CWM Fourth Quarter 2018 Investment Commentary

The year 2018 told the tale of two very distinct markets.

Firstly, because of the federal tax law changes enacted in late 2017, the U.S. economy experienced a meaningful re-acceleration of growth during the first half of this year. ISM manufacturing data registered a reading above 60 for the first time since 2010. Real GDP growth reached +4.2% in the second quarter of 2018. An already very tight labor market became even tighter. The unemployment rate fell to just 3.7% and hourly wage gains approached +3% by the fourth quarter. Credit markets remained open and credit defaults remained very low. Corporate earnings soared +20% YoY, a portion due to the tax law changes but mostly driven by organic revenue growth being translated into earnings growth. Despite some volatile moments earlier in the year, by September 2018 the market had reached new highs.

Those solid fundamentals slowed marginally during the fourth quarter of 2018, but the biggest change in the markets was that volatility showed up and stayed for the entire fourth quarter. The believed sources of this volatility comprise quite a list: Brexit and how the U.K plans to leave the E.U., the Fed's missteps in communicating both monetary policy and its associated narrative, China and tariffs, oil's -25% plunge during the month of November, the on-going Mueller investigation, the US mid-term elections, and, lastly, the current US federal government shutdown. This substantial list of issues had been well-known by all for a long while now, but during the fourth quarter of 2018 the collective sum of this list took over the narrative and resulted in an above-average drawdown. Important market technical levels were violated, and investor sentiment took a beating. Economic data and earnings fundamentals matter little when a long list of macro issues is met with algorithmic, computer-driven trading models and thin year-end liquidity conditions. To put it plain and simple, in a brief period of time, volatility won out.

It's very unusual to have economic growth, earnings growth, a strong labor market and an equity market down for the year, but that's where 2018 ended. Our view is that fundamentals appear to be disconnected with present market conditions and valuations. We believe the market has now priced in an imminent US recession, although the economic data we evaluate says we are unlikely to get one for a while. Earnings on the S&P500 in 2019 should be around $170 per share; at present the market is pricing in something closer to $150 per share. This earnings expectation gap is also highly unusual. As unpleasant as recent market activity has been, this volatility looks like a classic "correction within an expansion". Following a very low volatility 2017, it feels like the current volatile environment is something completely new and unprecedented. It's not. We've been here before. We've had three very similar periods since the Great Recession of 2008. Here's what those similar periods have all looked and felt like:

May/June 2010	Broad-based fears of a Eurozone slowdown and Greek debt crisis causes the S&P500 to fall -14% over the course of a month; the Fed responds by cutting interest rates; equity markets responded by rallying +24% over the subsequent six months.
August 2011	Standard & Poors downgrades the longstanding U.S. Treasury AAA credit rating and the S&P500 falls -19% over a period of six weeks; the Fed introduces "operation twist" as part of its QE program; equity markets responded by rallying approximately +29% over the subsequent six months.
January 2016	China currency concerns combine with a collapse in oil prices and the S&P500 falls -14% over the course of a month; the Fed responds by pausing its stance on any immediate interest rate hikes; equity markets respond by rallying approximately +21% over the subsequent six months.

<u>Where do we go from here?</u> For markets to start to do better there are two major issues that need to be resolved: the desire of the Fed to remove accommodative monetary policy and China. We think the former issue has already taken care of itself. Twice in the past ten days Fed Chairman Powell has voiced the Fed's commitment to "patience" and "flexibility" as it relates to further interest rate hikes and its balance sheet run-off program that as recently as December was deemed to be on "auto-pilot". The odds of two additional interest rate hikes in 2019 were nearly 80% in a month ago; today, those odds are just 15%, the same as the current odds of a rate cut occurring in the coming twelve months. Inflation data is largely in check and with other pockets of the global economy marginally slowing, there is limited reason for the Fed to go further with additional rate hikes in the near term. Negotiations with China over trade

issues is the wild card. China's equity market is now down nearly -35% since the tariff war commenced, and its economy is clearly slowing. The Chinese government just enacted the largest tax cut in their modern history to stimulate domestic demand. Most would agree that free trade and fair trade must co-exist. Trying to predict the outcome of any near term political drama is an impossible game, but there would appear to be room here to work out a framework for both sides. Investors shouldn't be surprised to see a watered-down trade deal announced in which both sides declare victory and agree to part the field. Markets would react favorably to such, particularly risk assets and emerging market equities.

We've done lots of communicating with clients throughout this volatile period but, in truth, we have done very little trading or re-positioning of portfolios. During times like the fourth quarter, it's best to talk a lot and trade little. That is counter to what the financial media wants individual investors to believe, but when fundamentals are still good history says that staying the course is the best action for one's portfolio. Our belief in the fundamental data which supports our asset allocation strategies has not changed. There will most certainly be a time to get more defensive but with an economy that's still growing, credit markets that are still open, and current equity market valuations at less than 15x forward earnings, we are not there today.

Volatile times such as these are also a very good opportunity to review individual objectives, revisit investment portfolio goals, and assess one's individual risk tolerance. We have said many times prior that getting the asset allocation right and being disciplined during times of volatility drives long term portfolio success. A disciplined process will lead to good performance and attaining goals over time.

We thank our clients for their continued trust and support.

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