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Q4 2018 Commentary: The Fed Pivots

What do you follow up the best quarter in five years with in the fourth quarter? The worst quarterly performance since 2011. Yes, volatility is back. The S&P 500 gave back all the gains of the first nine months and then some in the fourth quarter resulting in a 4.4% decline for the year. The large cap index fell 14.0% in the quarter. For all of 2018, there were very few financial markets that performed well. International stocks fell. Emerging market stocks fell. Bonds dropped. Commodities collapsed late in the year. With a rather dramatic six months in the rear-view mirror, most forecasters seem to expect more of the same in the next six months. While stock market volatility is likely to persist, we view the current situation quite favorably and an environment in which we expect your portfolio to do well.

There is some concern regarding economic growth in 2019, however the most probable outcome is for continued, but slower growth. The key for the stock market lies with inflation. As long as inflation remains near the Federal Reserve's target of 2.0%, the Fed and can act to promote economic growth and full employment. At this point, there are no signs of inflationary pressure building despite the long expansion. Economies around the world are slowing. The German economy contracted in the 3rd quarter and does not look to have improved in the 4th quarter. The rest of Europe will follow Germany's slowing path and the UK has serious Brexit issues. China's growth in 2018 slowed to its slowest pace in three decades. In the face of the slowing global economy, demand for commodities has fallen and their prices along with them. Tumbling commodity prices is no better exemplified than the price of oil falling from $75 to below $50 in the 4th quarter.

Absent inflation concerns, the Fed and its international counterparts have no need to continue raising interest rates. Fed chairman Powell indicated in December that the Fed is likely to stand pat if current conditions persist. Chinese authorities are already taking steps to strengthen their economy and the European Central Bank have essentially ruled out any rate hikes until 2020. This situation means that investors no longer need to fight the Fed and that monetary tightening will not pose a threat to the economic expansion continuing.

A potential benefit of the slowdown is the impact on various US trade negotiations. As economies weaken, the pressure will build on both to strike a trade deal. In the meantime, it is reasonable to expect further volatility due to the rise in geopolitical uncertainty. Since the Berlin wall came down marking the end of the cold war in 1991, we have been conditioned to practically ignore politics in investment deliberations. However, events of the past year have had an impact on the stock market. Trade wars are impacting economies and shifting policies are raising uncertainty which leads to a lower price that investors are willing to pay for earnings. The price to earnings multiple on the S&P 500 contracted significantly in the past year and now stands at 15X. Last year was one of adjusting to a new paradigm that had a negative impact on stock prices. At this point the adjustment appears to be substantially complete and political risks seem to be already reflected in the market. Despite slowing growth, the economy is still doing well. Investment sentiment appears as half full or half empty depending on your perspective. In recent months, investors embraced a half empty view. We are comfortable with investment prospects and finding attractively priced stocks. We view the investment landscape as a glass half full and feel that in time most will join us in our view.