

Living in "Interesting Times"

YEAR END 2018 REVIEW, 2019 FORECAST

There are many versions of the origin story of the apocryphal Chinese curse, "May you live in interesting times" but the gist of the curse is clear: interesting times are presumably when all the bad, unsettling, tumultuous events take place. Hence it is considered a curse rather than a blessing. It certainly is an apt description of where we find ourselves today. Though as is also said: "This too shall pass."

When confronted with the task of penning a review of 2018 with an outlook for 2019, all I could think was how much I would rather be writing this piece six months ago or six months hence. In mid-2018 the stock market was rallying robustly; interest rates were rising in a rather predictable and well-understood pattern by a confident Federal Reserve. Global economic growth was only just then showing signs of cooling but nothing that warranted panic and, if anything, needed only minor policy adjustments here and there to get back on course. Yes, the trade war was underway but the disruption it would eventually create was only a headline here and there and plenty of observers were opining that it would all come to pass rather painlessly. They would point to the renegotiation of NAFTA (the North American Free Trade Agreement) as really much ado about nothing and as a blueprint for a final resolution of the other trade dis-agreements. There was still the US mid-term elections to consider but polls were mixed and enough talking heads on TV



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made the prospect of divided government sound quite welcome given recent experience.

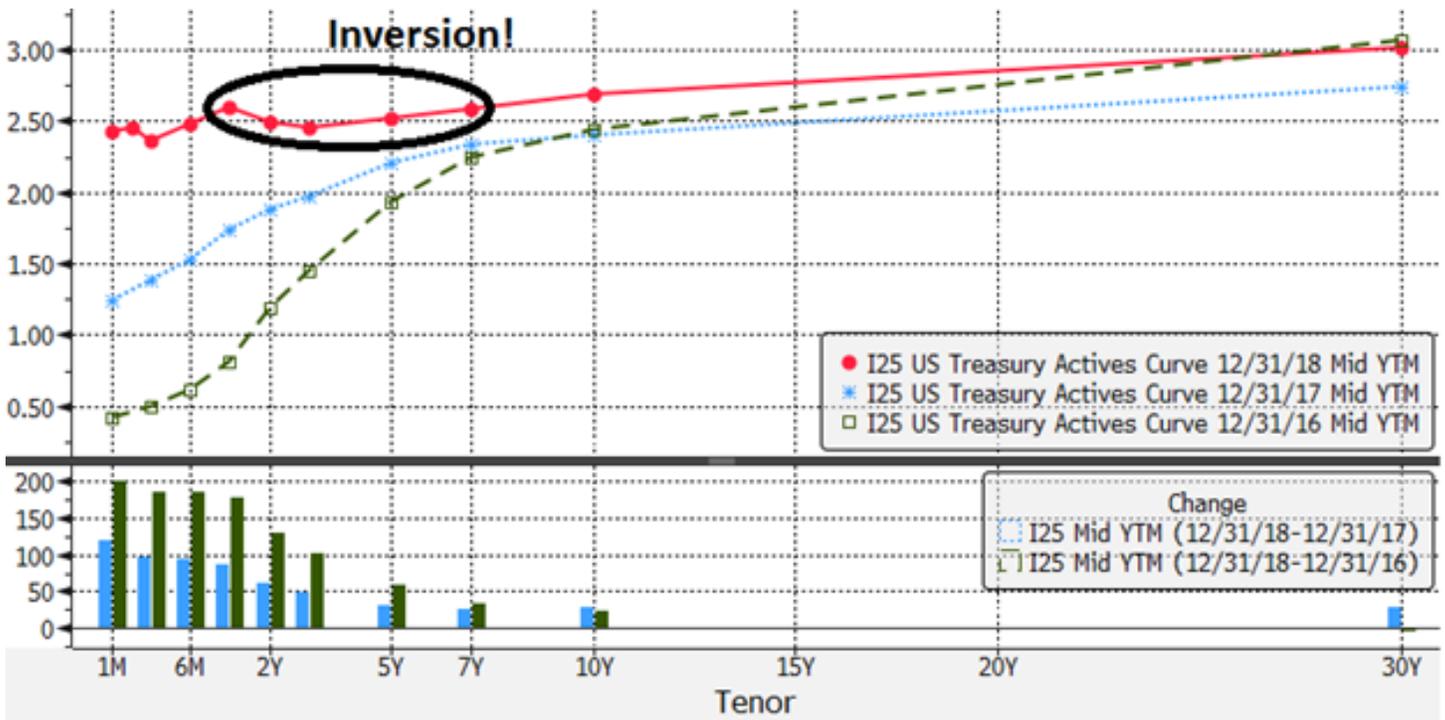
But in the intervening period, the times got much more interesting. Global growth, especially China—the world’s second largest economy—started showing a much more acute slowdown. Europe’s main economic engine, Germany, had also started to slow with Industrial Production figures turning negative year-on-year.

GERMAN INDUSTRIAL PRODUCTION (RHS) AND CHINA GROWTH (RED LHS) Y/Y



And the Federal Reserve continued to tighten policy with one additional hike to short rates in December. This finally caused a small inversion (where the slope of the curve turns negative) of the US Treasury yield curve – a traditional harbinger of recession. Amid all this, the Federal Government was shut down over a most unlikely but seemingly intractable dispute. Though compared to the debate in the United Kingdom over Brexit (which as of this writing looks to be heading toward a no-agreement departure which will result in who-knows-what chaos for the British economy) the shutdown over border wall funding seems almost quaint.

US TREASURY YIELD CURVE INVERTS (A LITTLE)



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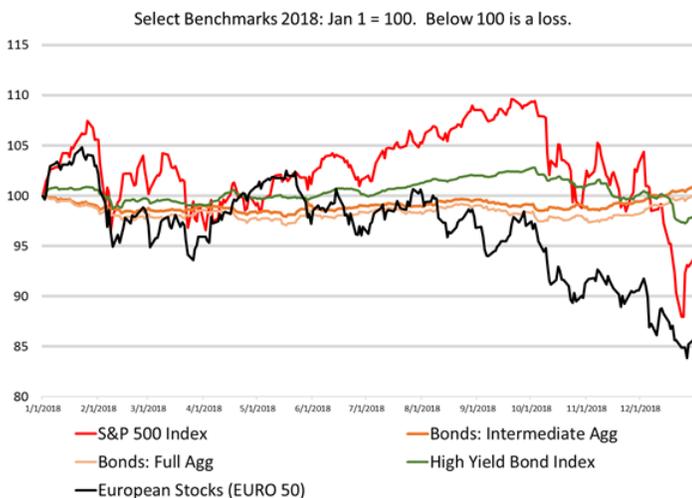
These unsettling events only cover a relatively small portion of the globe. The election of populists in Latin America’s largest economies – Brazil and Mexico – who seem determined to disrupt the status quo also add to market uncertainty. As do those populists who are gaining traction in Western Europe. There’s not enough ink to list all of the world’s problems. Suffice it to say there’s plenty to fret about.

As much as the actual news hurt market sentiment and contributed to the sell-off in shares, the unprecedented level of uncertainty we are living with likely has had an even larger deleterious impact. Investors project their greatest fears onto the blank canvas of the unknown which is why knowing what the bad news will be is better than

guessing how awful things might get. This explains why a sudden currency devaluation, or declaration of war, or election of someone whose policy proposals seem outlandish on their face causes so much short-term market turmoil only to recover later and often quite quickly.

The opposite is true of never ending uncertainty which is what the market has had to deal with for months on end and which finally seems to be dampening expectations, delaying investment decisions, slowing significant capital expenditures and sapping animal spirits. With politics at gridlock, the global economy cooling, consumer confidence, which had been riding high for the past couple of years, finally turned downward at the end of 2018 and while still overall positive, had certainly lost some momentum. Which is certainly understandable given the downturn in the markets over the past few months. When only the safest bonds make any money, and even then, only a pittance, it's safe to assume it was a bad year for most investors.

HARD TO MAKE MONEY IN 2018



LOOKING FORWARD: BRIGHTER PROSPECTS?

I mentioned earlier that I would also rather be writing this half a year hence. Six months from now it is unlikely that the US Government will still be shutdown. Brexit is likely to have seen some form of resolution—for better or for worse—but at least it won't be as completely fathomless as it is now. There will be greater clarity over the state of the economy and it is possible that the recent troubles represent a moderation of growth rather than the start of a recession. The US economy is still benefitting from the tax cuts and deficit spending program and these should continue to have an impact when the government reopens.

But as Nancy considers in the section that follows there are growing hopes that policy moves by China and the Federal Reserve could right the ship and allow for upside in the markets. It's too early to be sure that things will work out as she lays out in her section, but it certainly is a scenario to consider.

2016 REDUX FOR EQUITIES?

We see many similarities—3 big things to watch in 2019

China, The Fed and revenue guidance are critical to our thesis that 2019 is setting up to look a lot more like 2016 than 2018.

China: Below is a snapshot of Shibor (the Shanghai Interbank Offered Rate)—the equivalent of our Fed Funds rate. You can see that Shibor is adjusted much more frequently and aggressively by the People’s Bank of China (PBOC) than our Fed Funds rate. (If you were paying even just a little attention to stock market volatility over the last few months you would have been hard-pressed to find a commentator who didn’t blame Fed Chairman Powell for too aggressively raising rates in 2018—PBOC monetary policy wouldn’t fly in the U.S., to say the least.)



I draw your attention to 2015 – when China experienced a sharp slowdown and global stocks sold off on worries over a slowing global economy led by China. Note the response from Beijing: aggressive easing in monetary policy. Fiscal policy was also eased, and the yuan devalued against the dollar.

Enter 2016 when the U.S. stock market experienced the worst opening six weeks in its long history. The Fed, under Chairwoman Yellen, had just embarked on ending the easy money policy employed since 2008. First, by raising the Fed Funds rate 25 basis points in December 2015 (to 50 bps) and then by telegraphing four hikes in 2016. Oil prices bottomed at just under \$28/barrel in February as global demand dried up and stocks sold off not only in the U.S. but around the world. The Fed was forced to pause.

By the end of Q1 2016 the effects of China’s significant easing in 2015 began to bear fruit and ripple through the global economy. Oil improved, stock markets rallied, and the dollar declined. Suddenly, the phrase: Global Synchronized Growth was rolling off the tongue of every investor. And when the Fed hiked rates in December 2016 and into 2017, Beijing followed suit, choking growth in 2018.

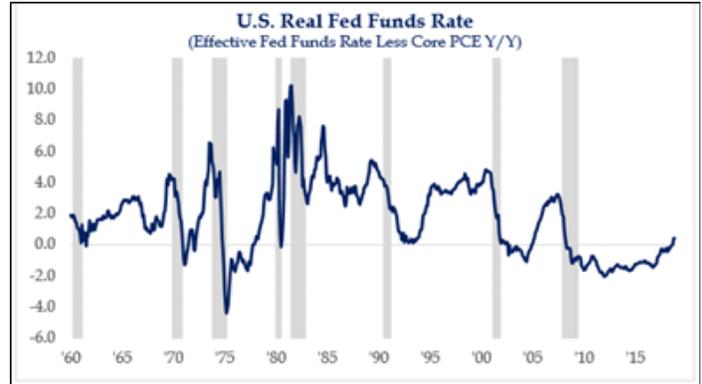
China also slowed infrastructure spending which dampened global growth further in 2018. U.S. trade tariffs were the icing on the cake. And so goes the cycle.

In 2018, we once again saw Shibor cut significantly—by over 200 bps. Beijing just announced a 40% year over year increase in rail infrastructure spending, eased bank reserve requirements and hinted at incentives to increase auto purchases in December. In short, we expect to see China’s GDP growth improve marginally in 2019 which will be good for the global economy, and will allow the dollar to ease up relative to EM currencies and improve demand for U.S. products. Oil, stocks and the dollar are beginning to price in improvement in global growth. And I believe China is determined to ease until the economy improves. Today’s imports/exports disappointment from China does not change our view. More imports, fewer exports in December reflect lagging data—it’s the next two quarters that matter due to the lagged effect of Beijing’s policies.

I also expect to see a quasi-meaningful trade deal announced between the U.S. and China by mid-year—U.S. presidents are interested in improving economic growth in advance of their next election, so we think the Trump Administration will get something done. I believe the market is not yet pricing that event into stock prices.

THE FED.

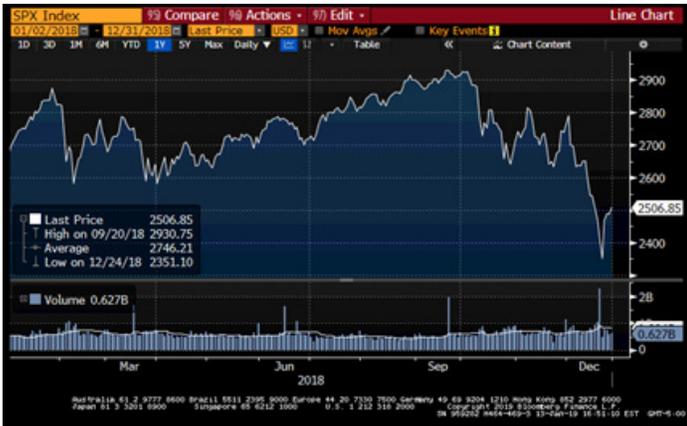
After the Fed raised three times in 2017 under Chairman Yellen, President Trump selected Jerome Powell to be the next chairman of the Federal Reserve. Chairman Powell’s Fed raised another four times in 2018 bringing the real (after inflation) Fed Funds rate above zero for the first time in a decade. All good.



(Chart courtesy of Strategas Research Partners)

Fueled by robust corporate profits, above trend GDP growth and low unemployment, U.S. stocks seemed to climb every wall of worry in 2018; every tweet and every trade tariff escalation delivered by the Trump Administration rolled off investor’s backs all the while the Fed was tightening. That is until straight-talking Chairman Powell gave an ill-advised interview on October 3rd stating that the Fed Funds rate was a long way from neutral (after three hikes in 2018). Then stocks began a relentless sell-off that was exacerbated by algorithmic trading models and year-end tax loss selling. The selling ended on Christmas Eve producing the worst December since the Great Depression (see below).

Eventually the Fed got the message: messaging matters. Since then, Powell has moderated his rhetoric, reinforcing the Fed’s desire to be data dependent. Stocks have improved significantly, and the 10-year Treasury has appreciated meaningfully. Like 2016 when Chairman Yellen’s Fed telegraphed four rate hikes but was forced to hold steady until the December meeting, I believe that Fed policy will be somewhat more accommodative in 2019 than previously indicated. With an expected-to-improve China and moderating Fed policy, I believe stocks will



continue to move up in the high-single, low-double digit range and am finding many more high-quality companies with attractive valuations.

Revenue guidance. After 2018’s 20+% earnings growth and revenue growth in the low double-digits for U.S. corporations, I am expecting mid-single digit earnings growth in 2019. The market multiple now reflects a slightly below the twenty-year average P/E. We don’t need multiple expansion for stocks to go up, just appreciation in line with mid-single digit earnings growth and the contribution from dividends.

Powell September 26 th - October 3 rd	Powell November 28 th
The economy is “remarkably positive,” “extraordinary,” “particularly bright.”	“There is a great deal to like about the outlook.” But things often turn out to be quite different.
“We are a long way from neutral at this point.”	Interest rates “just below” neutral.
“We may go past neutral.”	“There is no preset policy path.” We will pay close attention to incoming data.

(Table courtesy of Cornerstone Macro)

The odds of a recession in 2019 are low in my opinion. The U.S. is the best house on a recovering global block and the consumer—2/3’s of the economy—is well-heeled and sporting the strongest balance sheet in decades. Add to that an equity risk premium one standard deviation above the average at 332 basis points and investors are getting paid to take on stock risk.

Earnings and revenue guidance matter. Apple and FedEx have already warned due to China woes and the slowdown in the Eurozone. The big bank stocks kick off the season this morning. We will be watching for guidance and tone. But, one thing is for sure: volatility is here to stay. Still, until I see meaningful signs of pending recession, stocks are likely still the best game in town. I favor large, industry leaders with growing dividends trading at attractive valuations. – NT

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TO SUMMARIZE

It is easy to focus solely on the decline in equities in the final weeks of last year and ignore the bigger picture that the US stock market had, until that period, one of the longest winning streaks on record. Given such a spectacular run, a setback like the one we saw was more than overdue and yet it still failed to meet

the definition of a bear market. Not that we are calling for one, or that one necessarily must happen, just that we should feel fortunate to have had the run we just enjoyed.

But it is the case that for most investors relative performance for 2018 was determined in the crucible of the sell-off. It certainly was the case for our strategies. Our Equity Income portfolios performed exactly as we would expect in 2018. The strategy provided protection in a declining market, down 2.07% versus the S&P 500 which declined 4.38%. The strategy also ranked amongst the top 1% of its peer group in the Morningstar data base. Equity Growth performed slightly below the market with a negative 5.22% but still ranked among the top 10% of its peer group. We don't like losing but in a down market we like losing less whenever possible.

In fixed income, we gave back a little of our year-to-date outperformance as investors panicked and bought bonds in a flight to safety. Bond benchmarks moved from having lost money all year to a small net positive return. Our Taxable Active Fixed Income

strategy beat the Intermediate Aggregate benchmark by 74 bps with a 1.66% return to 0.92% for the year. The Fixed Income Mutual Funds also beat with a 1.46% return.

Unfortunately, we are still in the middle of the most interesting of times and so predictions are difficult. As Yogi Berra quipped: "Prediction is difficult; especially about the future." But we can feel confident about the following: in the longer-term stocks will recover and post positive returns over time even if 2019 proves to be troublesome. Bonds have seen yields recover from an unprecedented period of low rates but this transition is likely more than half-way over and finally fixed income provides positive real (post inflation) returns. It is no longer as easy to dismiss fixed income from one's asset allocation as it had been. We're looking at refining our own weightings to reflect this fact and encourage clients to confirm that your investments are aligned with your goals.