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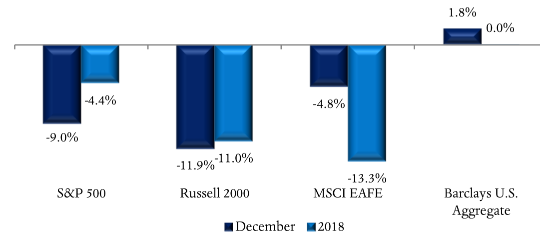
2018 Year In Review

2018 turned out to be a year of both ecstasy and agony for global equity investors. January boasted the best performance for the S&P 500 index since 1990, only to be followed by a sharp correction (triggered by a massive spike in volatility) in February. Thereafter, aided by a strong economy, US equity indexes marched upward, setting record highs once again in September. Consumer spending and corporate profits were robust, boosted by tax reform, deregulation and higher wages. Investors were ecstatic. However, equity markets had been resiliently absorbing worries over a curtailment in global trade, with disputes instigated by the US, versus nearly all its important trading partners. Further, the Federal Reserve, under newly appointed Chairman Jerome Powell, continued on its path of monetary tightening (aka Quantitative Tapering), raising interest rates each quarter, while concurrently reducing the size of its balance sheet, and commenting that the US policy rate was still "a long way" from neutral. Overseas investors also contended with a sharp slowdown in eurozone business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics, and populist demonstrations in France). Then came the agony, in the form of a fourth quarter bear market (defined as a decline of -20% from the highs) for stocks, across most markets globally. All said, for the full-year 2018, the S&P 500 benchmark declined -4.4%, while the smaller capitalization Russell 2000 index fell -11.0%. Overseas markets significantly underperformed as seen by the MSCI EAFE index's -13.3% return. European large capitalization stocks declined -10.3% while their smaller counterparts slid -19.2%. In Asia, Shanghai stocks were among the worst performers, declining -22.7%, while Japan's Nikkei 225 index dropped -10.3%. After years of steady growth in asset prices, 2018 proved challenging for investors.



On the positive side, fixed income lived up to its traditional defensive role. Since the start of the Fed's interest rate increase cycle there have been 9 hikes (4 of them in 2018), totaling 225 basis points (100 bps in 2018). During the current cycle, the yield on 10-year Treasury notes has risen 46 bps (27.9 bps in 2018), leading to a significant flattening of the yield curve (including a tightening of 33 bps during 2018). Trading inversely with equities, US Treasury prices declined through the end of the third quarter, until Fed Chairman Powell indicated that the central bank wasn't about to stop increasing interest rates any time soon. Leading into November, the US 10-year Treasury yield moved higher, topping out above 3.2%, yet ended the year at 2.69% (+28 bps ytd) after a significant December rally driven by a flight to safety and a more dovish November commentary by Fed Chair Powell. By December, markets had moved to price in a greater than 50% probability that US interest rates won't rise beyond 2.5% in 2019. For the full-year 2018, the Barclays US Aggregate index rose +0.01%, while the more volatile US high yield index fell -2.3%.

In commodities markets, most notably, crude oil followed a similar path to equities, reaching a multi-year high by the end of the third quarter, only to plunged precipitously thereafter. Rising supply, led by US shale production, caught up with demand. Fears around the outlook for global growth and hence lower demand for oil have also weighed on the price. For the full year, the Bloomberg UBS Commodity Index declined -11.2%.

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United States

US economic growth over the past year is likely to end-up as one of the best of the nine-year U.S. economic expansion. 2018 boasted an ending unemployment rate of 3.9%, registering multi-decade lows, GDP growth estimated at 2.9%, and consumer spending growth of 3.0%, all heady numbers. Inflation finally reached the Federal Reserve's 2.0% target, assisted by wage growth. In addition, income growth should remain elevated, government spending is still expanding and businesses are adding to inventories. Against this positive backdrop, to correct trade imbalances, the Trump administration imposed tariffs on the likes of steel, aluminum, washing machines and solar panels, in addition to tariffs on $250 billion worth of imports from China. The US, Canada and Mexico also agreed to rewrite the North American Free Trade Agreement, a perceived win for America. Still looming, however, is the threat of tariffs on car imports globally and the rest of China's $505 billion in exports to the US.

Looking ahead, the US economy is set to decelerate in 2019 as fiscal stimulus (lower taxes, as well as government spending at all levels) abates, corporate investment slows, and the wealth effect curtails consumer spending. Also, auto purchases are expected to remain soft, and housing is still reeling from higher interest rates leading to lower affordability. Exports are showing little growth, likely because of the trade war with China and supply chain changes are set to reduce productivity and increase costs. In all, 2019 is likely to be a year of trepidation for the US economy.

Europe

In Europe, business surveys trended down throughout 2018, approaching contraction levels during the fourth quarter. Political tensions likely contributed to a sharp fall in both the Italian and French business surveys. Bellwether Germany's economy is slowing but showing signs of resiliency. Chief culprit has been a sharp decline in the manufacturing sector's new export orders, which appears attributable – at least in part – to a slowdown in demand from China. Political factors have also been a drag on business sentiment across the region. The Italian government's confrontation with the European Union, over its budget, led to higher sovereign borrowing costs. Subsequently, a more compliant budget was submitted and is awaiting approval by Brussels. In France, protests surrounding a hike in taxes on diesel in the countryside, led to widespread unrest, which appears to have significantly dented business confidence. President Macron has since announced fuel duty cuts and other stimulus measures to ease the tensions. Despite the slowdown in growth, the European Central Bank ended its quantitative easing program in December, noting the broad-based nature of the firming in wage growth across the region.

December 2018 Economic Statistics

	Dec-18	*Dec-17*	Dec-16
Federal Funds Target Rate	*2.25 - 2.50%*	*1.25-1.50%*	0.50 - 0.75%
Consumer Confidence Index	*128.1*	*122.1*	113.7
Manufacturing PMI Index	*54.1%*	*59.7%*	54.7%
Unemployment Rate	*3.9%*	*4.1%*	4.7%
JPY/USD	*109.56*	*112.67*	116.87
USD/EUR	*1.1469*	*1.1996*	1.0513
Gold/oz.	*$1,282.73*	*$1,302.45*	$1,151.46
Oil (WTI)/bbl	*$45.41*	*$60.42*	$53.72

In the UK, wage growth has also been accelerating, rising at the fastest pace since the financial crisis. On the other hand, the ongoing uncertainty surrounding the Brexit negotiations has weighed on business and consumer confidence. Housing prices and transactions, are being affected by the uncertainty. The Brexit scenarios appear to be threefold, (i) the UK parliament revokes Article 50 (remain in the EU), (ii) a no-deal Brexit (which would lead to a hard border in Ireland and significant repercussions for the UK economy) and (iii) a negotiated exit, for which PM May is drumming up support, perhaps decided by a fresh referendum. The deadline for a final decision is March 29.

Asia

In China, economic growth decelerated in 2018, explaining part of the weakness in global exports. Staggeringly, imports into the country slowed from 37% year-over-year growth in January to 3% in November.

Due to a clampdown on lending, targeting the shadow banking sector, in an effort to clean up a complex web of debt, Chinese money supply growth slowed. This invariably led to a decline in the pace of retail sales growth and industrial production. Industrial profits fell for the first time in three years and the country's car sales dropped for the first time in nearly 30 years. In the aftermath, Shanghai stocks lost one-quarter of their value during 2018. In response, the Chinese state is once again seeking to stimulate the economy via a combination of monetary and fiscal measures. An alternate motive is to buttress the external headwinds emanating from the ongoing trade dispute with the US. However, given that China seems to have reached a point of diminishing returns from its credit stimulus efforts, the country's economic health is perhaps the largest risk to the world economy in 2019.

Outlook

Financial markets are fretting that global economies are set to slow, as interest rates rise, monetary stimulus fades and business investment peaks, coupled with the virtue of being late in the cycle. Importantly, one-off tax cuts helped boost US growth and corporate earnings in 2018 for which there will apparently be no encore. The US midterm elections in early November were important in this regard, as the Republican Party might have backed further tax cuts to support growth through to the next presidential election had they maintained control of the House of Representatives. However, with the Democrats winning the House, the likelihood of further meaningful fiscal stimulus, prior to the next US election, is significantly reduced.

Potential positive catalysts for investors in 2019 include a virtuous cycle arising from the implementation of Chinese stimulus, a successful outcome on Brexit, a trade deal between the US and China, continuing economic growth, and a moderation of the path tightening monetary liquidity as well as interest rate increases. On the other hand, economic uncertainties remain. Namely the possibility of a European recession, potentially restarting concerns about the sustainability of regional sovereign debt, at a time when European Central Bank monetary stimulus has ceased, and short term interest rates are poised to rise. Further, US growth is likely to slow and a recession in late 2019 or 2020 can't be ruled out, especially if trade tensions escalate.

Credit markets saw some signs of fragility late last quarter. This is important for investors to monitor, as non-financial corporate debt-to-GDP has risen to the highest level in over 70 years and the credit quality of the US investment grade index has deteriorated. The relaxed covenant quality in the leveraged loan market and the pervasive issuance of subprime debt in the auto loan market are also of concern. Further, credit market liquidity is much lower than it was before the financial crisis, when investment banking dealers acted as intermediaries, a warning sign of higher volatility to come. Against this backdrop, fixed income investors should remain defensive, sticking to relatively short duration instruments, perhaps coupled with hedged alternatives to dampen portfolio volatility. Those with greater risk tolerance may also consider an allocation to distressed credit, in anticipation of a greater opportunity set to come.

Global stocks, as measured by the MSCI World Index, declined -13.9% last quarter, their worst fall since the eurozone debt crisis saw equities tumble -17.1% in Q3 2011. To put the prior quarter's performance into perspective, it was the 11th worst since 1970. Yet the index has produced a total return of 151% over the trailing decade, a +9.6% compounded annual return. During the same time frame, the S&P 500 appreciated 243% (+13.1% annualized), a clearly superior performance. Yet, global equity markets are trading at a well-below-average forward price-to-earnings ratio of 12.9, equating to a 7.8% earnings yield (14.7 for the S&P 500; 6.8% earnings yield). Given long-term growth prospects, we feel that valuations are attractive, offering numerous actionable opportunities. We were well positioned in 2018, and some of our proven long-only managers produced positive returns, via stock picking. We expect them to again outperform in 2019. We also continue to recommend select hedged and non-correlated investment strategies whose absolute performance targets serve to reduce overall portfolio risk while dampening volatility.

Wishing you a happy, healthy and prosperous 2019!

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal

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