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Investment Commentary

4th Quarter, 2018

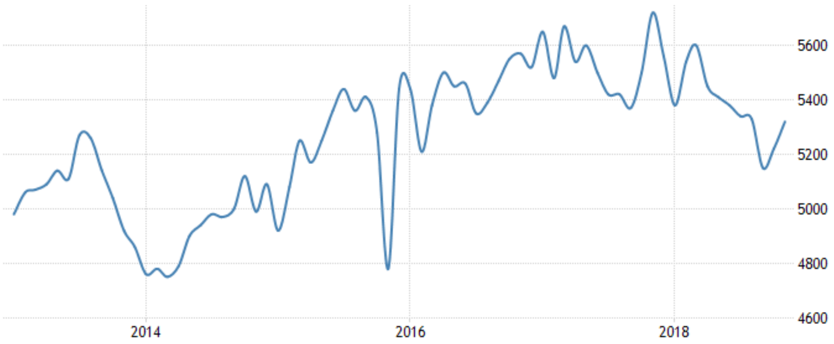
Below you will find our investment commentary for the most recent quarter. We hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call our office to schedule a meeting or conference call.

Economic Review & Outlook

Despite a tumultuous end to 2018 in the financial markets, economists remain optimistic 2019 is unlikely to usher in the first recession in nearly a decade. According to the Wall Street Journal survey of economic forecasts, real GDP is expected to increase by 2.3% in 2019. Not one of the 60 economists surveyed predicted a contraction next year. However, three of those surveyed are expecting a contraction by 2020 and the consensus growth rate drops to 1.7% in 2020. Although this shouldn't sound alarming, it does suggest economic growth is likely to slow over the next couple of years.

While it may feel good to know few economists are forecasting a recession next year, it is worth noting recessions have almost never been predicted in advance. One of the best leading indicators to economic growth is the housing market. The chart to the right shows the sales of existing homes over the past five years. What is most noticeable is the deviation in the upward trend from 2014 through early 2018. As you can see, we last saw a slowdown in the housing market in 2014, which was clearly followed up by renewed buying as everyone who owns a home in the U.S. is well aware. The concern this time is economic conditions have changed significantly since then. At that time interest rates were still in decline and the Federal Reserve was more than willing to keep financial conditions accommodative. We also didn't know it, but we were about to embark on unprecedented tax reform. Fast forward to today and it seems unlikely the Federal Reserve will remain as accommodative, nor do we have positive news likely to come from fiscal policy with control of the government now divided.

U.S. Existing Home Sales



Source: TradingEconomcis.com | National Association of Realtors

David Rosenberg, Chief Economist & Strategist at Gluskin Sheff , is worried the next recession may be closer than many think. In the December 28th Gluskin Sheff Newsletter he notes, "There have been 13 Fed tightening cycles since 1950. Ten of these landed the economy in recession, and neither the consensus nor the Fed staff saw them coming when they actually started. So before knowing anything else, the fact that we have been in the midst of a Fed tightening phase sends recession odds north of 80%. At this point, after a whopping 325 basis points of a de facto rate-hiking cycle (including the effects of QT), the only thing separating the recession call from becoming a reality is the inherent lag between monetary policy actions and the peak impacts on the economy."

Now before you get too concerned about an impending recession, we would like to point out David Rosenberg has a track record of typically being more cautious on the economy than many of his peers. He failed to see the recovery in the early stages of the current expansion before becoming more optimistic a couple years ago. Nevertheless, we find his research to be amongst the best in the business but predicting the future of the economy year-to-year is fraught with peril. Thus, the takeaway for our clients is to simply be prepared for a downturn, which we all know is inevitable at some point.

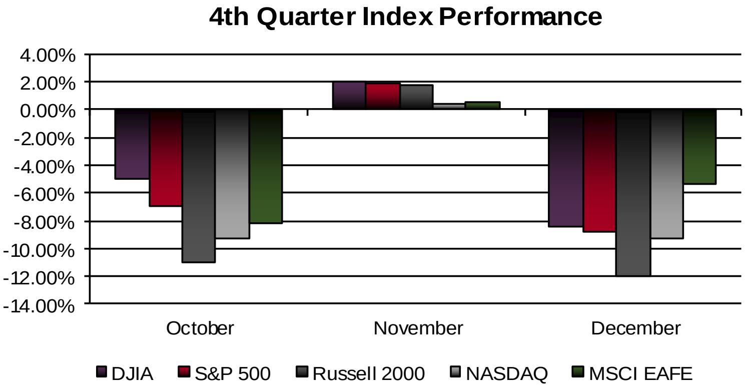
Bond Market Review & Outlook

It may be hard to believe, but bonds performed significantly better than stocks in not only the fourth quarter of 2018, but for the entire year. One of the most common questions investors have asked us over the past couple of years is simply, “Why do we own bonds?” The question is predicated on the fact that stocks have essentially gone up in a straight line for the past couple of years. The longer this continues the more likely an investor is to question the benefits of diversification. Hopefully 2018, especially the fourth quarter, is a reminder as to why bonds serve a crucial role in your portfolio.

The Barclays Aggregate Index delivered a 1.6% return for the quarter. What investors should really take away from this is from the September 20th high in the stock market, this index returned 2% through the end of the year. Over the same period of time the S&P 500 lost 14%. At one point the S&P 500 was off by 20%, which is why having a diversified portfolio is crucial to successful long-term investing. Very few investors are comfortable losing 20% or more of their investment portfolio over the stretch of a couple months. However, these are the inevitable realities of what happens when you invest in the stock market. Only time will tell if this recent downturn is as short lived as the ones in recent memory, or if this is something that will linger with us for the foreseeable future. Your allocation to bonds is what should allow you to handle these downturns without making an emotional decision to “go to cash” no matter how long this lasts.

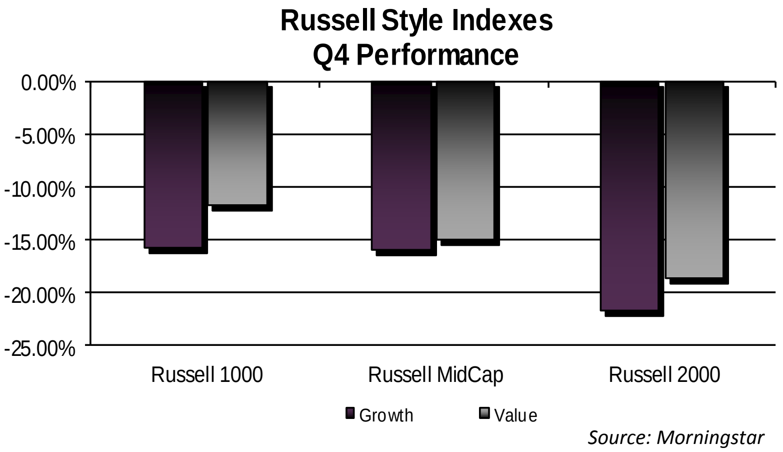
Stock Market Review & Outlook

Stocks definitely did not bring holiday cheer to investors in the fourth quarter. The Dow Jones Industrial Average delivered a loss of 11.3%, while the broad-based large cap S&P 500 index lost 13.5%. Small caps fared poorly as well, losing 20.3%. The technology laden NASDAQ Composite was no place to hide, dropping 17.3%. Although international stocks held up better than most, the broad based MSCI EAFE index lost 12.6%. This was the worst quarterly return for the equity market since 2011. What is most amazing was the speed with which the downturn arrived. The selloff in the fourth quarter is being primarily blamed on the Federal Reserve. Despite increasing pressure from the president, the Fed has raised rates twice since the market peak and have signaled one or two more may be to come next year. Needless to say, investors were not happy with the Federal Reserve’s actions.



Source: Morningstar

Whether the Federal Reserve is justified in raising rates is a topic of deep debate. The Federal Reserve is supposed to be a non-partisan entity that operates autonomously from the government. Their mandate is to maximize employment and maintain price stability. Over the past decade, the Federal Reserve has routinely succumbed to the demands of investors whenever the slightest bit of trouble arises. The actions by the current Federal Reserve serve as a reminder that monetary policy is not intended to always push stock prices higher. By standing their ground in the face of growing political rancor, they are essentially doing their job. Although we may be in the early stages of removing monetary policy as a tailwind to the economy, we think it is a stretch to call the actions by the Federal Reserve irresponsible as some politicians have suggested. Without question the economy has improved over the past couple of years and as a result one should expect interest rates to move higher. Unfortunately, there is no political benefit that comes from higher interest rates, so politicians will always question rate hikes when they are in office. From our view, we believe current monetary policy is appropriate and for the first time since the credit crises ended, the Fed now has some flexibility to make adjustments when the next downturn arrives.



Source: Morningstar

As one would expect during a sharp market decline, value stocks outperformed growth stocks in the fourth quarter across all market capitalizations. However, growth still managed to outperform value by nearly 10% for the year. This continues the trend of growth dominance over the past couple of years. How much longer can growth outperform value, who knows? A very compelling case can be made that value stocks are more attractively priced and if stocks have entered a period of lackluster returns, value stocks should perform better. With perfect hindsight, we will know this time next year whether or not that statement is true. Unfortunately, since we don't have a crystal ball our advice is to maintain proper balance between both growth and value stocks. To be sure, there is a period ahead of us where value stocks will significantly outperform growth stocks but identifying this in advance with any level of confidence is impossible. Thus, stick to your current asset allocation and remember that time is always your friend when it comes to investing.

As we close out 2018 and look forward to 2019, investors are understandably nervous. We have already highlighted many of the concerns facing investors next year, so being prepared for heightened volatility will be the key to maintaining a level head when it comes to your investments. With that said, there are some potential positives to look forward to. First, stocks are getting cheaper due to a combination of falling stock prices and rising earnings. This is a potent combination if in fact the next recession is still in the distant future. One of the most widely used valuation metrics is the Shiller PE Ratio. It uses 10 years of earnings data to try and "smooth" out bull and bear market extremes. Currently this resides at 28, which is still above its historical average of 25 over the last 30 years, but this doesn't tell the whole story. As 2019 progresses, the catastrophic drop in earnings from 2008 will begin to roll off this metric, thereby putting significant downward pressure on it as much higher earnings from 2018 and 2019 are used to replace the trough earnings of 2008 and 2009. If stocks continue to fall, this will put even further downward pressure on the ratio, likely resulting in a more attractively priced market in a relatively short period of time. You also have history on your side. According to S&P Capital IQ, since World War II, the S&P 500 has never suffered a loss during the third year of a presidential cycle. So needless to say, it isn't all doom and gloom despite what the headlines may lead you to believe.

One of Warren Buffet's most iconic and memorable quotes is, "Be fearful when others are greedy and greedy when others are fearful". It is safe to say the last couple of years has seen its fair share of greed when it comes to investor expectations. We may be moving to the flip side of this, so can you heed the advice of one of the greatest investors to ever live? Good luck!!

Sincerely yours,

McGill Advisors

Wealth Management Team
McGill Advisors

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