DANN ASSET ADVISORS, LLC

Fourth Quarter 2018 Update
January 11, 2019

4Q18 Highlights
- U.S. stocks decline the most since 3Q11 even with a late December bounce
- Interest rates also fall with the spread between long and short dated bonds narrowing slightly
- Stock, bond and many commodity prices seem to be signaling a weakening economy
- Concerns over trade, White House turmoil and the government shutdown added uncertainty
- Despite all these issues economic growth seems to have remained decent through year end

The table below summarizes the performance of some key indices during the fourth quarter and for the full year:

Market Performance		
Index	% Ch. 4Q18	% Ch. 2018
S&P 500	-13.5	-4.4
MSCI Developed Markets (excl US)	-12.5	-13.8
MSCI Emerging Markets	-7.5	-14.6
MSCI All Country World	-12.8	-9.4
US Aggregate Bond (1)	1.6	0.0
Liquid High Yield (1)	-4.2	-1.5
US Dollar Emerging Markets Bond (1)	-1.6	-5.2

(1) Barclays indices

Equities. After a robust first three quarters, U.S. stocks had a miserable fourth quarter with the S&P 500 index (large company stocks) returning a negative 13.5%. Volatility was high, especially in late December, with the S&P declining 7.7% in the four trading days leading up to Christmas and then rebounding 6.7% through year end. According to a December 25 Wall Street Journal article, at least some of the volatility was due to increased computerized program trading. Year-end rebalancing of portfolios also may have had an impact. Volatility has continued into 2019.

The S&P 500's full year return of -4.4% is a small setback in the context of the bull market that began in 2009. However, as it did for much of 2018, we believe the performance of the S&P 500 masked a substantially more difficult year for the broader market. For example, within the large company sector, value stocks (as measured by the Russell 1000 Value index) had a tougher year, falling 8.4%. Small company stocks had an even worse year, with the Russell 2000 index declining 12.2%. Even though they fell in the fourth quarter, large company growth stocks saved the market from a more significant decline, with the Russell 1000 Growth index down only 1.7% for the year (although growth lagged value in the fourth quarter as technology stocks were particularly hard hit after a strong first nine months).

As indicated in the table, international stocks had an especially bad year. Many investors began 2018 believing that international economies, as a whole, were in good shape. However, as the year progressed economic growth disappointed (the German and Japanese economies both contracted in the third quarter) and markets fell. Negative sentiment around Brexit, Italian budgets and U.S. trade policies all likely hurt markets. And while headline GDP still seems in line with government targets, the Chinese economy clearly has slowed as indicated by falling auto sales throughout 2018 and a recent decline in the purchasing managers index.

Fixed income. The 10 year Treasury yield hit a high of 3.25% in early October but declined significantly to 2.67% at year end. The two year note also declined, from a high of 2.97% in November to 2.50% at December 31. The 10 year and two year had begun 2018 at 2.41% and 1.89%, respectively, and the spread between the two narrowed from 52 basis points to 17 basis points (a basis point is 1/100 of a percent) over the course of the year. A negative spread is a usually reliable indicator of a coming recession; however, the spread remains positive and there can be a considerable lag between the onset of a negative spread and a recession.

With the rise in rates in 2018, the Barclays U.S. Aggregate Bond index (benchmark for U.S. investment grade bonds) generated a flat return for the year. More aggressive sectors of the bond market sold off in the fourth quarter as investors moved away from riskier assets, with the result that high yield and emerging markets bonds generated negative returns for the full year.

Market sectors. Utilities, with a less than 1% gain, were the only positive sector in the fourth quarter. Consumer staples and REITs were the next "less-bad" sectors, with declines in the mid single digits range. Utilities and staples generally are considered safer, more stable businesses that investors turn to when the market is volatile. Each of these three sectors also tends to do better when interest rates are falling (as they did during the fourth quarter) as their higher than market dividend yields become relatively more attractive. For the year, healthcare was the strongest sector with a mid single digits gain.

The fourth quarter's worst performing sectors were energy, industrials and technology, economically sensitive sectors that potentially are reflecting an upcoming softening in the economy. Of note, the price of oil fell nearly 40% in the quarter. Likely reflecting this decline, energy was also the worst performing sector for the year.

Portfolio Positioning

We made no material changes in fixed income during the fourth quarter and continue to be positioned most heavily in short duration (which we define as three years or less), investment grade funds. These are supplemented with modest exposure to more aggressive funds – also mostly short duration. On equities, for many clients during the quarter we sold a mutual fund focused on small-mid cap stocks. Similar to an international fund sold in the third quarter, we were concerned about this fund's allocation to economically sensitive sectors that could suffer if the economy slows significantly.

2019 stock market outlook. In our 2018 stock market outlook, we stated "… our guess is that the market is up at most mid single digits in 2018. We wouldn't be surprised to see it down for the year, and would be most surprised to see it up another 10% or more. In other words, looking out for the next year only, we see more downside than upside potential." After a volatile year, the end result was that our 2018 prediction was reasonably on target.

2019 already has started out interesting. As always, we have no better idea than anyone else what will happen. But among key issues with a likely direct impact on the market are, in our opinion: the strength of the U.S. and other large economies; corporate earnings; interest rates and Fed policies; and trade issues with China and others. Other issues that we view as important that may have an indirect impact include: the Mueller investigation and what we believe is a significant near and longer-term issue – the lack of political compromise on difficult issues in many developed nations. The U.K. (Brexit), France, Italy and even the U.S. are examples, in our opinion, of this increasing political dysfunction. Markets generally dislike uncertainty and if this dysfunction continues it could act as a longer-term cap on valuations.

Moving back to the more immediate, at December 31, 2018 the S&P 500 was trading at 14.4x 2019 consensus estimated earnings (per Yardeni Research). Based on historical multiples, this is a reasonable valuation, and compares with 17.3x at December 31, 2017. 2018 earnings came in higher than initially estimated, and we believe that's the primary reason the market was strong through the first three quarters of the year. Given tight labor markets, weakening international economies and higher corporate debt levels, we believe earnings are unlikely to increase at the currently forecast 7%-8% rate (Yardeni Research estimate) in 2019.

With a nearly 15% decline from the late September high to the 2018 close, in our opinion the market already has at least partly discounted the risk to earnings growth that we see. With earnings comparisons especially tough over the first three quarters of 2019, we believe it will be difficult for the market to move substantially higher over the first half of the year. In fact, if earnings are worse than currently anticipated, likely the market continues falling near term. However, if the downshift in corporate profits that we anticipate proves short term and moderate, as we currently expect, we believe the market will end 2019 higher than where it began.

As always, we acknowledge that our prediction is nothing more than an educated guess. We'd add that after a prolonged and strong bull market through the third quarter of 2018, we'd expect and be content with a modest downturn over a period of a year or so … "modest" and "a year" being key words. Finally, we expect fourth quarter earnings (to be reported beginning mid-January into February) to have a potentially significant near-term impact on stocks as investors respond to managements' outlooks for 2019 earnings.

Economy

U.S. GDP grew 3.4% in the third quarter, a deceleration from the robust and unsustainable 4.2% pace of the second quarter. Consumer spending expanded a still strong 3.5% in the third quarter, but inventory building contributed nearly two thirds of the quarter's growth and this likely will have a restraining impact on the fourth quarter. Fourth quarter GDP will be reported in the next couple of weeks and is expected to grow 2.0%-2.5% according to a recent Wall Street Journal survey of economists.

Concurrent with its mid-December meeting the Fed indicated that it expected to raise rates two times in 2019, with the economy anticipated to grow 2.3% and inflation to remain near the its 2% target. However, Chairman Powell clearly stated that the Fed was not on a preset course to raise rates and would adjust its actions depending on economic data … "[a]ctual policy will, as always, be adjusted as incoming data shed light on the state of the economy, the outlook, and the changing balance of risks." Mr. Powell reiterated the Fed's commitment to a flexible approach on January 4 during a public panel with former Fed chairs.

In October in our third quarter update we mentioned the possibility that the economy might slow, stating that, "[t]his possibility is not yet, in our opinion, reflected in economic numbers. Rather, we see the possibility of a slowing in the performance of certain sectors in the stock market. For example, the stocks of consumer discretionary companies (autos, homebuilders, RV manufacturers, jewelers, etc.) have been relatively weak over the past month or more. The stock market certainly is not always right, especially over short timeframes, but the performance of these types of stocks may be foreshadowing a slowdown in consumer spending."

Since October other cyclical sectors such as industrials, materials and financials also have declined significantly. As stated in the market outlook section, we believe management commentary with upcoming fourth quarter earnings will be helpful in getting a better read on the economy. While it's not a forward-looking number, we note that the December employment report was very strong, indicating that the U.S. economy ended 2018 on solid ground. However, recent downward earnings guidance from Fed Ex and Apple over the past month seems to confirm that international economies have slowed. The interplay of relative economic strength in the U.S. and weakness internationally will be an issue to watch in 2019.