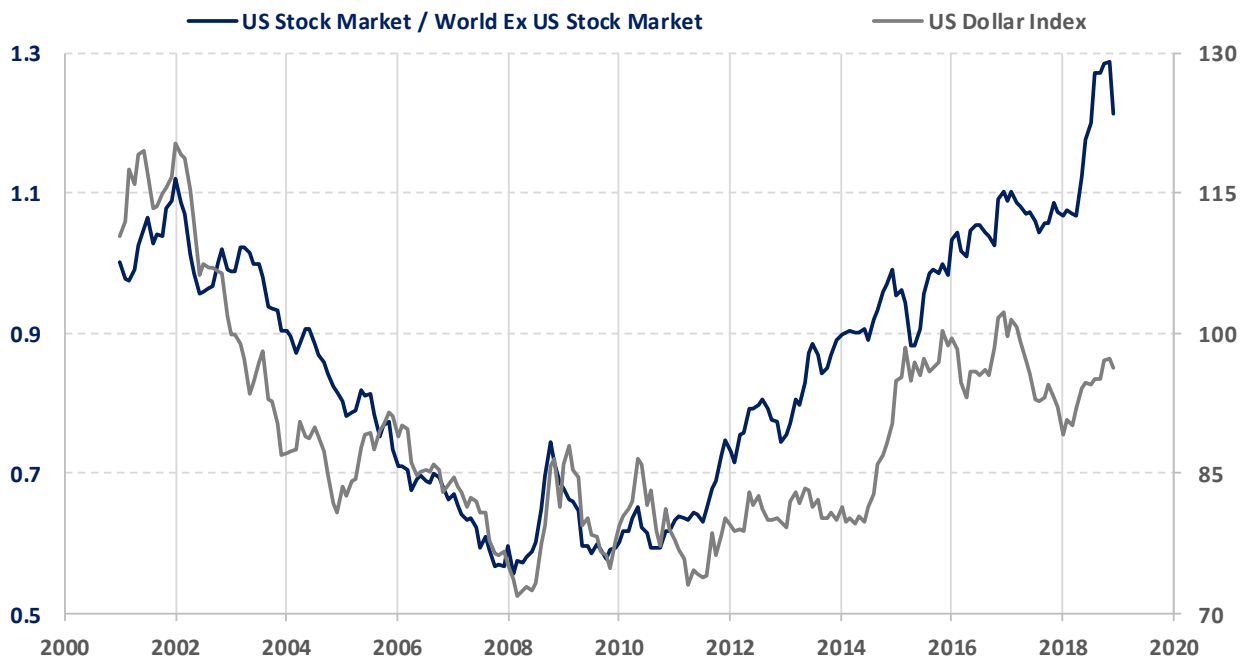


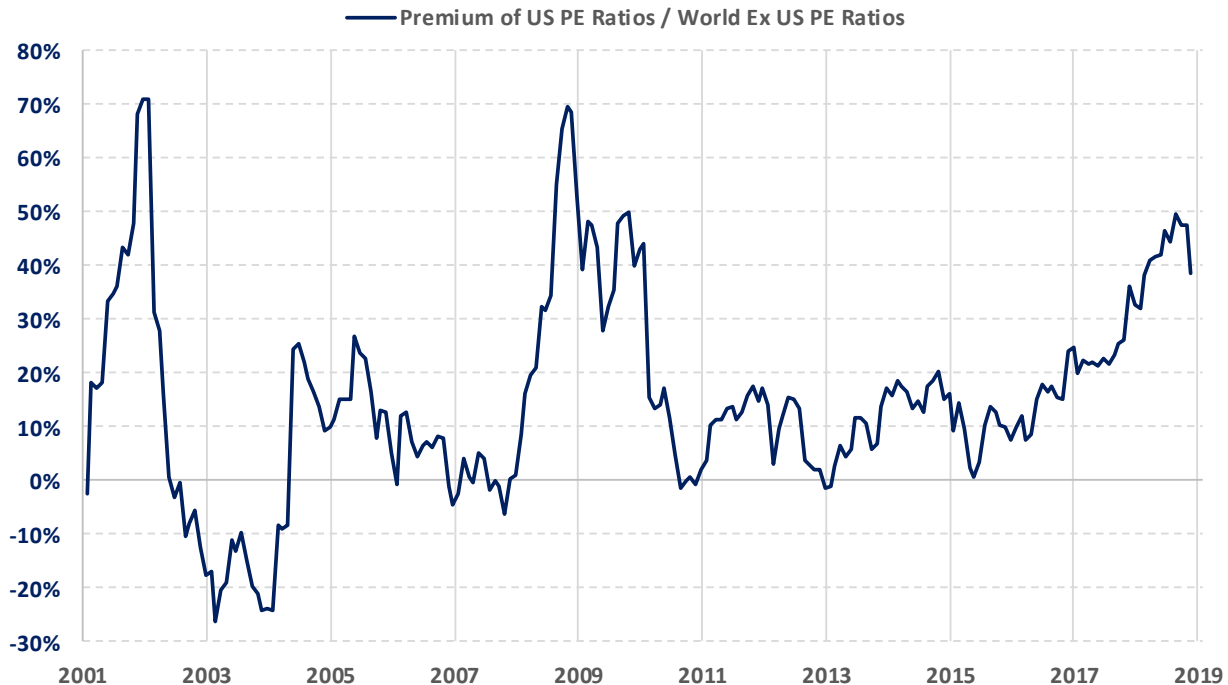
and AA and AAA-rate corporate paper. We also began adding more duration to our fixed income portfolios over the summer and into the fall to position them for a potential peak in interest rates. Following the 20% correction in the stock market we have returned most portfolios to close to their targeted equity allocations to begin 2019.

There are a few themes that we think offer opportunity even in what may prove to be a more challenging environment:

The first is to add some exposure to non-U.S. stocks. U.S. stocks have significantly outperformed the rest of the world over the last ten years. However, we believe that a lot of that has been due to the nearly 50% rally in the dollar capped by exuberance last year over the fiscal stimulus (**Chart 5**). This has led to the U.S. market now being valued at a meaningful premium to the rest of the world (**Chart 6**). We expect that a less restrictive Federal Reserve and the fading of fiscal stimulus as we move through 2019 may allow the rest of the world to close its performance gap with the U.S.

Chart 5: US Stock Market to World Stock Market Excluding US vs. US Dollar Index



**Chart 6:** Premium of US Price-to-Earnings over World Price-to-Earnings Excluding US

We are not gold bugs, but we do view the metal as being a useful source of diversification for a portfolio in certain market conditions. With the anticipation of a peak in interest rates for the cycle and a somewhat easier Federal Reserve and the potential impact of this on real interest rates and the U.S. dollar, we started adding the gold exchange-traded fund (GLD) to some of our portfolios early in the fourth quarter. We expect gold to continue to be an attractive asset in the anticipated market/economic environment in 2019.

We continue to view the interest rate outlook as benign, but remain concerned about corporate debt quality and refinancing challenges. The aggregate level of corporate debt outstanding is at a record high, but more concerning is the quantity of low-level investment grade debt and the amount that needs to be refinanced over the next few years. If the economy is going to slow, some of this debt will likely slip to junk levels and some companies may be forced to refinance their debt at significantly higher interest rates. As a result, we will continue to keep our portfolio exposures primarily focused on Treasuries and high-quality corporates.

Company Developments

We are continuing to work on upgrading a couple major aspects of our technology. Moving our data from servers to the cloud has been nearly completed. Our transition from our legacy reporting software system to a new system called Envestnet Tamarac is well underway and should be completed during the current quarter. Among the improved features will be full integration between reporting, billing, and CRM functions and a client portal that will be accessible from your computer, iPad, or smart phone.



We also expect to further expand the BAM team during 2019 with additional help in the advisor and administrative areas.

Administrative Items

Pershing will begin mailing 1099s for 2018 later this month. However, the initial versions are subject to potential revision. Pershing has until March 15th to send final versions, so please wait until then to be sure you are using final numbers for your tax filings.

As always, we welcome your comments and questions. Please don't hesitate to call, visit, or email at any time.

Scott, Brett, & Dave