TRADITION CAPITAL MANAGEMENT, LLC

January 2019

Economic & Market Commentary

Investors got a big lump of coal in their stockings this Christmas. For equity investors, the decline in prices that started the first week of October reached a crescendo on December 24th, when the Dow Jones Industrial Average suffered the worst Christmas Eve decline in its history, with the Average declining more than 1300 points (5.8%) and other equity measures following suit. With that decline, stocks reached close to a “bear market” level (most define this as a decline of 20% from peak to trough). And it wasn’t just stocks, many commodities followed a similar path. Crude oil, for example, was above $75 a barrel in October and by Christmas Eve it was below $43. After licking their wounds over the holiday, investors were presented another surprise the next trading day, as the Dow rocketed 1000 plus points the other way, for a gain of 5%. This was enough to make even the Grinch happy.

After all this volatility, the S&P 500 index produced a negative total return of 13.5% for the quarter and negative 4.3% for the year. It was the worst year for stocks since 2008, and the first negative year in a decade. Bonds spent most of the year in negative territory, as interest rates rose in response to a robust U.S. economy and the actions of the Federal Reserve. Rates reversed in the final quarter, as fears of economic slowing took hold. As a result, the full year performance of fixed income was flat to down, depending where investors’ assets were positioned on the yield curve. Volatile sentiment was prevalent across the globe and across virtually all asset classes. Bloomberg issued a chart late in December that showed 93% of asset classes had a negative return in dollar terms for the year to date.

Continuing the pattern that has been in place for some time, equity performance was narrow for both the quarter and full year. Only four of the eleven S&P 500 sectors beat the index for the quarter and the full year. Utilities were the only positive performer for the quarter, while Health Care and Consumer Staples beat the composite, they did so with negative returns. Utilities also ended the year on a positive note, along with the Healthcare and Consumer Discretionary sectors. Once again there was little place for the equity investor to hide. The FAANGs (Facebook, Amazon, Apple, Netflix, Google) plus Microsoft continued to play a prominent role in the market’s performance. For the first nine months, that group of stocks accounted for 66% of the composite’s gain. In the final quarter, that trend reversed, as Technology was particularly hard hit. Those six stocks, on average, were down over 20% each, accentuating the negative return for the index. For the year, however, they had a positive impact on the index (notably Amazon, Netflix and Microsoft). The fourth quarter’s reversal had the added impact of allowing large cap and value stocks to outpace small/mid cap and growth, reversing trends that had been in place for several years.

The investor complacency and lack of concern for risks that has been so prevalent for the past few years changed during the final months of 2018. It has been replaced by a fear of economic

slowing across the globe, and a heightened sensitivity to all risks. The "gray rhinos" (risks we mentioned in previous Commentaries) are coming home to roost, and it has taken a toll. *The Wall Street Journal* recently pointed out that a survey taken by the American Association of Individual Investors reported that roughly 47% of those surveyed believed stocks will decline over the next six months, one of their most bearish readings in years. Both complacency and fear tend to go to extremes and just as investors took complacency to an unwarranted level earlier, they could now be doing the same with fear.

As we have pointed out in prior outlooks, we have been in a 10 year bull market, and half a generation of investors have not seen the bear. The liquidity supplied by U.S. fiscal and monetary policies over the past decade has clearly provided fuel to raise asset prices over the period. Now that Quantitative Easing has been replaced by Quantitative Tightening, it shouldn't be a surprise that a contraction of liquidity might occur. This is evident in a look at the flow of funds into/out of equity products. The net inflow of funds into ETF's and Index Funds for the first 11 months, while positive, was down 62% and 37% compared to a year ago. Actively managed funds suffered outflows for the third consecutive year. In December alone, investors yanked $76 billion from U.S. Mutual and Exchange Traded Funds – the largest decline in a single month ever, according to Lipper data. Any volatility created by diminished liquidity is, of course, exacerbated by the full blown trend toward passive/algorithmic investing. These strategies are based on computer models that rely on a series of variables to make decisions. Most of the inputs are not related to economic fundamentals, but rather to market and price action. J.P. Morgan estimated that 85% of market trading volume is accounted for in this fashion. Many of these algorithms incorporate the same variables, so directionally they would tend to move in unison. This leads to a situation where the models can "buy high and sell low", as they rebalance their strategies, in some cases at the end of each trading day. This has the definite impact of accentuating market moves – both up and down. These factors have had a large influence on the equity market's recent decline. One positive aspect about this decline is that it has made the overall stock market valuation more reasonable. A few months ago, at its peak, the S&P 500 index was valued at more than 17x forward earnings. The then estimate of forward earnings, we believe, was too high (+10%). Now, even with a more realistic estimate of earnings growth (+5%), the S&P trades at 14x-15x, a more reasonable number.

Any discussion of valuation must take account of a broader view of the fundamental environment we will be facing. We view the U.S. economy as in decent shape. The 3% growth of 2018 will slow. The sugar high of tax cuts will diminish and we should be back in the +2% real GDP growth area. Employment is tight, wages are beginning to accelerate, but inflation remains benign. The problems are across the ocean. The Atlantic countries are faced with slowing economies. Brexit is still far from resolved and probably will lead to recession in the U.K., and the rest of the E.U. is frayed. Across the Pacific, the biggest issue is trade relations

with China. We wrote last time that we were in a tit-for-tat situation and that has not changed. Both of these situations could have spillover on the U.S. A year ago we expected a globally synchronized economic recovery that has clearly become desynchronized. The good news is that the U.S. is more self-contained than most economies, and is better able to withstand the destabilizing impact from others. Our consumer sector (70% of our economy) appears in good shape. Wages are picking up, tax burdens are less, and consumer spending came through the holiday season in robust fashion. Housing and business spending are the soft spots currently in the U.S. economy. Businesses are probably suffering from a lack of clarity on trade policies and are less willing to commit to long-term projects before some resolution. On balance, the data that we look at shows no signs of recession. Most observers have pushed those expectations out to 2020 – 2021. Granted, policy chaos and lack of direction from our legislative leaders is a big unknown. These could cause costly mistakes from Washington or from the broader geopolitical realm. But on balance, we view the underlying economic backdrop as being decent, so this is our base case.

We continue to have confidence in the stocks we have purchased for clients. We think they have significant unrealized value, and have the economic fundamentals to achieve our targets. It is worth saying a few words about two areas in particular: energy and financial. Both sectors have been disappointing underachievers in the past year. The energy companies are strongly impacted by the price of oil (and natural gas), which has declined from the $70/barrel area in October to a current price in the $40/barrel range. Increased U.S. supply has taken the blame for much of that move. In addition, the Iranian sanctions imposed by the U.S. encouraged the Saudis to respond with additional production during the last half of 2018. However, on November 5th, broad-based exemptions to many countries nullified the expected Iranian export cuts, left the world awash in oil and contributed to the price collapse. Declining price should discourage more drilling, so price should return to a more economically justified range ($50+ area), as supply and demand become more balanced. The companies we have invested in have strong reserve positions, tend to be low cost producers, and have strong balance sheets. We think they are deeply undervalued, and expect that to become apparent as we go through the year. Our financial sector holdings have suffered from a flattening of the yield curve (we have discussed this in the past) and economic growth concerns. The response has been price declines of significant magnitude, particularly in the latter half of the year. These stocks are now selling at valuations not seen in many years, both in relation to expected earnings and book value. Our judgement is that prices have been taken to an extreme, and we expect that to be corrected in the coming year. The other risks spelled out earlier clearly have our attention, and we'll be watching them closely as we go forward to determine if further action is warranted.

We enter 2019 with an optimistic point of view, despite the many challenges that exist. We believe the combination of a growing economy, modestly rising corporate earnings, restrained

inflation and meaningfully lower stock valuations should lead to a good year for equity returns. The biggest risks to our outlook would be a recession (which we discussed and don't currently foresee) or a significant policy mistake by the Federal Reserve or the Trump Administration.

Fixed Income

As mentioned earlier, after spending most of 2018 in negative territory, the Bloomberg Barclays Aggregate Bond Index finished the year flat with a .01% total return, after gaining 1.64% in the fourth quarter. The heightened volatility in the equity markets drove investors to seek safety in bonds, which resulted in higher prices and lower yields. Treasury yields for maturities under 1 year rose between 3-31 basis points during the fourth quarter, as the Fed hiked the Federal Funds rate by 25 basis points in December. At the same time, yields for Treasury Notes between 2 - 30 years until maturity fell between 19-44 basis points this quarter, resulting in an even flatter yield curve.

There was also a significant amount of attention focused on the yield curve "inverting" in early December. What occurred is that the 3 year Treasury yield was briefly higher (by 1.4 basis points) than the 5 year Treasury yield on December 3rd and then the 2-year and 5-year Treasury yields also slightly inverted. However, San Francisco Federal Reserve research comparing the 10-year Treasury yield to the 1-year Treasury yield has shown the most predicative ability in forecasting recessions, so it is important to note that these Treasury yields did not invert in December. The Fed research showed that a negative "term premium," or spread between the 10-year and 1-year Treasury yields preceded all 9 of the recessions since 1955, with only one false positive when only an economic slowdown occurred.

The ongoing tariff trade war, combined with weakness in economic indicators, including existing home sales and homebuilder sentiment, contributed to lower expectations for future economic growth and the decline in longer-term yields. The Federal Reserve is currently forecasting real GDP growth will slow to 2.3% in 2019 from 3.0% in 2018. In addition, investors were highly concerned about the impact on the economy from the number of rate hikes expected from the Federal Reserve, based on Chairman Powell's Oct. 3rd comments that the Federal Funds rate was a "long way from neutral." The "neutral rate" is an estimate of the rate at which the Federal Reserve's policy is neither accommodative nor restrictive and is consistent with maintaining full employment along with price stability. Then, at a meeting towards the end of November, Chairman Powell revised his previous month's statement and expressed that we were approaching the neutral rate, which implied that fewer rate hikes might be needed and provided some temporary relief to the markets.

The Federal Reserve previously projected it would increase the Federal Funds rate target 3-4 times in 2019. We believed that was aggressive, given the low level of inflation which

had fallen back 1.8%, after peaking in July at 2.4% and now is below the Fed's 2% target based on the PCE (Personal Consumption Expenditures) Index. In addition, wage growth has only moderately increased to 3.2%, compared to 2.7% a year ago. At the December Federal Reserve meeting, Chairman Powell revised down the rate hike forecast to 1-2 times in 2019. The takeaway is that further rate increases may occur next year, but they will be at a slower pace and a lower number of hikes than previously thought. The Fed Funds futures market remains highly skeptical that the Fed will raise rates at all in 2019 and even projects a 30% probability of a rate cut by January 2020.

With the extremely flat yield curve, particularly in the short-to-intermediate part of the curve, it makes sense to keep maturities on the shorter part of the curve, because investors do not gain much in yield by buying longer maturities. Although interest rates have fallen from the September 2018 peaks, our client portfolios remain positioned in the shorter part of the curve, particularly with the Fed projecting a couple of further rate increases in 2019, as well as expected record issuance of new Treasury securities, both of which could push yields higher.