Market Review and Outlook—January 7, 2019

Red Storm Rising—It is hard to miss the mass of red in the chart below, showing the losses that investors have suffered in the past three and twelve months. While national elections typically bring an end of uncertainty, this year the election was followed by a government shutdown, even before the Congress changed from one-party rule. Ongoing fear over global trade agreements and tariff threats has hung over the global economy for two years. Oil prices plummeted 38% in the past quarter, adding to investor anxiety despite the many positive consequences. With this tumultuous backdrop, US stock markets led the way down during the quarter, with dramatic daily shifts—mostly down but some remarkable up days, too.

The Year that Wasn't—2018 was supposed to be a wonderful year for investors. In December 2017 we got a new income tax law which drastically cut corporate tax rates, leading to, not just promised, but actual, corporate profit leaps of 25% or so. This was supposed to, and did, increase economic growth from about 2% to 3%. This sounds little, but is substantial. This good economic news would enable the Fed to continue to wean the country off historic levels of financial support, by boosting the Fed rate at a reliable, steady pace. This was all expected, and this all happened. What was expected was that this would boost investor confidence and asset levels. That failed to occur. The failure was broad, as the table shows.

Inflation Tame—Even before the bulk of the oil price decline, US inflation has remained fairly tame in 2018, despite a short rise this summer. With oil prices so low, and with only modest wage inflation despite dramatically low unemployment levels, inflation is expected to remain in this very low and manageable level of about 2%. This is good for just about everybody.

Passing the Buck—After falling 7% in 2017, the US dollar was expected to rise in 2018. Instead it fell further, about 3½%. This hurt foreign stocks, which led US stocks up in 2017, and led them down in 2018. As was the case a year ago, we are hopeful that the US dollar will fall in 2019, or at the least will not rise further.

Oil Leak—After rising 20% in 2017, oil prices fell 30% in 2018, all in the last three months.

Bonds—Short term rates rose 1% in 2018, while longer term rates rose ½%, and municipal rates changed little. With rising rates, bonds offered little return to soften 2018's stock market losses.

In short, 2018 was a year that most investors are happy to put behind them. But what will 2019 bring?

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.47%	+1.52%	+0.72%	+0.44%	+0.29%
Intermediate Term Bond	+0.86%	-0.50%	+2.15%	+2.27%	+4.31%
Intermediate Muni Bond	+1.19%	+0.77%	+1.71%	+3.05%	+4.24%
Large-Cap Stock	-13.53%	-6.26%	+7.67%	+6.66%	+12.00%
Mid-Cap Stock	-16.20%	-11.16%	+5.53%	+4.01%	+11.92%
Small-Cap Stock	-19.32%	-12.66%	+5.94%	+3.23%	+11.64%
Foreign Large-Cap Stock	-12.65%	-14.58%	+2.64%	+0.11%	+5.93%
Health	-16.30%	-0.42%	+3.68%	+8.90%	+15.10%
Real Estate	-7.18%	-5.96%	+2.47%	+6.91%	+11.50%
Technology	-17.61%	-3.21%	+13.80%	+11.71%	+17.03%
Moderate Allocation (60% stocks)	-8.66%	-5.79%	+4.71%	+3.67%	+8.33%

The data in this table comes from Morningstar and is as of December 31, 2018.
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Awful Results in 2018—Only two of my seven predictions came through for 2018 (marked in blue), and there was one dramatic miss (a 20% swing). I had called for all three large stock categories to earn more than 6% and all fell more than 6%. Growth did outperform value, but by losing less. Real estate lost, well below my prediction. General bonds did poorly, worse than predicted, while high-yield bonds did much worse than predicted. After a stellar year in my 2017 predictions, these 2018 predictions are among my worse (although the 2008 predictions were much, much worse).

Sector	2018 Prediction	2018 Actual	2019 Expectation
Large-cap US Stocks	More than +6%	-6.3%	More than +6%
Smaller US Stocks	More than +6%	-11.7%	More than +6%
Non-US Stocks	More than +8%	-14.6%	More than +8%
US Growth vs Value	Growth outperforms	Growth –2.09%, Value –8.5%	Growth outperforms
Real Estate	More than +5%	-6.0%	More than +5%
General bonds	Less than +5%	-0.5%	Less than +5%
High-yield bonds	More than +5%	-2.6%	More than +5%

2019 Expectations—I am leaving EVERY expectation unchanged for 2019. This isn't being lazy; I have looked at each of the seven categories, and I have no reason to change the expectation. My level of confidence is higher for the stock projections, and is weakest on the real estate projection. Regardless, I stand by this identical set of expectations for 2019. We do plan for this to be our last annual prediction (however we **will** report on the results next January), as it draws readers' attention to too short a timeframe, raising anxieties which can be counter-productive.

While emotions can and do affect stock market returns, a greater, longer-term factor is the underlying economics, specifically the profits earned by companies. These profits are driven by economic growth. The US economy has grown in 27 of the past 30 years. US stocks have risen in 24 of those 30 years. The last time we had back-to-back US stock losses was from the dot-com bust in 2000-2002, when the PE level (how expensive) of the stock market was higher than it had ever been. **It is this historical perspective that leads me to expect 2019 to be a good year for investors, and particularly stock investors.**

Aren't There Big Problems?—Yes. As of today, many parts of the federal government are shut down. Great Britain can't decide whether to exit the Eurozone. Fears of tariffs have cooled global economic plans. China's economic growth rate has cooled from its higher level a decade ago, while its public and private debt has continued to hit new record levels. Investigations into the President's activities will be entering their second year in 2019. The current economic expansion is months away from becoming the longest in history. This, coupled with a nearly inverted yield curve has caused many analysts to mention the R word—recession.

Why be Optimistic—Why Invest Now?—When was the last best time to invest? Ten years ago, in March 2009, the US stock market reached bottom after the financial meltdown. This was the best time to invest in stocks (or remain invested). Were there big problems then? Absolutely. Like today, in March 2009 we had problems, but we also had investors, and a stock market, fully aware of these problems, fixated on these problems, and that priced these problems into the markets. I am not afraid of economic problems. I am afraid of economic problems that are not priced into the markets. I am optimistic about 2019 due to my belief that today's substantial problems are priced in. **This is why I consider positive surprises to be more likely in 2019 than negative surprises.**

Oil has fallen sharply. Thus consumers will have more money in their pockets, as it takes less money to heat their homes this winter, and to fuel their cars each week. Inflation is low, also leading to more money in consumers' pockets. The late 2018 market turmoil and anxiety appears to lead the fed to end interest rate hikes sooner. This should help bonds return to more normal returns this year and beyond, with yields driving returns, rather than having a portion of their return sapped by price declines tied to rising rates.

In 2017 and 2018 we have felt comfortable with US stocks being a little more expensive than normal, due to factors such as lower-than-normal interest rates and inflation. We now have the US stock market cheaper than normal due to the fourth quarter losses, with inflation still very low, and interest rates nearly stable. While the US stock market is cheaper than normal, foreign stock markets including emerging markets are even cheaper. Investors who buy stocks (or hold on) now, even if it takes other investors awhile to appreciate today's bargain prices, are being rewarded by historically higher dividend yields. We are being paid to be patient.

A risk of recession certainly exists, however it is unlikely to be around the corner. Inverse yield curves typically precede recessions (in the cases that they actually predict a recession) by over a year. The Conference Board's Leading Economic Indicator appears to have plateaued, but has not yet fallen, which it typically does, again with about a year notice. Even if a recession started tomorrow, our economy's cyclical sectors are not over-heated, indicating that, if it comes soon, the next recession should be fairly benign.

There are real areas of concern for investors in 2019. We are comforted with the knowledge that economics and odds favor investors who look at 2018 as a year that has brought bargains along with the concerns. We see many bargains for stock investors, and we see a quickly normalizing bond environment. This gives us confidence to expect that 2019 will be a good year for those investors who have remained calm throughout 2018, and who keep their eyes on the horizon, through a commitment to investing for the long haul.