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Fourth Quarter 2018

"The light can at any time go from green to red without pausing at yellow." Warren Buffett

2018 turned out to be a roller coaster ride for investors. Following a 10% correction in the first quarter, U.S. stocks were able to slowly regain their footing over the next six months. By late September, the U.S. market had reached new all-time highs. This was quickly followed, however, by a selloff that started in October and continued through much of the 4th quarter. Investors received a lump of coal on Christmas Eve as the S&P 500 hit bear market territory, having fallen almost 20% from the September highs. The last trading days of the year showed some improvement off the lows, but not enough to register positive returns for the year. U.S. broad market indices were generally down 3% to 5% for the calendar year including dividends.

In the last 50 years, the S&P 500 has produced negative returns 11 times. 2018 was one of those years, and relatively modest in terms of severity. The chart below shows the highs and lows of the U.S. market in 2018.

S&P 500 Stock Prices 2018

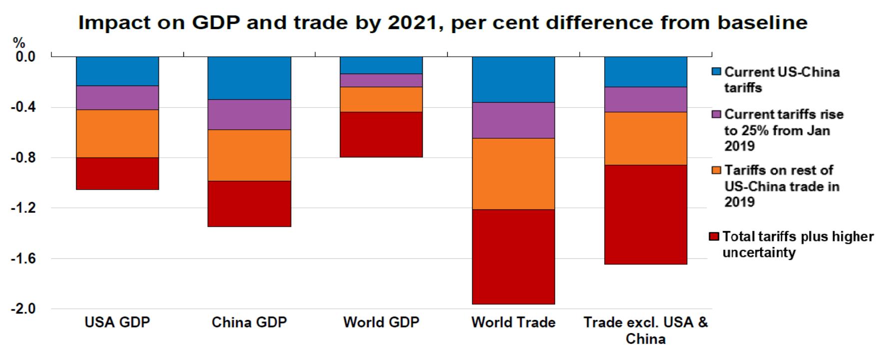
Source: Yahoo Finance

Despite what the spike in volatility would imply, we don't think the fundamental picture changed significantly in the 4th quarter. Midterm elections came and passed with results in-line with expectations. Trade tensions with China continued to experience highs and lows, but both nations agreed to a 90 day truce to try to come to terms. Inflation and interest rates moderated off their recent highs, but remained above year ago levels. The yield curve continued to flatten but did not invert. And the Fed raised rates in December as expected. None of these are new or dramatic enough to move the market 20% over the past 3 months. And while economic data has been mixed, key drivers such as jobs growth, GDP, and corporate earnings remained very strong.

So why the big year-end selloff? Consider the following factors: 1) We have likely seen peak economic and earnings growth in the U.S. for this cycle, and the market is pricing-in a lower growth scenario going forward 2) "Risk-off" investor sentiment is increasing as we approach the later stages of the economic cycle and endure greater political headlines, and 3) Momentum trading, tax-loss trading, and thin holiday trading volume exacerbated downside price action.

Both GDP growth and corporate earnings growth have been above trend this year, primarily due to tax reform and spending deals implemented early in 2018. The comparative benefit of these legislative acts will diminish in 2019, causing both economic and earnings growth to revert to more normal levels going forward.

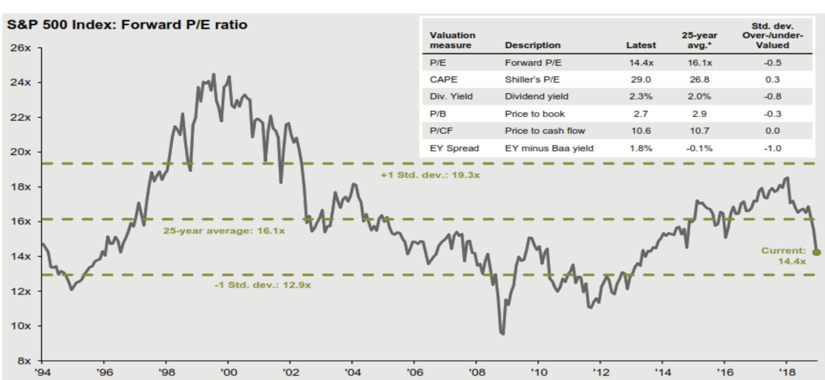
U.S. GDP is expected to grow 3% for 2018 and fall closer to 2% growth in 2019. Global GDP growth is expected to moderate as well, going from approximately 3.7% in 2018 to 3.5% in 2019. Depending on the outcome of U.S. and China trade talks, these numbers could come in lower, with the worse-case scenario likely a recession. The chart below attempts to quantify both the direct and indirect impact of escalating tariffs on U.S., China, and global GDP.



Source: Organization for Economic Cooperation and Development

Corporate earnings growth is also expected to slow in 2019 but remain positive. Fading tax benefits and the mathematical headwind of y/y comparisons are the biggest factors affecting earnings growth rates. Analysts currently expect 2018 earnings growth of 20% to slow to around 7% in 2019. Similar to GDP growth, these estimates would be subject to negative revisions if there were a deterioration in trade talks.

The anticipated growth deceleration described above has led to a re-pricing of stocks. At the beginning of 2018 the S&P 500 traded at 18.3x forward earnings. Today that multiple is 14.4. While stock prices may get even cheaper from here, the market is trading below the 25-year average and appears fairly attractive in absolute terms. This is especially true when taking current low interest rates into account. A lower starting multiple also offers greater return potential over time.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

Source: JP Morgan Asset Management, Guide to the Markets, December 31, 2018

The other factors we believe contributed to the downturn—negative investor sentiment and the impact from trading factors—require little explanation. Investors in the quarter were quick to sell in response to recession fears, political concerns, and declining stock prices. The negative wealth effect and loss of confidence from lower stock prices are real. We note that extremely bearish investor sentiment can be followed by better than average stock returns in the near term.

Where does this leave us going into 2019? We think there are valid arguments for both a modestly bullish and modestly bearish outlook from here. The table below provides a good summary for each case.

A CONFUSING AND CONFLICTED OUTLOOK

The bullish view...	...and the bearish
Solid earnings growth	Earnings uncertainty is high
Growth is slowing, not collapsing	Fed policy is too tight
Fed is becoming more dovish	Tariffs will slow growth
Trade issues could improve	Global growth is unbalanced
Correction has been broad-based	Financial market volatility could rise
Sentiment is very negative	Political uncertainty is pervasive
Valuations have improved	The end of the cycle is inevitable

Source: Nuveen Market Outlook, December 31, 2018

While uncertainty remains high and either outcome is credible, we lean towards a modestly bullish scenario for 2019. Our view is that a recession is less likely until 2020 or beyond. Breaking this down into the components of GDP, we think that a solid labor market and a modest uptick in wages continue to support consumer spending. Likewise, business spending should hold up over the near term given positive earnings growth, low corporate tax rates, and solid demand. Government spending should continue to expand based on recent legislation. Finally, lower mortgage rates and slower price gains may help the housing sector in 2019.

We also believe it likely that the Fed moderates its pace of tightening this year based on the current absolute level of short term rates, along with lower inflation expectations. Inflation moderated in the 4th quarter, helped by the decline in oil prices. Most inflation measures are now at or below 2%, with CPI at 2.2%. A more dovish Fed would improve investor sentiment and could help stabilize stock prices. A slower pace of rate increases could also allow the yield curve to steepen at the margin.

Perhaps the biggest wildcard for 2019 is global trade. More visibility around trade and a positive outcome in U.S. and China negotiations could boost both business and consumer confidence. An easing in trade tensions could lead to greater spending, higher trade volumes, and more stable growth. A negative trade scenario would almost certainly lead to the opposite outcomes and further downside in the markets. This is something we will be watching closely.

Only with the benefit of hindsight will we know when a bottom is in place for the economy and the markets. In the meantime, we remind investors that volatility is normal, and that stock price declines are not a reason to abandon a thoughtful long term investment approach. Most investors that attempt to time markets get out too soon and return too late, resulting in worse long term returns than having done nothing. While the direction of stocks (and even bonds) is highly unpredictable in the short term, it is surprisingly predictable over the long term—producing positive returns for disciplined investors. We remain focused on managing near term volatility through a high quality, low cost, diversified portfolio that can produce reasonable returns under a variety of market outcomes.

The Private Capital Management Team

By the numbers…

Index	4th Quarter	2018
S&P 500	-13.5%	-4.4%
Dow Jones Industrial Average	-11.3%	-3.5%
Russell 2000	-20.2%	-11.0%
MSCI EAFE	-12.5%	-13.8%
MSCI Emerging Markets	-7.5%	-14.6%
Barclay's US Aggregate Bond	+1.6%	0.0%
Bloomberg Commodity	-9.4%	-11.3%

Domestic total return and international net return data provided by Morningstar as of 12/31/2018