The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets January 2019

From: *Philadelphia* Investment Management Group

OVERVIEW

- *Domestic Economic Growth Will Remain Positive, But at a Reduced Level*
- *Geopolitical Concerns Will Continue to be a Major Headwind to the Economy*
- *The Federal Reserve Will Move With More Caution*
- *Equity Fundamentals are Positive But Will Face the Above Concerns*
- *Fixed Income Total Returns Will Remain Nominal, But Income Will Now be a Positive Factor*

THE ECONOMY

As we moved through 2018, investors were confronted with a range of contradictions. Unemployment ended the year at nearly a 50-year low and wages have been rising; yet, fears of a recession have increased. Also, corporate earnings were amazingly strong, but stock prices sank sharply into correction territory by the end of the year. Investors are now left to question whether solid fundamentals or growing uncertainty will shape the economy and the financial markets as we move through 2019.

Ironically, 2018 was relatively calm until the fourth quarter. Outside of a brief correction in January and February, driven by fears of rising interest rates, investors focused on an accelerating economy and strong earnings growth. Stock prices rose to record levels by the end of the summer, and interest rates trended somewhat higher.

The forces driving the recent swings in the markets during the fourth quarter, with some teeth-rattling ups and downs for stocks, bonds and major commodities along the way, are not anything new. First, three years' worth of interest rate increases by the Fed are finally starting to pinch interest rate-sensitive sectors of the equity market. After years in which the economy has become heavily tilted toward industries that depend on low interest rates, a potentially painful rebalancing is underway.

U.S. economic growth was quite strong in 2018, helped in no small part by the 2017 tax cuts. At the beginning of the year, real U.S. Gross Domestic Product growth was expected to reach 3%, which came to pass. However, as we moved through the fourth quarter, the economy struck mixed chords, with consumer confidence high and household spending robust, but manufacturing pulled back as the global economy continued to cool.

Personal consumption expenditures, a measure of household spending, increased for November, as reported in December. That made the ninth straight monthly increase in household outlays. On the other hand, demand for durable goods produced by U.S. factories showed signs of weakness. Orders for machinery, electrical equipment and motor vehicles and parts all fell. Low oil prices might be helping consumers, but, in turn, hurt business investment.

Added to the mixed U.S. economic growth picture were the geopolitical concerns that overhung the financial markets during the year while increasing in the fourth quarter, slower global growth, trade concerns and England leaving the European community. In addition, the degree of rising interest rates and the partial Government shutdown remained as headwinds for the financial markets in the quarter.

Part of the headwind on financial markets has come from fears that the Federal Reserve has been underestimating these concerns or risks and was set on raising interest rates several more times in 2019, even as the economy is still trying to adjust to the early round of increases. Those fears have recently eased somewhat, as the Fed has signaled an open-mindedness about the path ahead. The tricky thing for the Fed is that it must set its policies for the whole United States; it cannot set one interest rate for the service sector in big coastal cities and another for farm equipment makers in Iowa.

The tax cuts that lifted corporate earnings and economic growth in 2018 will not be repeated in 2019, meaning a harder slog for companies seeking higher profits. In addition, it is well known that the trade war between the U.S. and China will start to pinch corporate earnings.

Furthermore, the dollar closed out 2018 at the top of global foreign exchange currencies. The rise has hurt the balance sheets of multinational companies that need to convert overseas earnings into dollars, thus weighing on U.S. exporters by making their products less competitive abroad.

A stronger dollar, higher interest rates, a more volatile stock market and less benign credit markets equal more expensive and less available money, i.e., a tighter financial condition. This type of a condition does not just impact financial assets, but also the real economy. As borrowing costs rise, confidence is challenged, and credit growth decelerates.

There are many questions about the economy as we move into 2019, but we feel that, as of now, it is fairly certain that the United States will not fall into a recession. We do not see any signals that make a reasonable case for recession, though we think economic growth will moderate in 2019. The consumer sector looks strong, particularly the labor market. The corporate sector is basically firm, although management has scaled back some plans relative to trade concerns. And the government sector appears to be expanding, as spending is likely to rise. Federal Reserve policy remains easy, but we do believe the economy can withstand some additional tightening, going forward.

Our call in 2019 is for a moderate uptrend in economic and earnings growth and a slight uptick in inflation and bond yields. A positive long-term outlook for equities, and income earned may be a catalyst for the fixed income market.

FINANCIAL MARKETS

EQUITIES

Until recently, the U.S. stock market had been something of a standout performer among global markets. Well into September, the S&P 500 was up 9.6%, including dividends, for the year to date. But over the last few months, those gains disappeared as investors began to assess the potential fallout from a trade war and rising interest rates.

Equity markets closed out 2018 with their steepest annual decline since the financial crisis, reflecting a growing unease among investors about the health of the nearly decade-long bull run. Stocks suffered a bruising stretch of selling in the fourth quarter as investors grew more pessimistic about the global economy and grappled with anxieties about the unwinding of the Central Bank's easy-money policies, plus the Government shutdown and growth concerns. As indicated in The Economy section above, the litany of issues has led to dizzying moves across the markets.

During December, U.S. equities posted their worst-ever Christmas Eve selloff, then logged their biggest one-day gain on record. The swings buffeting stocks, as indicated previously, left major indexes firmly in the red for 2018, even with a New Year's Eve rally, as shown in the following table.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	-13.52%	7.71%	3.43%	-0.76%	-4.38%
Dow	-11.31%	9.63%	1.26%	-1.96%	-3.48%
NASDAQ	-17.54%	7.14%	6.31%	2.32%	-3.88%
Russell 2000	-20.20%	3.58%	7.75%	-0.08%	-11.01%

*Total: price change + reinvested dividends

While the yearly negative returns for three of the indices were in the single-digit range due to the stronger performance in the second and third quarters, the damage to the markets for the year is seen in the double-digit negative returns in all four of the indices for the fourth quarter. The major damage was in the NASDAQ and Russell 2000, both of which were the winners earlier in the year.

The bruising selloff in the small cap arenas of the NASDAQ and Russell 2000 knocked valuation measures to their lowest level in six years and below that of their bigger counterparts in the S&P 500. This could attract cost-conscious investors. While multi-nationals have to contend with slowdowns in Europe and Asia and converting foreign sales more costly, small caps will not be handicapped with these concerns.

Asset valuations cheapened significantly in 2018 as uncertainty increased and the Federal Reserve raised interest rates. Equity valuations are now back in line with post crisis averages. We enter 2019 with less-demanding valuations and risks better reflected in many asset prices. Yet, fears over an economic slowdown and trade conflict loom large. U.S. stocks, in December, posted their worst month since February 2009, as "safe havens," such as gold and U.S. Government bonds, garnered more interest.

During the past three months, cyclical sectors, such as Energy, Materials and Technology, have fallen more than 10%, based on relevant S&P 500 sector indexes, as indicated in the following table. Conversely, Utilities, a classic defensive sector, defied the broader market and posted a positive return, the only one among all eleven.

	S&P 500		
		Returns*	
Sector	**Weight**	**4th Qtr**	**2018**
• Energy	5.3%	-23.78%	-18.10%
• Materials	2.7%	-12.31%	-14.70%
• Industrials	9.2%	-17.29%	-13.29%
• Cons. Discretionary	9.9%	-16.42%	0.83%
• Consumer Staples	7.4%	-5.21%	-8.38%
• Health Care	15.5%	-8.72%	6.47%
• Financials	13.3%	-13.11%	-13.03%
• Info Technology	20.1%	-17.34%	-0.29%
• Communication Svcs	10.1%	-13.19%	-12.53%
• Utilities	3.3%	1.36%	4.11%
• Real Estate	3.0%	-3.83%	-2.22%

12/31/18
*Price + income
Source: S&P Dow Jones

For the full year, however, five sectors of the S&P had double-digit negative returns, basically orientated towards the more cyclical areas of the economy. In recent months, analysts have begun to cut their earnings forecasts for 2019 on more than half the companies in the Index, according to FactSet, the first time that has happened in two years.

Technology, which had soared in prior years, retreated late in the year, hurt by valuations and signs of slow sales growth. Energy slid with oil prices, while shares of trade-sensitive manufacturers and automakers lost ground as China and Washington fought

over trade policy. Health Care stocks, considered defensive investments that usually hold up better in times of economic turbulence, overtook Technology shares as the strongest performer in the S&P for the year. Utilities placed second for the year, and Consumer Discretionary eked out another positive return.

Volatile market conditions for most of 2018 left no groups of stocks that share similar characteristics a clear winner. Earlier in the year, when the S&P 500 slumped 10% in February, momentum stocks, the markets' best performers, and growth stocks, those with the fastest growing businesses, were able to maintain their lead and keep surging as the markets recovered from the correction.

At the beginning of the fourth quarter, given the concerns mentioned above in The Economy section, the market went into a retreat. Momentum stocks, once stars, lost ground faster than any other group. Growth stocks, showing weakness even earlier, declined in the third and fourth quarters more than five percentage points worse than the S&P 500. On the other hand, as investors sought stability in an uncertain environment, high-dividend and low-volatility stocks, which underperformed for most of the year, became very cheap and started a sharp and rapid revival.

For now, profits are expected to continue to grow, but at a slower pace. Expectations are that earnings may grow by 7.8% in 2019, down from their forecast of 10% in September and 22% at the beginning of 2018. Among the factors weighing on companies are higher costs for labor and imported materials, the fall-off from the boost from tax changes and sliding economic growth abroad, as about 37% of their revenue comes from outside the U.S.

Over the longer term, the direction of the stock market is likely to be determined by whether the economy sinks into a recession. We do not expect that will happen. It may take some time, but we believe that still-positive economic and earnings growth should convince investors that now-lower equity valuations have made stocks look more attractive. At this point, we think investor sentiment has become too negative, which is a good sign for future price action.

FIXED INCOME

In our view, 2018 was a transition year from the era of easy money, characterized by low interest rates and bond buying programs by major central banks, to gradually tighter monetary policy. After nearly a decade of zero-to-negative short-term interest rates and central banks expanding their balance sheets, the trend is now toward tighter money.

The bond market has already gone a long way in this process. Short-term rates have been moving higher since late 2015, and 10-year Treasury yields have more than doubled over the course of the past two and a half years. It has not been a smooth ride by any means, with negative annual total returns in major fixed income sectors since 2013. However, "real yields," that is, the returns after inflation, have trended up, representing a return to a more normal policy.

The upward movement in interest rates during 2018 is reflected in the trend of U.S. Treasury securities, the base rate for fixed income, and is shown in the following table. For the year, rates, in general, trended higher, with the major change in shorter maturities due to the Federal Reserve's action of increasing short rates in light of the increase in economic activity and the fear of higher inflation. Long-term rates moved somewhat higher, but less than shorter rates, as the continued demand for greater yield by global investors added some stability to the long end of the interest rate curve

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2017	1.38%	1.88%	2.21%	2.41%	2.74%
Sep 30, 2018	2.20%	2.81%	2.95%	3.06%	3.20%
Dec 31, 2018	2.35%	2.49%	2.51%	2.68%	3.01%
Change:					
9/30-12/31/18	0.15%	-0.32%	-0.44%	-0.38%	-0.19%
12/31-12/31/18	0.97%	0.61%	0.30%	0.27%	0.27%

If short-term yields trend higher than long rates, creating the well-discussed inverted yield curve, one interpretation, by some, is the Fed is about to make a mistake by raising rates too much and cause a recession. However, as we moved through the fourth quarter, economic growth and inflation expectations were altered to some degree, which, in turn, were reflected in statements by the Fed that they would be more cautious in future rate increases. Thus, interest rates trended lower in the quarter.

The feeling, by many, is that the 10-year Treasury yield, the benchmark, may have peaked for this cycle around the 3.25% level. The Federal Reserve likely will continue to raise short-term interest rates to about 3% in 2019, but we do not see longer-term yields moving much above the recent highs. Limiting the move will be the factors mentioned in The Economy section of this commentary.

The movement in interest during the fourth quarter and year are set forth in the table below. With the concerns about economic growth in the fourth quarter, the government sector performed the best, as investors moved into that area for safety while realizing a new higher level of interest rates. This was also reflected in the year-to-date returns for the longer area of that market. With the decline in rates in the quarter, returns were basically positive for most sectors of the fixed income markets.

The only negatives were in the longer and lower quality areas of the corporate sector due to the increase in supply and the degree of economic growth. The lower investment quality area of the corporate group is now the largest area of the market as firms rushed to sell new debt at the existing low level of interest rates. Given the feeling that economic growth may be slowing, lower-rated companies may have problems selling debt and servicing existing debt that is currently outstanding.

Fixed Income Returns

Index	4th Qtr	YTD
Corp/Govt	1.52%	-0.32%
Int. Corp/Govt	1.61%	0.89%
Long Corp/Govt	1.25%	-4.11%
U.S. Government	2.60%	0.80%
- Intermediate	2.19%	1.43%
- Long	4.24%	-1.63%
Corporate	-0.06%	-2.25%
- Intermediate	0.61%	-0.17%
- Long	-1.63%	-6.97%
- **Quality**		
- AAA	1.25%	-1.89%
- AA	1.18%	-0.54%
- A	0.51%	-1.94%
- BBB	-0.80%	-2.82%
Municipal	1.56%	1.04%
- Intermediate	1.51%	1.69%
- Long	1.59%	0.60%

Source: BofA Merrill Lynch

Corporates had mixed returns, as the yield spread between corporates and governments began to widen, i.e., lower prices, thus the move to Treasuries for safety factors given the narrow yield loss. This movement can be seen within the greater negative returns in the longer maturities and lower-quality investment groups.

The municipal market again held its own for the quarter and full year. Municipals proved more resilient than other fixed income asset classes for several reasons: higher coupons with higher income distributions, improving credit quality, moderate new issue supply and the longer-term benefits of the 2017 tax reform legislation, a trend that should continue.

Since October, credit spreads, the difference between the yield on comparable maturing base Treasuries and other fixed income areas, have increased. Average investment grade debt is paying at least 1.4% above Treasuries, up from less than 1.0% at the start of 2018. Spreads on junk bonds, issued by companies that are considered less creditworthy, have risen even more, from around 3.2% to more than 4.5%, according to FactSet. The widening is a reflection of the lower level of economic growth going forward.

Like the equity markets, we expect further volatility in the fixed income markets, especially in riskier parts, such as high yield and emerging market bonds, due to issuers' high leverage, as the Federal Reserve continues to normalize interest rates and reduce its balance sheet. Credit quality will become more important as we move forward. Municipal bonds may, in turn, post solid performance in 2019, as demand appears strong for tax-exempt income.

The increase is telling us that investors are now more nervous. The same change in sentiment is playing out in the stock market, and the reasons are largely the same. The increase in bond market spread moves can have an impact on the economy by discouraging borrowing and investment in the industrial area of the economy.

Looking into 2019, we see the potential for intermediate- to long-term bond yields to hit a cyclical peak on expectations that economic growth and inflation will moderate due to current global economic conditions. If we are right, there is not a great reason to further reduce the maturity structure of portfolios, but investors should consider moving up in credit quality within the tiers of the corporate and municipal bond markets.

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