January 2019

Market and Economic Outlook

2018 Ends With Downside Volatility, Recession Fears, Slow Housing Growth

Create Opportunities

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Despite a post-Christmas rally, December 2018 was one of worst-ever months for U.S. stocks. The S&P 500 fell 9 percent in December and nearly 14 percent for the fourth quarter, jarring investors and creating a veritable storm of fear-mongering headlines and chatter in the financial media. The sudden re-emergence of big downside volatility has many investors feeling anxious about the potential for a bear market and/or a recession.

We thought it would be fitting to take a step back and explore the historical record on bear markets and recessions. We will also take a look at fourth quarter market action and highlight some of the contributing factors. In addition, we will touch on recent developments in the U.S. housing market.

Positives	Negatives
Employment is strong	Future returns (for the next seven to 10 years) from stocks and bonds are expected to be lower than long-term historical averages
U.S. corporate earnings are firm and supported by tax reform	Escalating global trade tensions, which could derail economic growth and possibly lead to a trade war
Consumer and small business confidence remains high	Uncertainty on the effects of global central banks removing monetary stimulus measures
The U.S. economy is on pace to grow at a robust 3 percent or more for 2018 (although the expectation for 2019 is lower growth)	Signs of slowing global growth

Recessions and bear markets: What can we learn from history?

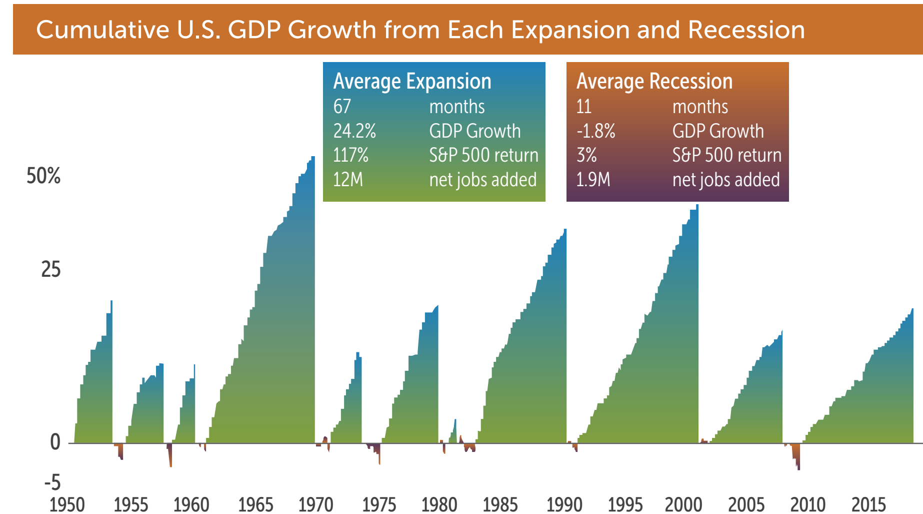
The economy and capital markets are cyclical. They expand and contract, rise and fall. This is perhaps an obvious point, but it's always worth remembering, especially in stressful times. Recessions and bear markets are simply part of the cycles of economies and markets.

Economic Cycles	
Expansion A period of sustained growth across the economy (including many variables, such as gross domestic product [GDP], employment, production, and real income.)	**Recession (Contraction)** A significant decline in economic activity spread across the economy, lasting normally at least two quarters.

Stock Market Cycles	
Bull Market A prolonged period of rising prices. The most common definition is a rise of at least 20 percent from its previous low.	**Bear Market** A prolonged period of falling prices. The most common definition is a fall of at least 20 percent from its previous high.

Although recessions are fact of life, the economy is more often in expansion mode. Consider the chart of expansions and recessions data going back to 1950.

Cumulative U.S. GDP Growth from Each Expansion and Recession



Sources: Capital Group, National Bureau of Economic Research, Thomson Reuters. As of 9/30/18. Month-end values used for S&P 500 returns. Nearest quarter-end values used for GDP growth rates. GDP growth shown on a logarithmic scale.

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There is no universal definition of a recession or a bull/bear market. Therefore, the closest we may come to an "official scorekeeper" is the National Bureau of Economic Research (NBER), a private, nonprofit organization that the investment industry often looks to for monitoring these cycles.

The steep stock market decline in the fourth quarter may or may not be considered a bear market, depending on how much of a stickler you are. On December 24, 2018, (the low point for the year), the S&P 500 price fell by more than 20 percent from its peak on an *intraday* basis. But at the 4 p.m. ET close, it was *only* down 19.8 percent, just shy of the hypothetical 20 percent standard. However you may want to define, it definitely felt like a bear market, even with the partial post-Christmas recovery. The table to the right (from Pension Partners), does define this fourth quarter swoon as a bear market, and details bears going all the way back to the late 1920s.

A couple of points to note regarding the data to the right:

- A bear market doesn't necessarily mean a recession is around the corner. Of the previous 20 bear markets, only 11 were associated with a recession.
- When a bear market happens with a recession, they tend to last longer and have steeper losses.

S&P 500 Bear Markets (Defined as 20 Percent Peak to Trough Decline): 1929 to Present

Bear Market Period	Bear Market Length (Months)	NBER Recessions	Recession Length (Months)	S&P Start	S&P End	% Change
Sept. 2018 – Dec. 2018	3			2941	2347	-20%
May 2011 – Oct. 2011	5			1371	1075	-22%
Oct. 2007 – March 2009	17	Dec. 2007 – June 2009	18	1576	667	-58%
March 2000 – Oct. 2002	31	March 2001 – Nov. 2001	8	1553	769	-51%
July 1998 – Oct. 1998	3			1191	923	-22%
July 1990 – Oct. 1990	3	July 1990 – March 1991	8	370	295	-20%
Aug. 1987 – Oct. 1987	2			338	216	-36%
Nov. 1980 – Aug. 1982	22	July 1981 – Nov. 1982	16	142	102	-28%
Sept. 1976 – March 1978	18			109	86	-20%
Jan., 1973 – Oct. 1974	21	Nov. 1973 – March 1975	16	122	61	-50%
Dec. 1968 – May 1970	17	Dec. 1969 – Nov. 1970	11	109	69	-37%
Feb. 1966 – Oct. 1966	8			95	72	-24%
Dec. 1961 – June 1962	6			73	51	-29%
Aug. 1956 – Oct. 1957	14	Aug. 1957 – April 1958	8	50	39	-21%
June 1948 – June 1949	12	Nov. 1948 – Oct. 1949	11	17	14	-21%
May 1946 – May 1947	12			19	14	-28%
Nov. 1938 – April 1942	36			14	7	-46%
March 1937 – March 1938	12	May 1937 – June 1938	13	19	9	-54%
July 1933 – March 1935	20			12	8	-34%
Sept. 1932 – Feb. 1933	5	Aug. 1929 – March 1933	43	9	6	-41%
Sept. 1929 – June 1932	33	Aug. 1929 – March 1933	43	32	4	-86%
Average Without Recession	12					-29%
Average With Recession	17					-42%
Average All	15					-36%

Source: Pension Partners

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Although the movements of the economy and stock markets are not always synchronized, stock prices — average and over time — advance more than they decline.

	Bull Market	Bear Market
Average length	9.1 years	1.4 years
Average cumulative total return	473 percent	-41 percent

Bull and Bear Cycles 1926 to Present

* Not applicable since duration is less than one year.

Sources: First Trust Advisors L.P., Morningstar. Returns from 1926 — 12/31/18.

Given this context, what, if anything, should investors do now if they are fearful of a bear market or recession?

- **Long-term investors should stay put —**The future is unknowable. Market cycles can last longer or move in greater magnitude than would seem reasonable based on before-the-fact-analysis. Perhaps even more importantly, the turning points of cycles are unpredictable. It may be tempting to believe that you can sell (or dramatically reduce exposure to) stocks prior to a bear market and then buy back in at lower prices, but it is highly unlikely that any investor will do so successfully.

  Even if you are fortunate enough to sell at the "right" time, there still remains one more timing decision — when to buy back in — that you have to navigate as well. The unpredictable nature of the markets, combined with behavioral biases related to normal, human psychology (overweighting the pain of losses versus the joy of gains, extrapolating the recent past into the future, and many other biases that can lead to poor investment decisions) make the attempt to time the markets a bad idea.
- **Reassess your ability and willingness to take risk —** Given the lengthy and steep rise in stocks since 2008 – 2009, some investors may have stretched their comfort zone with regard to their stock market exposure. This could mean that it's appropriate to somewhat reduce stock exposure. It's important to draw a distinction here between market timing (dramatic portfolio changes based on predicting the future) and adjusting a portfolio. It is important to have a portfolio's risk (potential volatility and short-term unrealized losses) aligned with your ability to withstand that risk. A long-term investment plan — no matter how good — won't work if you can't stick with it long-term.

Total Returns (%) as of December 31, 2018

Index Name	Capital Market Segment	4th Quarter 2018	Year-to-Date 2018	2017
Bloomberg Barclays U.S. Aggregate	U.S. Investment Grade Bonds	1.6	0.0	3.5
S&P 500	U.S. Large Cap	-13.5	-4.4	21.8
Russell 2000	U.S. Small Cap	-20.2	-11.0	14.7
MSCI EAFE	Non-U.S. Developed Markets	-12.5	-13.8	25.0
MSCI EM	Emerging Markets	-7.5	-14.6	37.3
Hypothetical 60/40 Portfolio*	Diversified Mix of Indexes	-7.5	-5.1	15.3

* 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM

An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

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Nearly every asset type disappointed investors in 2018

December was not just bad — in some ways it was *historically* bad. The S&P 500's -9 percent return in December was the worst monthly showing since the financial crisis of February 2009 and the worst December return since the Great Depression (December 1931).

Pain was felt widely in U.S. stocks. Only two of the 11 market sectors (health care and utilities) finished with positives returns for the year, while the biggest loser was energy. With oil prices in free fall — West Texas Intermediate crude fell nearly 40 percent during the fourth quarter — stocks in the crude-sensitive energy sector fell more than 18 percent for the year (Standard & Poor's, *Morningstar*).

It wasn't just that U.S. issues disappointed in 2018. Nearly *everything* disappointed investors. One way to put this in context: a broad list of 17 major asset classes (different types of bonds, U.S. and foreign stock market indices, listed real estate, and commodities, as compiled by Bloomberg) all had a return lower than the inflation rate last year. This is a stark reversal from the previous two calendar years, where almost all assets beat inflation.

Large cap growth stocks — which we and others have accused of flying too close to the sun in this cycle — fell materially in the fourth quarter. The Russell 1000 Growth Index, a subset of about 550 companies that make up the large cap Russell 1000 Index, shed nearly 16 percent in the last months of 2018. The small cap counterpart, Russell 2000 Growth, was down 22 percent.

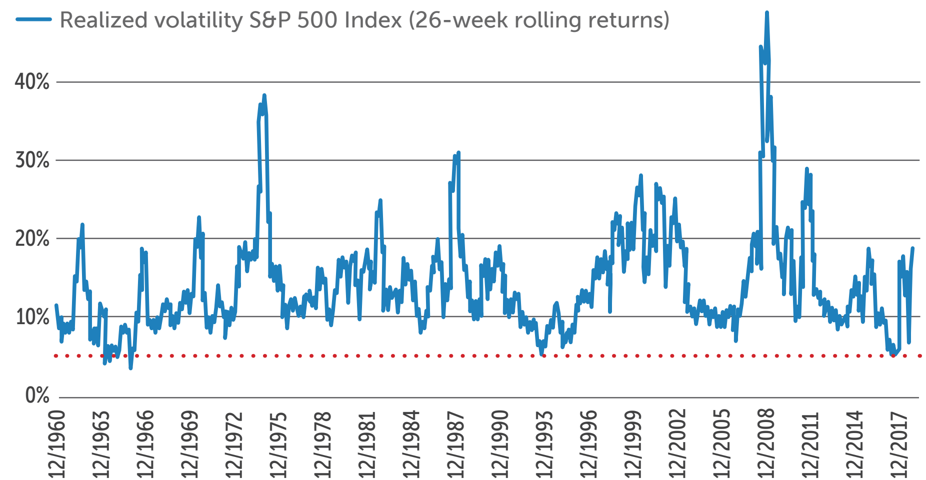
Small cap U.S. stocks suffered a bear market in the fourth quarter, with the Russell 2000 index down just more than 20 percent. Smaller company stocks may have been hit with a double-whammy of rising rates (smaller companies, in general, rely more on shorter-term and adjustable-rate financing than larger companies) and fears of lower growth (it is believed that smaller companies are more economically sensitive).

In terms of the relative performance of growth versus value stocks, the fourth quarter saw value outperform. As discussed in the October 2018 issue of *Market and Economic Outlook*, value has been languishing for an extended period versus growth. The final quarter of 2018 was therefore a welcome reprieve for value investors, but it remains to be seen if this is a long-term turning point.

This year's market volatility may feel worse than it actually is

Last year's ups and downs feel especially jarring after several previous years of relative calm. Below is a graph of the S&P 500's volatility (over six-months rolling periods), and we can observe how — relative to decades of market history — the recent gyrations are well within the range of what may be called normal.

Consider that the stock market, in any given individual year, almost never provides a return close to the long-term average return. Looking at the calendar year returns of the S&P 500 going back to 1926, you see that roughly 70 percent of all yearly returns are either greater or less than 10 percent. Remember, too, that the inherent riskiness of stocks is why they provide a "risk premium" (higher returns than safer assets). There is no return without risk.



Source: Bloomberg

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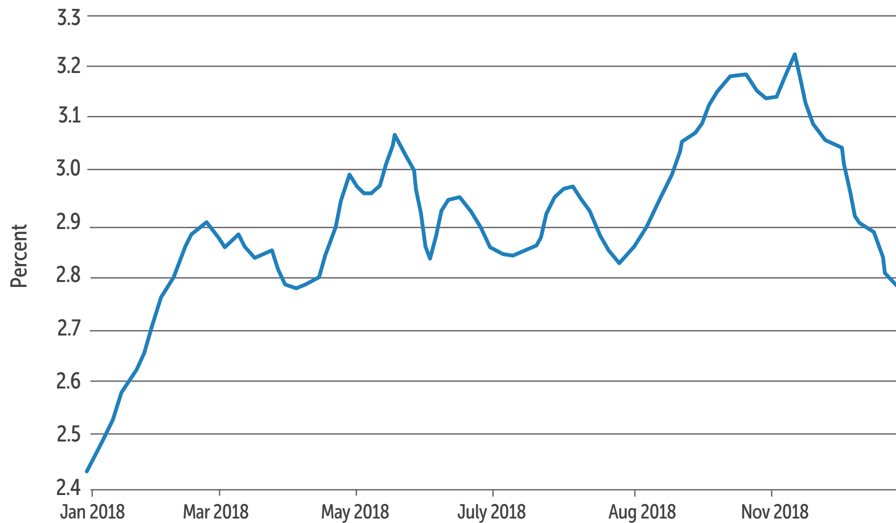
Bonds, in the red for most of the year, ended up providing satisfactory returns. The broad investment-grade bond universe, as measured by the Bloomberg Barclays Aggregate index, staged a rally in the last quarter (up 1.6 percent) to finish flat (0.0 percent) for the calendar year. Two key factors driving this rally were investors seeking a refuge from stock market volatility and speculation that the Federal Reserve would not raise rates in 2019 as aggressively as previously anticipated.

Municipal bonds provided positive returns for the year, with the Bloomberg Barclays Municipal index up more than 1 percent. If, indeed, the Fed pauses on interest rates hikes, the nearly $4 trillion-dollar state and local government debt securities market would also benefit.

10-Year Treasury Constant Maturity Rate

The bellwether bond yield peaked at above 3.2 percent in November before diving to 2.7 percent.



Source: Board of Governors of the Federal Reserve System

Overseas markets were also off at year-end

Non-U.S. stocks suffered losses in the last three months of the year as both developed and emerging markets finished 2018 in the red (MSCI EAFE down 13.8 percent and MSCI EM off 14.5 percent year-to-date according to Morningstar). Developed international markets showed signs of slowing growth in the fourth quarter. Germany, the manufacturing engine of Europe and the world's fourth largest economy, reported that factory orders unexpectedly fell sharply in November (*Wall Street Journal*). The MSCI Germany stock index fell by nearly 15 percent for the quarter, and is down more than 21 percent for the calendar year.

Another major European market, France, dropped by 15 percent in the fourth quarter. Political turmoil dampened market sentiment there, as anti-government protesters wreaked havoc on the streets of Paris. Meanwhile, this year Italy emerged as a definite concern of investors. Italy's growth has long been sluggish and its large but troubled banking sector has a pile of debt. Some see parallels to the debt crisis in Greece nearly a decade ago. This is worrying as Italy is the Eurozone's third largest economy. An Italian debt crisis would be far more difficult to deal with than the Greek situation.

The largest international developed market, Japan, also reported sluggish growth. The Japanese economy shrank in the third quarter. Its growth estimate for 2018 is about 1 percent, below the Bank of Japan's target and significantly lower than growth in other developed and emerging markets. The broad Japanese stock market ended 2018 with a negative 14 percent return (in U.S. dollar terms).

In emerging markets, all eyes are still on China. There are downside risks for emerging markets in general and the global markets relative to China's slowing economic growth and expanding debt levels. An index that measures Chinese manufacturing dropped abruptly in December into "contraction territory" for the first time since 2016 (Bloomberg). As far as debt issues with China, the opaque nature of the data reported by the ruling party makes a true accounting difficult. China's officially reported debt-to-GDP ratio is a reasonable 48 percent (compare to the United States and Japan's ratios of 105 percent and 250 percent, respectively). Some third-party estimates are much higher. The Institute of International Finance, for instance, places China's debt-to-GDP at an alarming 300 percent. (Forbes)

U.S.-China trade relations have also weighed on global markets this year. From a U.S. perspective, the goals of reducing trade imbalances

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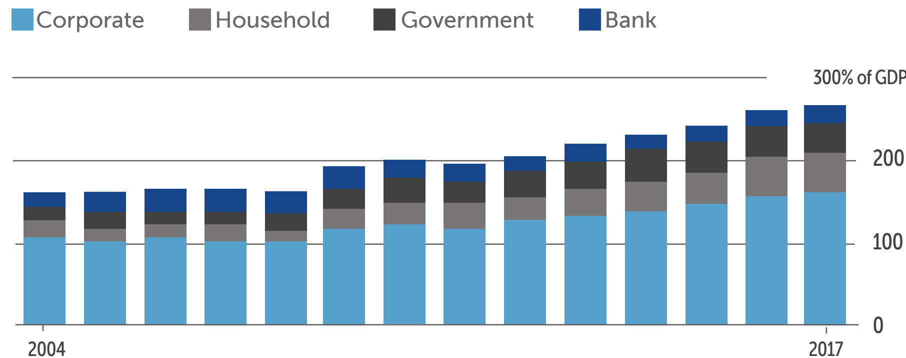
China's Bulging Debt Dwarfs Its Economy



Source: Bloomberg Economics

are laudable, but tariffs are blunt tools that could potentially lead to a full-blown trade war. About six months after the U.S. administration first applied tariffs on Chinese goods, we have observed specific signs of negative short-term impacts. Apple, for example, lowered its revenue guidance based on unexpectedly slower iPhones sales in China. The worst outcome is not assured on this issue, as the United States and China have talks scheduled to continue in Beijing in January, with officials on both sides expressing some optimism regarding a resolution to the trade stand-off. In addition, some market analysts believe that the bad news of U.S.-China trade is already "priced in," setting the stage for a rally if the situation improves.

Brexit — the term describing the United Kingdom's potential exit from the European Union (EU) — was back in the news at the end of the year. Soon after the 2017 referendum we wrote that "contentious debate is certain to be part of any trade deals and debt arrangements between EU participants," and that observation has been born out by the lack of a post-Brexit trade deal. The topic is complex, fast-moving, and can involve diving into arcane U.K. parliamentary procedures. The March 29, 2019, target date for the official exit from the EU is approaching fast, but again, there is some real uncertainty about whether it will happen. A second referendum (which would be a re-do of the original vote in June 2016) is a possibility. The bottom line with Brexit is that there are potentially bad, disruptive outcomes that could severely rattle U.K., European, and global markets. We will continue to monitor it closely.

U.S. and global politics also come into play

Our national political scene never seems to lack for drama, but the last quarter delivered even more than usual. Midterm elections saw Democrats winning enough seats to gain control of the House of Representatives, while Republicans maintained control of the Senate.

From a historical market perspective, it tends to be a good thing when Congress is divided. The average stock market returns are higher under a divided government than when one party controls both chambers (*Investors' Business Daily*). This may be because gridlock — though despised by politicians and the public — can have a positive impact on markets by preventing extreme legislation in either direction. In addition, the period following midterm elections has been a seasonally positive period for the market. In the 12 months following the last 17 midterm elections, the S&P 500 has never had a negative return, and the average return is 15 percent (Strategas, 1950 to 2014 data).

Nevertheless, the day-to-day news out of nation's capital should continue to deliver lots of twists and turns, some of which — like the December 2018 to January 2019 partial government shutdown — may be unsettling to the markets and the economy.

The Fed may have a big impact on markets in 2019

In December, the Federal Reserve raised a key short-term interest rate a quarter-point for the ninth time since abandoning the zero-interest-rate policy that had been in place for seven years (post-great financial crisis). Like all of the previous hikes in this cycle, this move was telegraphed by the Fed and widely priced-in by the market. After the December 2018 meeting and rate hike announcement, Fed Chair Jerome Powell issued guidance for three rate increases in 2019, which was a change from September, when the prescribed number was four.

Various measures of what the market anticipates show that many believe three rate increases in 2019 seems unlikely, and two would be more probable. The president, who in September stated that the Fed

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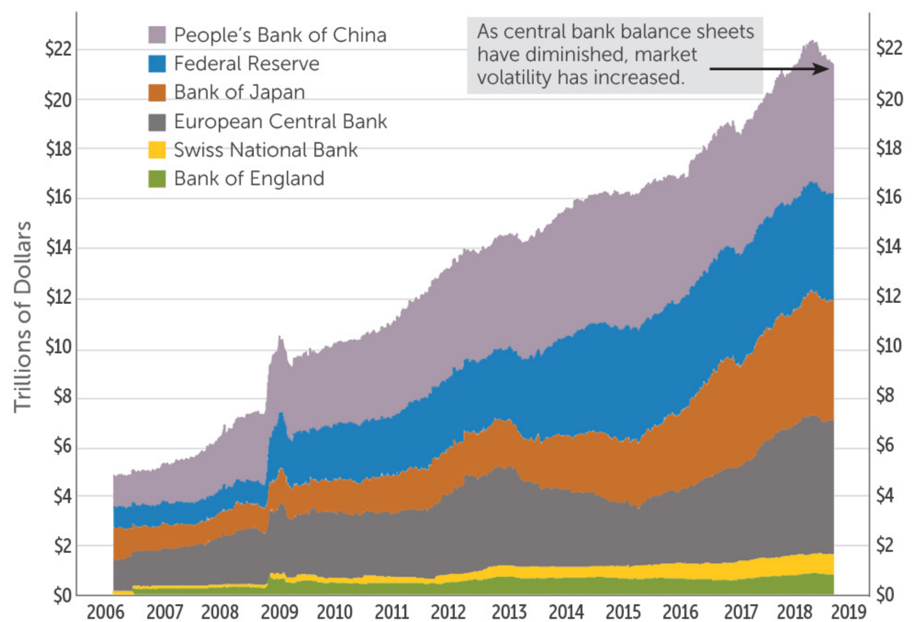
had "gone crazy," took to Twitter to rebuke the Fed for raising rates and asking them to instead "feel the market." As of the writing in the first week of January, market expectations appear to change on a dime, with one measure now forecasting a greater than 50 percent chance of a rate decrease by the Fed in 2019. All of this underscores that we are likely now entering a new era regarding Fed rate policy, one marked by uncertainty about future moves and, therefore, the potential for Fed announcements to create market volatility.

In November 2018 Dereck Hicks, a senior wealth advisor for CLA, wrote that "tightening monetary policy means less liquidity in the capital markets, which has contributed to the volatility we have seen in the past year." It may be impossible to quantify, but the Fed and other central banks around the world clearly have had a substantive impact on asset prices. The unwinding of these prodigious balance sheets may continue to create market volatility in the years to come.

Cumulative Central Bank Balance Sheets (in Dollars)



Sources: Federal Reserve, European Central Bank, Bank of England, Swiss National Bank, People's Bank of China, Bloomberg

U.S. housing market shows signs of slowing, but fundamentals are strong

Real estate is the world's largest asset class. With an estimated value of $280 trillion globally as of 2017, real estate is more valuable than all stocks and bonds combined (FTSE Russell). And even though *only* about $60 trillion of the total is income-producing real estate that is tradeable between investors, it is still an absolutely massive investment universe (LaSalle Investment Management).

Housing and real estate also play a huge role in our economy. The National Association of Home Builders estimates that housing contributes nearly one-fifth of our gross domestic product (2016 data). That in itself would be good reason to closely monitor the housing market. We are also inclined to keep a close eye on the sector because most CLA Wealth Advisors clients own a home(s) that may be a significant portion of their personal balance sheet. Many client portfolios also hold real estate investment exposure, either indirectly via listed real estate stocks (such as, real estate investment trusts [REITs]) or, where appropriate, directly via private equity real estate funds.

"Our clients have very different outlooks on 2019 depending on their geographic region and which stratum of the housing market they participate in," says Jack Rybicki, CLA's managing principal for the real estate industry. He works with real estate developers, funds and investors, owners, and operators. "Common concerns being expressed across the country relate to inflated home prices, the impact of interest rates and regulation, and household formation trends that are either tempering optimism or deepening pessimism."

After bottoming out following the financial crisis, U.S. housing prices rose consistently since 2012, aided by low mortgage rates and low unemployment. Although the broad backdrop for housing remains positive, the data show a marked slowdown in the last several months of 2018.

Measures of affordability declined, as rising interest rates caused 30-year mortgages to rise materially. The monthly payment on the median-priced, single-family new home is 16 percent higher than one year ago, according to Bloomberg on November 20, 2018. One widely

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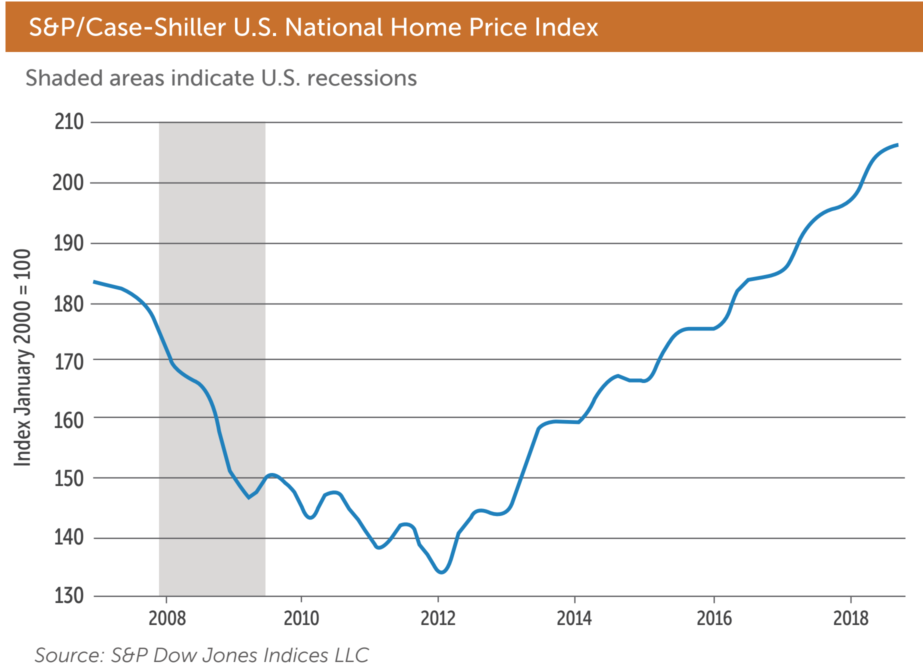
watched affordability index (John Burns Consulting) is now at levels not seen since 2008. The dotted line the Housing Affordability Index graph below is the long-term average; a reading above the line indicates less affordability.

S&P/Case-Shiller U.S. National Home Price Index

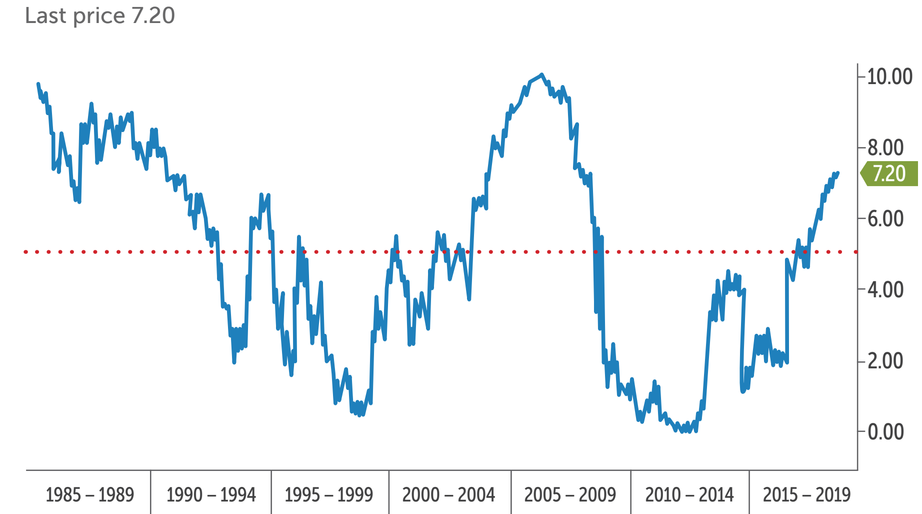
Shaded areas indicate U.S. recessions



Source: S&P Dow Jones Indices LLC

Housing Affordability Index

Last price 7.20



Sources: John Burns Real Estate Consulting, Bloomberg Intelligence

The *Tax Cuts and Jobs Act* of 2017 provided a unique tax incentive for investing in real estate located in certain economically distressed communities. With Opportunity Zones, investors can potentially defer and reduce taxes on capital gains, and earn tax-free income from potential gains realized in the investment. Learn more about Opportunity Zones.

Demand is also suffering recently. National data for perspective buyer traffic, future sales expectations, purchase applications and year-over-year sales have all fallen in the last several months. Although year-end is a seasonally slow period, these lower readings, and less optimistic forecasts, are more evidence of a slow-down in housing.

With tightening financial conditions and potentially peak employment making it more difficult for some Americans to purchase a new home, we believe that rentals — including multifamily (apartments), single-family rentals, and manufactured housing communities — will continue to have strong fundamentals.

The survey of homebuilders' sentiment fell significantly during the year. Investors also clearly felt less optimistic about the prospects of publicly-listed homebuilders. The exchange-traded fund (ETF) that tracks homebuilders (symbol XHB), having reached an all-time high in January, entered an ugly bear market by October, and finished the calendar year down 26 percent, much lower than the broad S&P 500.

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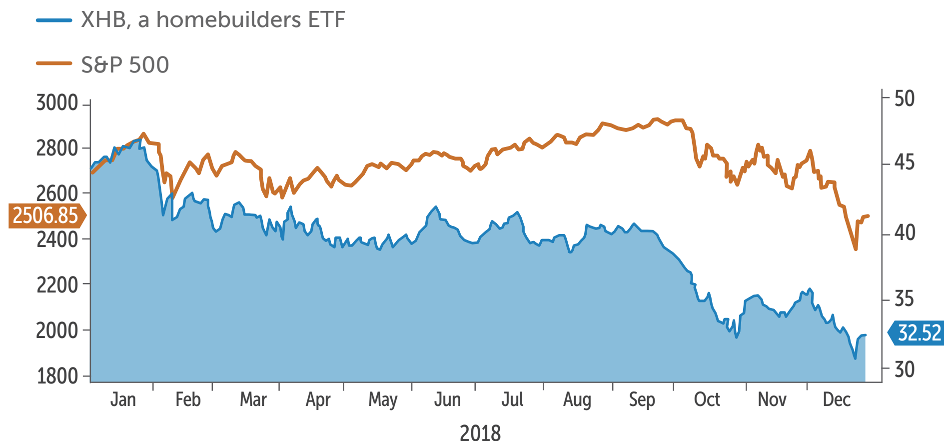
Homebuilders ETF Performance Compared to S&P 500



Source: Bloomberg

"One thing that is clear," Rybicki adds. "All projects are getting more scrutiny before they come out of the ground."

Looking forward to 2019 despite uncertainty in the markets

After nine years of rising stocks prices and recent years of unusually low volatility, 2018, especially the fourth quarter, was anything but comfortable. And yet, in many ways, 2018 was much more of a "normal" year than the last several before this. 2019 will undoubtedly bring its share of surprises — and perhaps additional volatility — but we look forward to the new year with optimism about the market opportunities and the economy, but clear-eyed about the risks we face.

We wish you and yours all the best for 2019.

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