2019 OUTLOOK - GROWING, BUT SLOWING

To help understand where we're going, we always study the past. 2018 was a year characterized by stress and volatility. In many ways, it was the complete opposite of 2017. That didn't mean there wasn't stress in 2017; there was. But the Market ignored growing risks that year, both politically and geopolitically, as the Stock Market experienced unabated growth. That came to a crashing end in 2018, however the declines came after an unusually strong January.

JANUARY BAROMETER BROKE

You've probably heard the adage, "as goes January, so goes the year." It's called the January Barometer, and it has a fairly high success rate. It didn't work last year though. With a 5% increase, 2018 brought the strongest January for the S&P since 1987. Throughout history, the S&P has jumped 5% to start the year 13 times now. Previously, when the S&P 500 increased by 5%+ in January, the full year had never finished lower. It was 12 for 12. That includes 1987, which you may recall saw a massive one-day sell-off in October. Now it's 12 for 13. With the 6% decline for the S&P last year, the perfect record is over. It doesn't end there.

EXTREME VOLATILITY

2018 was a year of extremes, with highs and lows. Growth in corporate earnings and the US economy accelerated. 2018 stood out for a number of extremes in Stock Market history. The headlines gave you whiplash. There were 19 new, all-time highs in 2018. 14 of them came in January. There were 17 trading days in 2018 which saw a whopping 2% move. There were zero in 2017. The year started with a 5% gain and finished with a 5% decline. 2018 was the worst December for the Stock Market since the Great Depression. The worst Christmas Eve on Wall Street was followed by the first ever 1,000-point gain on the DOW. There were 2 separate 10%+

corrections, with a near 20% sell-off from the September highs to the December lows. The volatile price action has been gut-wrenching.

Investor sentiment saw extremes as well, with the most Bullish readings of this 9-year cycle at the highs in January then plummeting to the most Bearish readings in December, at the lows. Investor sentiment is a contrarian indicator. Emotions are generally strongest at extremes. Wall Street is the only market where 20% sales drive buyers away. If Amazon or Macy's slashed prices by 20%, buyers would stampede in with open wallets. The Black Friday shopping is evidence of that, which brought record numbers for the holidays. The fact is, selling on Wall Street has always spooked investors. The problem is, the selling was extreme to close out 2018.

To be clear, this has been crisis-like price action. But we still don't think this is a crisis period anything like the Great Recession or the Great Depression. Not even close. We do believe this is a Bear Market. We've said it many times, Bear Market rallies can be some of the most powerful. The 1,000-point DOW day is an example. We can see a continuation of this type of price action in the first half of the year. We still believe we are in a longer-term, secular Bull Market. Bearish cycles are just part of the process. They're also not fun.

SO WHERE DO WE GO FROM HERE?

Growth is clearly slowing. There are some new signs that recession could be on the horizon for the US. Things change quickly. Growth seems to be slowing faster than previously thought. The US economy is still expected to grow 2% this year. This would be solid growth, which would sustain our economy. But it's nothing to get excited about either. Circumstances are more challenged overseas. The larger International economies like Europe and Japan have been facing larger recessionary pressures. China, the second largest global economy, continues to see its growth rate shrink and experience economic contraction in certain areas. Trade tensions have certainly played a role in the slowdown.

With the Consumer representing 70% of US economic activity, Americans need confidence to continue spending. Providing some confidence here were really strong retail numbers reported for December. Despite the massive Market sell-off, the American consumer kept spending for the holidays. Retail sales grew at the highest rate in 6 years. That's a very key sign.

STILL ABOUT THE FED

The secular Bull Market was born in 2009 after the Federal Reserve basically backstopped the financial system from complete collapse. Its series of quantitative easing programs increased the money supply and injected substantial liquidity into the system. Interest rates fell, sending money into higher-risk assets, namely stocks. It worked. For 9+ years the US Stock Market made a historic run, outdistancing all others around the world. Sure, there were corrective periods along the way. That's part of the deal and it's a healthy process. Those corrections addressed the excesses and created a buying opportunity for the resumption of the Bullish uptrend.

This trend reversed last year. Every oversold bounce since October was sold. At first, the rally would last a couple of weeks. Then it switched to a couple of days. In some cases, rallies were only a matter of hours before being knocked back down. This was certainly the case around the final Fed meeting. Fortunately, the year ended with some selling reprieve and recovery is in its early stages.

A major issue in our minds is the Fed's quantitative tightening program underway. It is the process of unwinding the quantitative easing. In 2007, the Fed had less than $900 Billion on its balance sheet. 10 years later, it had ballooned to $4.5 Trillion. The process of unwinding has been well telegraphed, but its impact was unknown. It's the right thing to do. The problem is, this has never been done before. The Fed has let nearly $500 Billion roll off its balance sheet in over a year, mostly in the form of $50 Billion per month. They have not sold securities. They just didn't reinvest the proceeds from maturities, which has taken money out of the money supply. The biggest issue so far has been reduced liquidity which has exacerbated Market volatility.

INTEREST RATES, THE DOLLAR AND BONDS

Previously, the Fed forecast 3 more interest rate increases in 2019. At the December meeting, they guided closer to 2. At this stage, we aren't sure there will be even one rate hike this year. We believe the slowing growth at home and overseas, combined with Market turbulence, will lead to the Fed putting on a semi-permanent pause this year. This should reverse the strong Dollar trend, which would be an added boost to American assets. It would also enhance Corporate American revenues overseas.

Interest rates have fallen in the credit markets, which has flattened the yield curve to inversion in some measures. We see the US economy continuing to grow, but at a much slower pace. Inflation is tame, which will allow the Fed to take its foot off the brakes a bit. This should also provide a nice backdrop for the Bond Market for the first half of the year. We have been buyers of Bonds the last few months and still like them for predictable cash flows and defined maturities.

DEBT IS A 4-LETTER WORD

Low-interest rates mean cheap money. That was the case for years since the Financial Crisis. Borrowing was the theme. Governments borrowed to stimulate markets and their economies. Companies borrowed to invest in their businesses and buy back stock. People borrowed to buy assets and live their desired lifestyles. It can't last forever. The world has never had as much debt as it does right now. That number is over $250 Trillion. The United States, China, Europe and Japan account for 2/3 of global household debt, 3/4 of corporate debt and over 80% of government debt. China has perhaps the greatest credit risk. China's debt to GDP ratio is nearly 250%. The US is in relatively decent shape in comparison but still has debt obligations over 100% of GDP.

The issue of deficits and debt has been around for years and keeps getting kicked down the road. At some point, it's really going to matter. US Federal debt just cleared $20 Trillion for the first time. The US deficit was over $800 Billion last year. It's less than it was at its peak of over $1 Trillion a decade ago during the Financial Crisis, but it's still historically high. Servicing the debt has gotten more expensive with higher interest rates. Social Security and Medicare are running at unsustainable rates. How it's best addressed is hotly debated. The Market is going to run out of patience. The road will come to an end eventually. This clearly has our attention.

CHINA AND THE TRADE WAR

Where this is headed is anyone's guess. Will there be a deal with China, or will this be a long-lasting Cold War? Our sense is a deal gets done in 2019. Both nations are experiencing economic challenges and both Presidents need a win. China reported economic contraction for the first time in years and Apple just announced Chinese demand came to a screeching halt in November. The 2 largest economies in the world have been in a standoff, and the global economy is suffering because of it. Nobody wins in a trade war. The US had been in a stronger position for negotiations last year. That position of strength has eroded of late. The Market continues to make that clear.

It seems likely that an agreement will be formed, in which both sides declare victory. However, the issues are so complicated and critical to each nation's economic future. Protecting trade secrets and intellectual property is a must. American companies are basically competing with the Chinese government. A Cold War seems evident and its continuation inevitable considering the desire to dominate the Digital Age. Investment and supply chains will continue to move away from China and into other emerging market nations in Asia and beyond. Our sense is trade tensions with China will last far beyond 2019.

INTERNATIONAL MARKETS

We're also seeing further developments in Emerging Markets and Mature Markets. Populations are younger and growing in Africa, the Middle East and parts of Asia. Demographics are much older in the US, Europe, China and Japan. Despite the fact that China is the second largest economy in the world, it is still referred to as an emerging market. The Chinese Consumer continues to emerge, 1 Billion plus of them. Emerging Market consumers are experiencing new wealth and higher protein diets, but still earn far less than the Western World. Most consumers in Singapore, India and South Africa are growing up in the Digital Age but cannot afford a $1,000 phone or a $50K car. Companies continue to learn how best to participate in these markets. The opportunities are massive, but the circumstances are quite different from the West.

Global norms continue to change. Nationalism and protectionism are the driving themes today. Europe is less unified while the British attempt to leave the Union. The rallying cry of "America First" has sent shockwaves through Global Markets. Money has poured into the Dollar driving its value up and reducing the attractiveness of American products and assets. This theme is likely to continue well into the new year.

Global trade has never been free, and its fairness has long been an issue. The trade war is addressing some of these critical issues, which ultimately is a good thing. But the process is both bumpy and messy and is challenging the global financial

system. We don't see resolution on the horizon, but a path seems to be getting carved out. However, Emerging Markets are the cheapest they've been in over a decade, and a weakening US Dollar could send these stocks higher, particularly with a resolution to the war on trade.

EARNINGS DRIVE STOCK PRICES

Growth accelerated last year. Corporate America was a big beneficiary of the tax cuts, which resulted in a 20% growth for earnings. But it was essentially a one-time benefit. Earnings are expected to continue to grow in 2019 but at a much slower pace. In December, Wall Street analysts cut their earnings forecasts for 2019 on more than half the companies in the S&P 500. That's the first time that had happened in two years, at the end of the earnings recession in 2016. This doesn't come as a surprise. Growth is slowing and the Market sell-off has told us that estimates were too high. Keep in mind, the Street is generally late to cut. This is another contrarian indicator that the lows could be near, but the end of the choppy price action is not. At this stage, stocks seem to already be pricing in slow to no growth for 2019.

TECH, CONSUMER AND HEALTH CARE

Health Care was the best performing sector last year. Tech has been the growth engine for many years. Both have experienced corrections which we believe are buyable, but selectively. Many of these stocks became very expensive with the explosive growth over the years. They are digesting the moves which tend to result in an oversold situation. Biotech has emerged from a 3-year correction after flaming out in 2015. Tech seems to be in the beginning stages of a similar corrective pattern. Companies tied to China and smartphones have been hit harder in light of Apple's lowered guidance. Smartphone innovation is slowing as are replacement cycles. It's a sign of maturity. We do like both Tech and Health Care for investment; we just will be more selective.

As long as the Consumer continues to prove its resilience, we think Consumer stocks are attractive. The Media industry was forced to change in the Digital Age, and leaders are clearly emerging. Selective retail has become compelling, with an emphasis on online spending, big box stores and coffee. Takeover has become a theme again as mature companies continue to seek long-term growth opportunities. We always find it comforting to see companies willing to invest, finding value and thinking long-term.

GOLD

After 7 years of hibernation, the precious metal has awakened. Gold proved once again its allure and safe haven status amidst the Market turbulence. We have patiently maintained a position in Gold as a hedge against potential sell-offs in stocks, inflation, a weak Dollar, and Geopolitical tensions. Our patience paid off in late 2018 and we think Gold will perform even better in 2019.

BIGGER PICTURE INVESTMENT THEMES

Looking past the near-term challenges, we see many bright investment themes for years to come. The innovation in artificial intelligence and automation, renewable energy, cybersecurity and Blockchain is real. Companies that continue to invest in these areas will either secure their success or will be the next Tech Titans. Communication and commerce continue to evolve. The iPhone was a game-changer and is now 11 years old. Smartphones today are like the PC 20 years ago. They're mature and ubiquitous. It's a problem for hardware companies, but innovators always find solutions. The next big things are coming in wearable technology and smart devices tied to the "internet of things." The growth is real and it's investable. We're just looking for more stability before being willing to aggressively invest in growth again.

The DOW and S&P suffered their biggest declines in a decade last year. It is rare to see back-to-back annual losses for the Stock Market. But it's not unheard of. We believe a continued choppy first half of the year will lead to a promising finish to 2019. We believe the secular Bull Market which began in 2009 is still intact, but a Bear Market cycle began last year and has further to go before it's finished. We plan to stay defensive. Bear Market rallies can be powerful though. The DOW spiked over 1,000 points in a day, for the first time ever. It took just 6 hours. For perspective, it took the DOW 76 years to close above 1,000, from 1896 to 1972. History has taught us to be patient but guarded. Our patience is being tested. That's what's required to be an investor.