POTOMAC WEALTH ADVISORS, LLC

Here's To Your Wealth

2018 Year End Market Commentary
"A Tale Of Two Cities"

The year-end Holiday Season conjures up memories of the Charles Dickens seasonal masterpiece where he writes about Ebenezer Scrooge. However, at this time of year, I am thinking more about his classic novel "A Tale Of Two Cities". With the divergence between the strong U.S. economy and most of the rest of the world, investors face a stark, contrasting choice when making investment decisions.

On the one hand, an optimistic investor can focus on the strong U.S. economic data and our healthy economic fundamentals. While the 2018 daily headlines often rang a tale about chaos and discord in Washington, the economy solidly chugged forward. This year saw GDP jump above the 3% range with strength in manufacturing, service industries, and transportation all boosting corporate profits.

We also saw a strong U.S. consumer, spending at record levels fueled by a jump in year over year wage growth (to over 3%) and unemployment near generational lows of 3.7%. And, despite our strong economic growth, we continue to have modest inflation, thanks in part to declining prices of oil. All of these indicators point to a strong economy and are usually considered positives for the stock market.

Alternatively, investors can legitimately worry about global geopolitical and economic uncertainties coming out of Europe, trade tensions with China, slowing global economic growth and a hawkish Federal Reserve Bank (The Fed) raising interest rates. European troubles include the uncertainty surrounding the British exit from the European Union, riots in the streets of Paris that go far deeper than just a tax on gasoline, an Italian government in a budget battle with the EU, and Europe's largest bank, Deutsche Bank, in financial difficulty (joining many of Italy's biggest banks). Europe has structural unemployment, a large migrant and youth population that is economically disenfranchised, and ballooning budget deficits.

Another factor further weakening overseas economies has been the trade dispute that the U.S. is having with our European and Chinese trading partners. These trade actions, while legitimately trying to correct some inequities, have been pursued in a highly charged, public manner which may reduce the probability of a smooth resolution. The net result could be higher costs to consumers and market uncertainty - which is rarely positive for stocks.

On top of these two dramatically different perspectives we have the wild card of a Federal Reserve Bank that is concerned about the rapid growth of the U.S. economy causing inflation. Since no one knows with certainty how they will approach monetary policy (and I am not sure they know exactly what their plan is), this adds another element of uncertainty.

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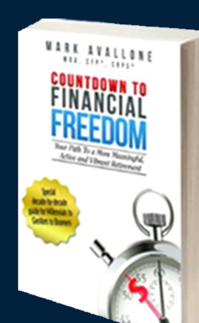

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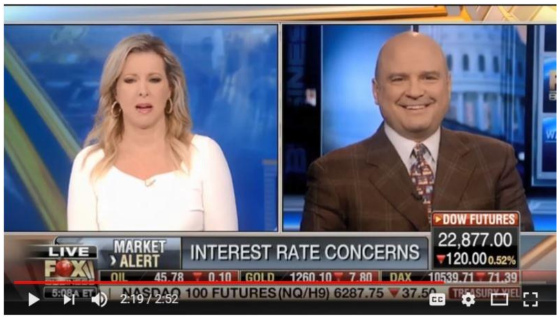

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So the 2019 market outlook is fuzzy but with reasons to be optimistic. Valuations have improved significantly since January when the forward S&P price to earnings multiple (a measure of how stocks are valued) was elevated at over 18. Now we're around 15x forward earnings which close to the historical average. So while there are global issues (noted above), we've built a margin of safety with improved stock valuations.

The Fed, despite some recent increases to interest rates, is still neutral (Fed Funds rate is about 2.50% which is near current inflation rates). And with slow overseas economies and the decline in oil prices, inflation expectations have diminished which may allow The Fed to slow down or stop future interest rate hikes.

Another positive is that divided government, and gridlock, has been historically good for stocks. And, anecdotally, the year following the past 14 mid-term elections have all been positive!

While we remain cautiously positive, if you are concerned about the value of your portfolio in the short-run, are retiring soon, or are having trouble sleeping at night, we would suggest lowering your stock allocation and reducing risk. Otherwise, we believe, barring an unforeseen 'Black Swan" or catastrophic event, the U.S. economy will remain healthy, earnings should rise again (albeit at a much slower rate), and the consumer will continue to be strong. Furthermore, the benefit of the tax cuts, while waning, will still be felt throughout the economy.

If the Fed doesn't act to aggressively stocks could perform well. And it is also important to remember that in the long-run, stocks typically outperform cash. So while it may feel good to have cash on the sidelines, it may be prudent to remember that volatility is the price you pay to be invested in stocks. It rarely is a smooth ride and we expect continued volatility in 2019.

Please call us if you have any questions about your unique situation

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