Macro Summary

- The fourth quarter of 2018 volatility was disproportionately large relative to the strength of the US economy. A highly tenuous political environment is making corporate and household planning nearly impossible.

- Fears of continued interest rate increases and the removal of quantitative easing will continue to unsettle the global financial markets in the year ahead.

- China might be the story of 2019 as the world's second largest economy is slowing despite being the only major economy that is attempting to stimulate their economy incrementally.

- The historical performance of equities after midterm elections and, relatedly, the influence of the Presidential election cycle show an impact. The Standard & Poor 500 Index has increased on average +15 percent in the twelve months following the midterm elections since 1950.

- It's understandable to see some housing market weakness as the financial conditions tighten, but in the current environment of strong employment, and favorable demographics, we don't think it poses a major risk.

- The table below is one of the best illustrations of the power of long-term thinking. On a daily basis, it's essentially a coin flip between being positive or negative, but the further out you extend the time horizon, the better your chances of success.

60/40 Portfolio: 1926-2018

Time Frame	Positive	Negative
Quarterly	70%	30%
One Year	80%	20%
5 Years	95%	5%
10 Years	100%	0%
20 Years	100%	0%

60% S&P 500 / 40% 5 Year Treasuries

- In summary, after evaluating the probabilities, monetary policy, the potential for a trade agreement, valuations, and political exigencies make it difficult for us to be bearish on stock prices in 2019.

A Look Back at 2018 – Cash Outperformed Every Major Asset Class

Fear and uncertainty gripped the financial markets as 2018 drew to a close. The list of concerns seemed to grow longer as the quarter progressed. Investors reacted to repeated interest rate increases enacted by the Federal Reserve, trade policy negotiations, uncertainties over the federal government shut down, and foreign policy de-risking their investment portfolios.

Global stock markets fell with the Standard & Poor 500 Index (S&P 500) down 13.5 percent. Oil was another casualty, dropping to levels that had not been seen in four years. The fixed income market provided some solace as intermediate bond prices rose and the 10-year Treasury yield ended the year near where it began.

The depth of the fourth quarter swoon would suggest the economy was heading toward an inevitable recession. In our view, this is not the case. The case for Armageddon ignores strong employment trends, increasing capital investment, low inflation rates, and the benefits of tax reform and de-regulation.

ASSET CLASS RETURNS (BY YEAR)

RANK	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	10 Years
1	EM 68.9%	REITs 28.4%	TIPS 13.3%	EM 19.1%	Small Cap 41.0%	REITs 30.4%	REITs 2.4%	Small Cap 26.6%	EM 37.3%	Cash 1.7%	Small Cap 15.0%
2	Small Cap 41.6%	Small Cap 27.2%	REITs 8.6%	Int'l Stocks 18.8%	Mid Cap 35.2%	Large Cap 13.5%	Large Cap 1.3%	Mid Cap 20.5%	Int'l Stocks 25.1%	Bonds 0.1%	Mid Cap 13.4%
3	Mid Cap 37.6%	Mid Cap 26.3%	Bonds 7.7%	REITs 17.6%	Large Cap 32.3%	Mid Cap 9.4%	Bonds 0.5%	Comdty 12.9%	Large Cap 21.7%	TIPS -1.4%	Large Cap 13.0%
4	REITs 30.1%	EM 16.5%	Large Cap 1.9%	Large Cap 16.0%	Int'l Stocks 21.4%	Bonds 6.0%	Cash -0.1%	Large Cap 12.0%	Mid Cap 15.9%	Large Cap -4.6%	REITs 12.1%
5	Int'l Stocks 27.0%	Comdty 16.2%	Small Cap 1.1%	Small Cap 15.7%	REITs 2.3%	Small Cap 5.5%	Int'l Stocks -1.0%	EM 10.9%	Small Cap 13.1%	REITs -6.0%	EM 6.6%
6	Large Cap 26.4%	Large Cap 15.1%	Cash 0.0%	Mid Cap 15.2%	Cash -0.1%	TIPS 3.6%	TIPS -1.8%	REITs 8.6%	REITs 4.9%	Small Cap -8.6%	Int'l Stocks 5.8%
7	Comdty 20.1%	Int'l Stocks 8.2%	Mid Cap -1.5%	TIPS 6.4%	Bonds -2.0%	Cash -0.1%	Small Cap -1.8%	TIPS 4.7%	Bonds 3.6%	Mid Cap -11.3%	TIPS 3.3%
8	TIPS 8.9%	Bonds 6.4%	Int'l Stocks -12.3%	Bonds 3.8%	EM -3.7%	EM -3.9%	Mid Cap -2.5%	Bonds 2.4%	TIPS 2.9%	Comdty -13.1%	Bonds 3.1%
9	Bonds 3.3%	TIPS 6.1%	Comdty -14.0%	Cash 0.0%	TIPS -8.5%	Int'l Stocks -6.2%	EM -16.2%	Int'l Stocks 1.4%	Comdty 0.7%	Int'l Stocks -13.8%	Cash 0.2%
10	Cash 0.3%	Cash 0.0%	EM -18.8%	Comdty -2.1%	Comdty -11.1%	Comdty -18.6%	Comdty -28.2%	Cash 0.1%	Cash 0.7%	EM -15.3%	Comdty -4.9%

Funds: EEM, VNQ, MDY, SLY, SPY, EFA, TIP, AGG, DJP, BIL

The Year in Review

A review of 2018 summed up in headlines illustrating a year of volatility…

Date	Headline
January 17th	Stocks soar to records on earnings enthusiasm
February 8th	The year's S&P 500 gains erased after nine day rout; DJIA drops 1,000
March 28th	Nasdaq 100 is heading toward a monthly loss of almost 6 percent
April 24th	The 10-year Treasury yield breaks 3 percent for the first time in 4 years
May 21st	Treasury Mnuchin says US is putting China trade war 'on hold' for now
June 13th	Stocks fall as the Federal Reserve signals steeper path for interest rates
July 31st	West Texas Intermediate (WTI) crude oil surges above $74 a barrel
August 2nd	Apple Inc.'s market value reaches $1 trillion, the world's highest
August 6th	Stocks close at highest level since January
September 20th	The S&P 500 sets record close as trade fears abate
October 26th	Technology shares meltdown pushes stocks to edge of correction
November 19th	VP Pence heats up China rhetoric; WTI closes below $57 per barrel
December 31st	Stocks post their worst December since the Great Depression

The Economy – A Recession Is Not Likely In 2019

> ***'Wall Street has predicted nine of the last five recessions.'***
> – Paul Samuelson, American Economist

The United States economy struck mixed chords as it rounded out 2018, with consumer confidence high and households spending robustly, but with the manufacturer sector pulling back as the global economy cooled down.

United States real Gross Domestic Product (GDP) appeared to be on pace to rise 2.9 percent last year, making it one of the strongest years of the expansion in recent memory. Employment growth showed persistent strength in the face of near record low unemployment. There have been more job openings than unemployed persons. The tight labor market has pushed wages and salaries higher, and productivity growth has also picked up which should help offset some of these increases.

Recent macro indicators have continued to confirm several running themes. First, inflation has remained very close to the Federal Reserve's 2 percent target, which provided policymakers with some leeway in normalizing interest rates. Second, United States consumer spending has remained robust as evidenced from personal income and spending data. Third, the housing market has remained soft, but recent data points and the long-term trends are encouraging.

As the boost from strong consumer spending and fiscal stimulus wears off, US growth should slow to a healthy 2.5 percent in 2019. Chairman Powell's decisions in the new year will hinge on what happens next for inflation. If the Fed believes inflation has stabilized at 2 percent, it will pause their interest rate increases. To that point, recent soft inflation readings have suggested the probability of such a pause in 2019 is rising.

The volatility sweeping global financial markets has underscored investors growing unease about the durability of the nearly decade-long bull market, even as there is little risk of a near-term recession. Investors' worries have run deep, taking into account not only the negative impact of a trade war, but also fading fiscal stimulus, rising short-term interest rates, the United Kingdom's uncertain departure from the European Union in March, fiscal crisis in Italy, and declining bond buying by the major central banks - all of which have exacerbated worries that the United States economy is due for a contraction after a lengthy expansion.

But many economic trends have not fit with patterns that preceded previous downturns. The behavior of the data over the last four quarters in the United States, Eurozone, and Japan has been completely incongruous with any of the recessions that took place since 1980. In fact, by most measures, the US economy has remained in a stable position. Not only has the pace of economic growth topped 3 percent for two straight quarters, but consumers appear to be on particularly strong footing having reduced leverage since the financial crisis while benefiting from an increasingly tight labor market.

Another way of judging the probability of recession is to look for clues in the fixed income markets, as bond market participants are uniquely attuned to stresses in the economy that can lead to bond default. One relatively reliable signal of impending recession can be found in watching the evolution of the spread between short and long-term interest rates - the so-called yield curve. An inverted yield curve (long-term rates lower than short-term rates) signals a pessimistic view from the bond market about long-term growth, and predicts central bank easing via lower reference rates to combat that.

We acknowledge that recession risks are real but we don't know for certain if the next one will be in 2019, 2020, or beyond. We do know there will always be recessions; they are part of the normal business cycle. The risk should be low in the next twelve months. While the financial markets might be expecting it much sooner than the data reveals, the economic data have not said it has happened yet. Our investment committee agrees as we remain positive on the outlook for the 2019 economy.

The Federal Reserve

The mainstream media have been full of criticisms of Chairman Jerome Powell's December press conference, where the global markets did not hear what it wanted to hear and immediately began selling off. They basically accused him of being tone deaf and not listening to the financial markets. What was the Fed Chair thinking?

There were many accusations that Powell fumbled the ball, not telling the market what it wanted to hear. As if that was his job.

We think it is possible that Powell said exactly what he wanted to communicate. The last three Federal Reserve Chairpersons have basically acted like the Federal Reserve has three mandates: the two official ones which are keeping inflation under control and doing what is necessary to maintain full employment, and the unofficial one adopted by the last three chairmen, to make sure that asset prices rise, which is what investors wants to hear. Not just the stock market, but real estate and all asset prices. It started with the Greenspan Put, morphed into the Bernanke Put, and reached its apex with the Yellen Fed and Put.

And as a result what did we get? A series of asset bubbles. Legendary investor Stan Druckenmiller said that the really big Federal Reserve mistake was 2003 and 2004 by Greenspan, keeping rates too low for too long, resulting in the housing bubble and the Great Recession. He clearly helped the massive bubble in 1999-2000. Obviously, Bernanke was watching the financial markets closely. His reluctance to raise rates in 2012-13 from zero when the economy was manifestly recovering fueled the asset price bubble. Yellen continued that course when she became chairman in 2014. The reluctance to raise rates until Trump won the election, when the economy was booming and unemployment was clearly falling, is inexcusable.

There is the very real possibility that Jerome Powell was not being tone deaf. I think there is the possibility that he wanted to communicate that the Federal Reserve is independent, not only from politicians but from Wall Street. Yes, he worked on Wall Street and was an investment banker, and even ran his own hedge funds, as well as numerous posts for the Treasury before he came to the Federal Reserve, so he is clearly an insider.

The Federal Reserve should be just as concerned about Main Street as they are about Wall Street. If Jay Powell allows the financial markets do what they want to do, without coming back and giving a speech essentially saying 'I'm sorry, I really meant to be more dovish,' then we will know he is really trying to establish the independence of the Fed, and has decided to go back to the two main established mandates.

Fixed Income

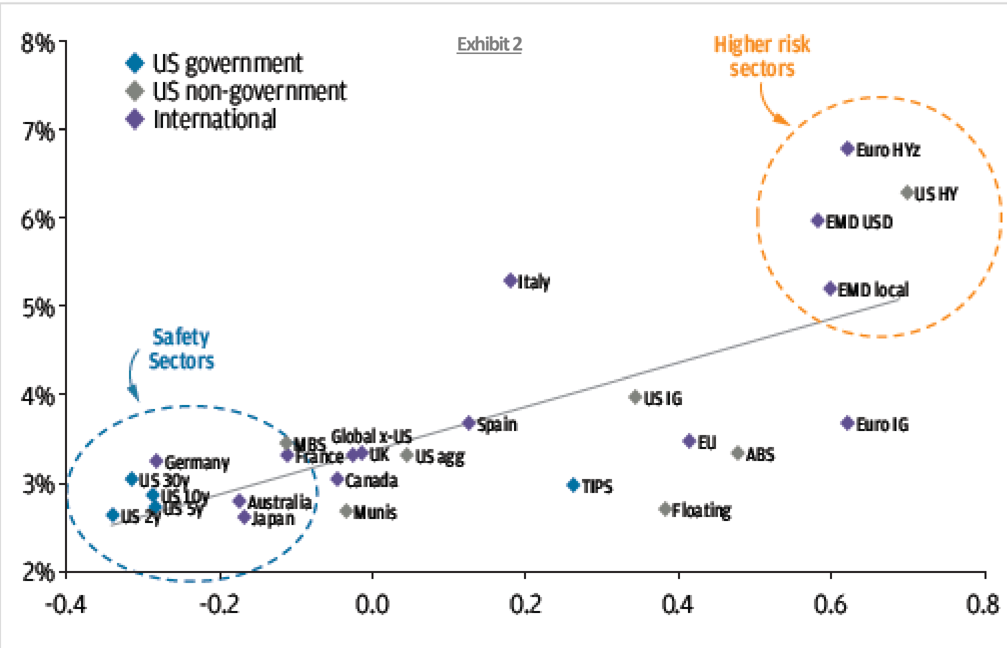
The environment for fixed income investors was challenging in 2018. Faster economic growth, growing fiscal deficits, and balance sheet reduction pushed the US 10-year Treasury yield from 2.4 percent at the end of 2017 to 3.15 percent by mid-November.

So what might 2019 hold for investors in bonds? Chairman Jay Powell may continue to raise rates in 2019; however his tone in recent weeks has turned more cautious about his approach in the year ahead. However, if economic growth slows in the second half of 2019, inflation should remain remarkably stable allowing the Federal Reserve to pause its hiking cycle, and economic data may not give them reason to resume tightening again.

A number of other central banks will also join the Fed in gradually tightening monetary policy in 2019. The European Central Bank will finish purchasing assets by January 2019 and should begin raising rates by mid-2019. Other central banks, such as the Bank of England and the Bank of Japan, should engage in some form of modest tightening.

So how should investors be positioned going into next year? As we get later into this economic cycle, it is important that investors begin to reduce some of their riskier bonds, shorten durations, and seek the safety of traditional fixed income investments. In doing so, investors might sacrifice greater returns in the short-term for some additional principal protection.

Exhibit 2 highlights that higher yielding, riskier asset classes, such as Emerging Market debt or high yield, may offer more yield, but with stronger correlations to the S&P 500. Therefore, if equities fall sharply, riskier bonds will not provide much protection. In short, higher yield equals higher risk.



Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management. Data are as of July 7, 2018.

A common theme for many investors in this cycle has been the hunt for yield, as they allocate monies into unfamiliar asset classes searching for higher returns to offset the low yields in the core bond category. This isn't necessarily an incorrect strategy in the early or middle stages of an economic expansion; however, this strategy becomes riskier as economic uncertainty rears its head and recessionary fears begin to percolate. Again, short duration, higher quality bonds offer yield to investors with downside protection.

The US Markets

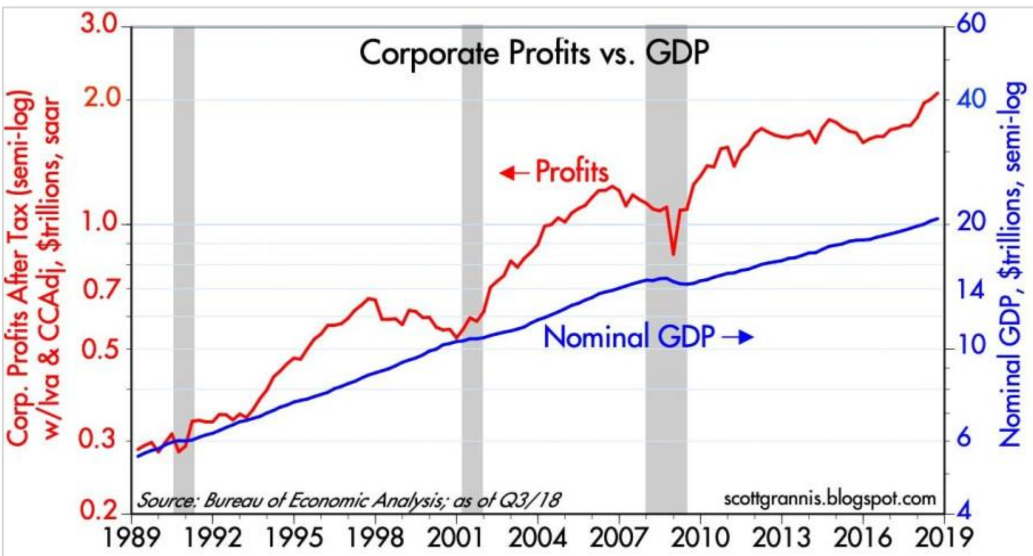
2018 ended with an emotional 'run' on the global stock markets during which fear played a larger role than did the actual company fundamentals. If I were to compare 2017 and 2018 to an amusement park, 2017 was more like a calm train ride (slow, smooth, and steady), while 2018 was more like a rollercoaster (fast, and rocky with a lot of ups and downs). The Stock Trader's Almanac tells us that on average stock prices should fall -5 percent three times per year and -10 percent one-time each year. Well, 2017 was like a walk in the park if you consider there were no -5 percent or -10 percent declines during the year, whereas in 2018, we had -12 percent and -20 percent corrections, before recovering somewhat during the final trading days of the year.

The heightened level of volatility can be seen in the Volatility Index - VIX (see chart above), which has been bouncing around in response to the following news headlines:

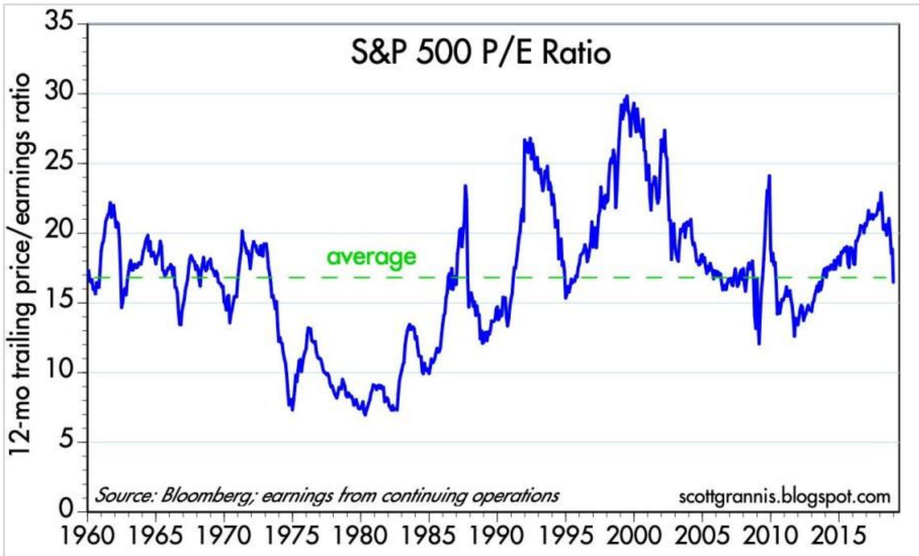
- Global Trade (China)
- Federal Reserve Interest Rate Policy
- Federal Government Shutdown
- Mueller Investigation
- New Balance of Power in Congress
- Brexit Deal Uncertainty
- Recession Fears

While there have been some signs of slowing economic growth, the overall economy has been resilient on the back of consumer spending, which accounts for upwards of seventy percent of our country's economic activity. In fact, MasterCard recently released consumer retail holiday spending data grew +5.1 percent to a record level exceeding $850 billion.

Corporations, which are also helping propel continued growth in our $20 trillion economy, are producing record profits, as you can see from the chart below. This in turn has led to an amazingly low unemployment rate of 3.7 percent, the lowest jobless figure posted in almost fifty years.



Fears of an impending recession overpowered the good news last month, resulting in stock prices that are attractively valued, in our opinion. For example, if you are shopping at a department store, it's much more advantageous for the buyer to purchase items on sale versus paying full price. And, recently, investors have been very fearful. As you can see from the chart below, prices as measured by the Price-Earnings ratio (P/E) are below the long-term, multi-decade average. This fact is even more relevant in light of the historically low inflation and interest rates (10-year Treasury yield at 2.69 percent). Unsurprisingly, during the 1970s and early 1980s, double digit interest rates and inflation were relatively high leading to low, single digit P/E stock ratios over many years.



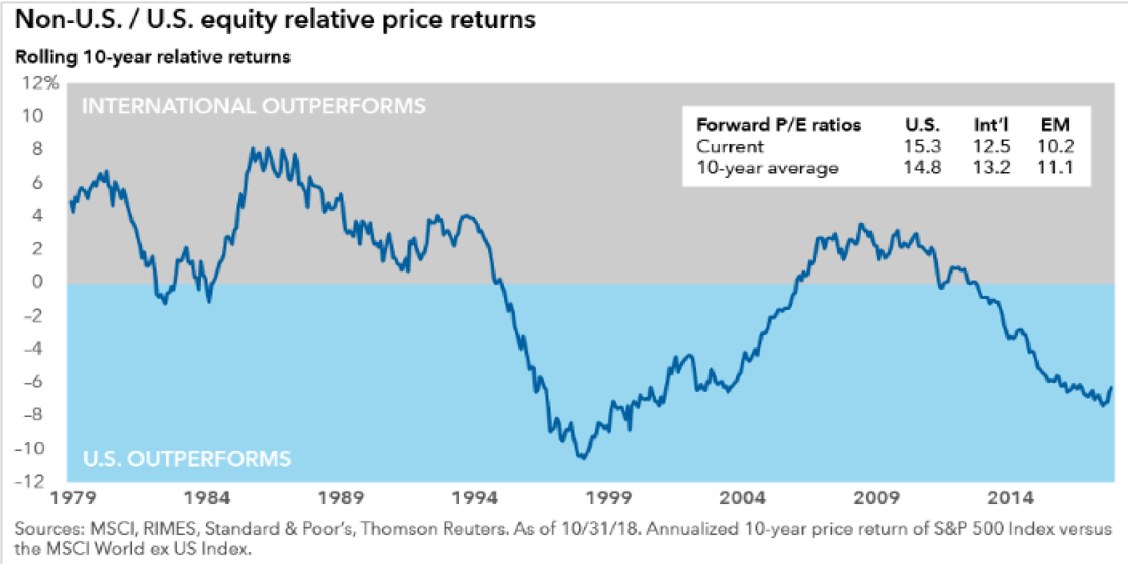
Just because stock prices went down last month, does not mean they cannot go lower. The adrenaline-filled ups and downs may feel scary now, but the ride will be more enjoyable if you buckle up and don't lose sight of your long-term goals.

International Markets

Stop us if you've heard this one before: Equity valuations outside the United States look incredibly attractive on a historical basis. To us, they have looked that way for quite a while, and the gap is widening. The relative outperformance of domestic stocks compared with their non-US brethren is at the highest level in history. The pivotal question is: How long can this continue?

The trend has accelerated in recent months as rising global trade wars, interest rate uncertainty, slowing global growth, federal government shutdown in the United States, and recession fears have weighed on international equities.

This divergence between the US and the rest of the world is indicative of a wider and longer-running storyline. For nearly a decade, international and emerging markets have lagged the United States' markets, and lagged badly. There is no sugarcoating it.



Looking ahead, the 2019 outlook for international equities is clouded by a series of upcoming events in Europe that should be considered daunting, to say the least. They include:

Brexit Showdown – The UK is expected to extricate itself officially from the European Union in March. European Union leaders recently approved a 'divorce' plan drafted by Prime Minister Theresa May. However, the plan already has come under intense criticism from within May's own Conservative party and the opposition Labour party. An initial vote is expected this month, and some political observers say May's future as prime minister hangs in the balance.

Merkel Uncertainty – German Chancellor Angela Merkel's administration was severely weakened during recent regional elections in which her Christian Democratic party lost significant ground. Europe's longest-serving leader has said she will not run for reelection in 2021, but a rising chorus of voices is calling for her to resign well before then. Therefore, it is possible that Europe could lose two of its most important political leaders - Merkel and May - in the span of just a few months.

ECB Transition – European Central Bank President Mario Draghi's term ends in October 2019 and, before that, a new president must be selected. The normally low-key process could be highly contentious this time around if more fiscally conservative candidates vie for the position. The political maneuvering will happen at the same time that the ECB is adapting to life without stimulus measures and, perhaps, attempting to raise interest rates as well.

Italian Budget Dispute – Italy's new coalition government has unveiled a budget proposal that is expected to dramatically increase deficit spending, despite strenuous objections from EU leaders. In response, Moody's has slashed the country's debt rating. A showdown is looming with the EU and it is possible that new elections will be called in 2019 if the current coalition government can't get its fiscal house in order.

di·ver·si·fi·ca·tion – by definition, means that some areas of a portfolio are down while others are performing well. Achieving this balance is crucial to successful long-term investing (see chart on page 2).

Given what could be a potentially ugly news cycle in 2019, the question remains: When will international equities finally turn a corner? The truth is no one knows the answer to this. For the myriad of reasons stated earlier, international stocks are out of favor. We continue to believe market sentiment will eventually shift. In the meantime, we continue to recommend investment strategies with a disciplined and proven process.

Concluding Thoughts

Long-term investing doesn't happen by accident. We recognize and respect the recent extreme volatility experienced in the financial markets. After a long bull market with limited volatility in stock prices, investors are skittish, and rightfully so. The United States economy remains on solid ground; however, policy uncertainty accounts for much of the consternation. As with most policy changes - trade wars, interest rates, taxes & de-regulation - history tells us that the American businesses' will adapt. The current economic expansion is unlikely to be derailed by headlines alone as the primary driver of economic growth, the American consumer, is stronger financially than at any other time in the past 100 years.

We look forward to another year working with you and helping you navigate the global financial markets for another year. Thank you for giving us the opportunity.

Here's to a happy New Year!

David

David A. Massart
President & Founding Partner

To learn more about Next Generation Wealth Management, please visit us at www.ngwealth.com.

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