# Trumbower Financial Advisors, LLC
## 4th Quarter 2018
## Investment Market Commentary

### *The Bears are Back in Town! Passing Through or Here to Stay?*

Investors snatched $75.5 billion from equity funds in December, the largest outflow for any month…ever. During intra-day trading on Christmas Eve, the S&P 500 officially backed into a bear den, tanking -20% from its record high on September 20th. When trading reopened the day after Christmas markets pulled an about-face evidenced by the largest daily point gain by the Dow (+1,086) in history. Massive pension rebalancing (to the tune of ~$60 billion) flowing from fixed income securities into downtrodden US equities deserves some of the credit. Low trading volume during the holiday season amplified the effect.

Abundant algorithm trading programs share blame for exacerbating down trends. It has been estimated that 85% of all trades emanate from computer implemented formulas. We saw a glimpse of the havoc they can wreck as mass "robo" transactions generated a few memorable flash crashes during the last decade. This new reality will magnify the impact of a large-scale exodus when declining prices trigger indiscriminate sell signals.

We may recognize 2017 as the last year in an era reigned by stimulus and marked by complacent financial markets. In fact, at an average of 16.6 in 2018, the VIX (measure of volatility or "the fear index") is now in line with historical averages. Many investors have never experienced "normal" levels of volatility and were startled by 2018 tempests. It is the VIX's dramatic surge from 2017's tame 11.1 that has rattled cages and raised concerns that the bull cycle is finally over. On the other hand, perhaps optimists are just taking a well-deserved breather. It should come as no surprise that after 10-years of more or less consistent appreciation many people decided to take profits off the table. We have done our share of this as indexes reached historic peaks.

Needless to say, US equity market advances during Qtrs 2 and 3 evaporated in the 4th. At the end of 2018 Large Cap US stocks were down -4.38% while Mid & Small Caps both sluffed off around -11%. Tech heavy NASDAQ held up

## Selected Benchmark and Category Average Returns

### Large Cap Equity

| Benchmark Indx & Category Average* | 4th Q 2018 (Total Return) | 12 Mos. |
|---|---|---|
| *S&P 500 Growth* | -14.71 | -0.01 |
| *Large Cap Gr Avg* | -15.50 | -1.68 |
| *S&P 500 Value* | -12.04 | -8.95 |
| *Large Cap Val Avg* | -12.71 | -9.12 |
| *S&P 500 Index* | -13.52 | -4.38 |
| *Large Cap Blnd Avg* | -13.81 | -6.86 |

### Mid Cap Equity

| Benchmark Indx & Category Average* | 4th Q 2018 (Total Return) | 12 Mos. |
|---|---|---|
| *S&P MC 400 Growth* | -17.63 | -10.34 |
| *Mid Cap Gr Avg* | -17.33 | -5.07 |
| *S&P MC 400 Value* | -16.89 | -11.88 |
| *Mid Cap Val Avg* | -16.65 | -14.47 |
| *S & P 400 Index* | -17.28 | -11.08 |
| *Mid Cap Blnd Avg* | -16.44 | -12.34 |

### Small Cap Equity

| Benchmark Indx & Category Average* | 4th Q 2018 (Total Return) | 12 Mos. |
|---|---|---|
| *Russell 2000 Growth* | -21.65 | -9.31 |
| *Small Cap Gr Avg* | -20.85 | -6.19 |
| *Russell 2000 Value* | -18.67 | -12.86 |
| *Small Cap Val Avg* | -19.49 | -16.36 |
| *Russell 2000* | -20.20 | -11.01 |
| *Small Cap Blnd Avg* | -19.50 | -13.41 |

### International Equity

| Benchmark Indx & Category Average* | 4th Q 2018 (Total Return) | 12 Mos. |
|---|---|---|
| *MSCI EAFE* | -12.86 | -16.14 |
| *Intl Equity Avg* | -13.93 | -15.97 |

* **Category average** calculated using *Morningstar Direct*. Fund universe screened to include funds that meet the following criteria:

- **A.** M-Star Category consistent with designated asset class and management style.
- **B.** M-Star Style Box consistent with designated management style.
- **C.** Fund's Objective consistent with asset class.
- **D.** Excludes Index Funds.

We have not independently verified *Morningstar* data.

**_4th Quarter Equity Market Results_**

| | 4th Qtr. % Chg. | 12-mo. % Chg. |
|---|---|---|
| S&P 500 | -13.52 | -4.38 |
| S&P 400 | -17.28 | -11.08 |
| Nasdaq | -17.29 | -2.84 |
| Russ 2000 | -20.20 | -11.01 |
| MSCI EAFE | -12.86 | -16.14 |
| MSCI Emg MMkt | -7.47 | -14.58 |

fairly well, down -2.84%. Health care, often a refuge amid turbulence, was the S&P 500's top sector in 2018, up 6.29%. Industrials, Financials, Materials and Energy suffered losses ranging from -13.08% to -18.1%. Developed Foreign and Emerging Markets, more or less break-even after the 3rd Qtr, ended up plunging -16.14% and -14.58%, respectively. Preference for Growth over Value stocks continued in 2018 and was most pronounced in the Large Cap space where Growth outpaced by nearly 9%.

Oil markets whipsawed after reaching 4-year highs in early October. Increased output and hints of slowing global growth sent prices tumbling in the 4th quarter. Brent crude finished the year down -20% while West Texas Intermediate (WTI) lost -25%. OPEC agreed to curtail production by 1.2 million barrels/day at the beginning of 2019. It is hard to imagine that producers can respond as nimbly as the spot markets suggest, but in the words of Neal Dingmann, an oil equity analyst, "…the cure for low prices in the U.S. is low prices." There is evidence that a number of companies are putting brakes on the pumps.

Currency markets were on the move in 2018, most notably the US Dollar Index ramped up 4.29%. Not necessarily a welcome outcome. Foreign countries, especially lesser developed net importers, are paying a higher premium for US dollar denominated exports and debt. US multinationals with foreign currency earnings take an exchange rate hit not to mention competitive pressures and prospects for declining sales of price sensitive goods. If the Fed continues to raise rates the dollar could become even more attractive, and heightened demand for US debt always seems to shadow volatile stock markets and uncertainty. If other central banks embark on a similar path and trade tensions subside the dollar could lose some of its allure - without a complete meltdown in US financial conditions.

The Fed raised base line rates by another quarter point to 2.5% in December citing strong economic activity/household spending and low unemployment. Following the meeting, Fed Chairman Powell projected 2 rate hikes in 2019. Equity investors objected strongly - strange in view of the fact that this move was widely anticipated. They may have been motivated by other irritants. Chairman Powell subsequently refined his statement indicating a "wait-and-see" approach. Speculators in Fed funds futures are betting there will be no rate increases during 2019 and possibly a cut in 2020. If investors really believe disaster lurks behind higher interest rates, they should find comfort in this.

US bond yields moved up across the board in 2018. Mounting demand put a lid on safe-haven Treasury yields, and the spread between US Government and corporates widened. The 1-5 Year US Treasury Index closed ahead by 1.53% while the Aggregate Bond benchmark barely broke even (0.01%), a manifestation of the Q4 flight to safety. Increases in yields on longer-term securities did not keep pace with shorter maturity dates. The curve continued to flatten finishing the year with a mere .19% difference between 2 and 10-year Treasury yields, and it inverted between 2 and 5 years during the 4th quarter. Consider the following before the fearsome inversion sends us into hibernation: 1) flattening is common during rate hike cycles, 2) this time around the curve is emerging from a shape distorted by years of quantitative easing – its predictive powers are questionable, and 3) growth rates are expected to subside but there are other factors suggesting recession is avoidable.

December was a solid month for US workers – adding 312,000 new jobs - well ahead of forecasts. Unemployment ticked up slightly but as a result of increased labor force participation, currently at a 5-year high. Wage growth is also on the rise. It hasn't leaked into inflation statistics yet but is poised to pinch future profits. US corporate earnings projections declined steadily during the quarter. Analysts overestimate on average by 5% at the beginning of a year, but an earnings recession (2 consecutive declines in S&P 500 earnings) is not implausible – whether or not an economic recession materializes. The shot in the arm from corporate tax cuts has dissipated. Lower oil prices will depress Energy sector earnings even if the move is ultimately sourced to oversupply and not an accurate prediction of lethargic economic activity. As previously noted, strong dollars weaken results for multinationals, and they face a double whammy as Europe teeters on the brink of recession, China skids and tariffs kick in.

The trade war between the US and China has started to hit home. While still a healthy and profitable enterprise, Apple pointed a finger at shrinking iPhone sales in China when it announced a decline in first quarter revenue estimates. Yet robust by historical standards, December's ISM manufacturing data declined to the lowest level in over two years. Capital spending plans took a huge nose dive during Q3 as CEO's paused to ponder uncertainty. As of this writing, US and Chinese officials may be negotiating a deal that will give many cause for a deep sigh of relief.

A resolution to the China standoff could be far reaching but may not be enough to rescue the Eurozone. After turning the corner in 2015, recovery appears to have been short-lived. Italy's budget woes, no progress on Brexit and more recently France's efforts to placate "yellow vesters" dominate headlines, but a persistent deceleration in consumer spending across the biggest economies has had the most depressing impact. Spain is the bright spot in terms of actual productivity but shares gloomy business sentiments with the rest of the zone. Europe is having trouble absorbing its own output much less that of its trading partners. Unemployment remains rampant - except in Germany where low paid part timers pad the statistics. Government policies may further jeopardize the region's financial health. The EU's limit on budget deficits constrains fiscal stimulants, and the ECB has announced its intention to stop adding to its balance sheet and begin the process of raising rates. President Draghi emphasized reliance on sound economic judgement not an arbitrary schedule, however, he will be retiring next year and a replacement may lack his acuity and negotiating skills.

The last few weeks have been uncomfortable, but we can't in good conscience recommend selling out. We acknowledge there is a risk of continued and more dramatic retraction, but we are confident in the resiliency of financial markets longer-term. In recent years we have selectively skimmed extraordinary (and admittedly unsustainable) profits from equities in situations where it is appropriate to enhance conservative portfolio components. This isn't market timing – but rather an effort to take advantage of opportunities to lock in respectable returns when time horizon is limited, regardless of the potential for continued upside. The past few months, while ugly, have far from wiped out gains achieved over the past decade. Those who cannot or are not willing to bear risk can still capture admirable performance. Major US equity indices are up 12% to 13.7%, annualized, for the ten years ended 12/31/18. Growth style specific US indices have delivered from 14.86% to 15.29% over the same period. International equities have struggled with economic challenges and conversion into strengthening dollars but are still positive at 6.32% (Developed) and 8.02% (Emerging), annualized. The chart below helps put experience following the 2008 financial crisis into perspective.

We don't want to underplay the dangers but there are plausible scenarios in which economic growth and investor confidence are revived. US legislators can put the government back in business – sooner than later. Instead of arguing about a wall, Congress could finance a variety of infrastructure projects while interest rates remain historically low. The Fed may make good on promises to act cautiously. Maybe we will cut a trade deal with China - an economy upon which much of the world's prosperity depends. Investors should embrace higher levels of volatility instead of panicking. Corrections are healthy. The S&P 500 forward price to earnings multiple rests at 14.4, down from 20 early last year. The Developed Foreign equity index forward PE multiple is around 11.5. 20-year averages are 15.8 and 14.2, respectively. Bargain hunters may be rewarded even if growth rates cool down for a while.