Quarterly Commentary: Q4 2018

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Equities:

What a difference three months can make. Global equity markets sold off considerably throughout the 4th quarter, with sentiment turning negative as investors pondered the consequences of further monetary policy normalization in the wake of lower expectations for economic growth and inflation. The S&P 500 briefly entered "bear market" territory (defined as a 20% decline from previous highs) on Christmas Eve before bouncing off of lows, but the selloff was large enough to push markets into negative territory (as measured by total return, including dividends) on the year for the first time since the 2008 financial crisis. However, while there are indeed some signs of a moderation of economic growth (slowing housing market and fading impact of recent tax reform), the probability of recession in the near-term remains low. History suggests that non-recessionary bear markets tend to be short-lived.

Bonds:

The Federal Reserve was a major area of focus for bond investors throughout 2018, and that continued into Q4. The Fed implemented its 4th rate hike of the year following its December meeting, but acknowledged that its previous estimate of 4 further hikes during 2019 may be too aggressive. The shift in posture from the Fed reflected a sense of restraint that was already being priced into bond markets and represented a significant change in expectations from just 3 months prior. In our experience, sentiment tends to shift much faster than economic data, and the data still suggests that the US economy is healthy. However, the Fed will face a difficult balancing act as it continues its normalization process even as markets have begun to show signs of fragility.

The "risk-off" sentiment that dominated the 4th quarter made its way into the corporate bond market, as credit spreads (the difference in yield between corporate and government bonds) widened to their highest level since 2016. However, overall bond market performance was positive during the 4th quarter as the volatility in equity markets caused investors to seek the relative safety of fixed income. It should be noted that despite what many pundits have deemed an unhealthy environment for bond investors, the overall bond market finished the year flat. To us, this is evidence that fixed income remains an important component of a properly diversified portfolio, and that a "bad" year for bonds looks very different from a "bad" year for equities.

Outlook:

After nearly a decade of healthy returns, it is unsurprising that markets have paused to digest the changing economic environment that we currently find ourselves in. Markets managed to squeeze 3 year's worth of gains into just 12 months during 2017, and ultimately, it has been an incredibly impressive run for US equities over the past 10 years. Despite the negative sentiment that has dominated markets over the past 3 months, it is not unreasonable to suggest that stocks can generate positive returns in 2019.

We continue to express that we believe the forward outlook for investment returns across asset classes looks very different than it did even 5 years ago, but that is more a product of starting point than anything else. The key areas of focus for markets moving into 2019 will continue to be trade, the Fed, and global economic growth (with a particular emphasis on China, which has showed signs of slowing). We continue to believe that the possibility of "surprises" remain skewed to the upside with respect to trade (potential deal being reached with China) and future Fed policy (slower pace of rate hikes), but believe that the Chinese economy will be important to watch moving forward. It used to be that when the US sneezed, the world caught a cold. But eventually, China's economy will be large enough that the same could be said for the world's most populous nation.