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2018 – The Year Volatility Returned

Year End Market Review & 2019 Outlook

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"Volatility caused by money managers who speculate irrationality with huge sums will offer the true investor more chance to make intelligent investment moves. He can be hurt by such volatility only if he is forced, by either financial or psychological pressures, to sell at untoward times" - ***Warren Buffett***

Key Points:

- The theme of 2018 was the return of volatility to capital markets around the world.
- This letter will review some of the causes of that volatility and how markets performed in light of it.
- We will also discuss the positioning of our portfolios in early 2019 and consider catalysts for market moves ahead.

The calm and serenity of 2017 was proven to be an anomaly as volatility returned to the capital markets in 2018. We saw not one, but two bouts of volatility in the U.S., the worst of which we just witnessed in the 4th quarter. The S&P 500 fell 20%[1] from a high on October 3rd through the close on Christmas Eve. Fear is generally the catalyst to drive stock markets down so much in such a short period of time. This time was no different as fear of a trade war between the U.S. and China, fear of a hawkish Federal Reserve over-tightening monetary policy, and fear about geopolitical activities around the world pushed investors into a risk-off sentiment.

At Shepherd Financial Partners we are investors not traders; we invest based on our clients' long-term goals and risk objectives. The correction in equity prices has presented an opportunity to invest client assets at prices that are much more attractive than at the end of Q3.

Economic Review:

Q4 2018 By the Numbers[2]	Q4 2018	Q3 2018
GDP Est.	2.6%	3.5%
Inflation (CPI)	1.9%	2.2%
S&P 500	-13.5%	7.2%
Bloomberg Barclays U.S Aggregate Bond Index	1.8%	-0.8%
Bloomberg Commodity Index	-10.0%	-2.5%

After seeing some of the best growth in years during Q2 & Q3 of '18, the 4th quarter saw GDP growth slowdown to an estimated level of 2.6%. Higher interest rates seemed to help slow activity in interest rate sensitive sectors of the economy like housing and autos. The current estimate of 2.6% GDP growth is more closely in line with the trend range of GDP growth in the U.S. since the financial crisis. Our internal estimate is that growth for 2019 will slow from the highs of Q2 & Q3 and trend back towards the current economic cycle averages. The Trump Tax reform had a large impact on year over year growth in '18 and that growth will be hard to repeat. Given structural headwinds in the U.S. economy from demographics and productivity, it is hard for the economy to run for an extended period with growth over 3.0%. However, we are still expecting economic growth and view this as a positive. The key to whether growth will be at or below expectations will have a lot to do with some of the big picture issues mentioned in the beginning of this letter.

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[1]Source: Factset

[2]Source: Factset

Can the U.S. and China come to an agreement on trade? Will the Federal Reserve continue with its tightening cycle or will they pause and see how the economy reacts to the actions already taken? If we can see progress on those issues then maybe growth exceeds expectations. If not, then growth may undershoot our expectations. We don't foresee a recession in the U.S. economy over the next 12-months despite the extended duration of this cycle. While not all of the macro-economic factors we follow are in positive territory, and we are starting see some indicators show late-cycle characteristics, our analysis points to trend growth in 2019. Outside the U.S., economies seem to be breaking from the synchronized global growth story present at the beginning of 2018. Trade or volatility around trade negotiations, as well as higher interest rates, have worked to slow activity in emerging markets and developed economies. Emerging economies are much more dependent on trade than developed countries like the U.S. For example, exports make up 19%[3] of China's overall economy. For Korea and Taiwan, trade represents 36%[4] and 55%[5] of their economies. Therefore, when the U.S. looks to shake up trade deals, those countries will see an outsized impact. Sure enough, recent economic data out of those economies shows they are slowing. The International Monetary Fund sees emerging market growth flat with 2018 at 4.7%[6]. Hopefully progress on trade can limit the slowdown in the near term and the slowdown in activity as a result of uncertainty can be put behind us.

Equity Markets:

US Sector Returns[7] (%)	Q4'18	Q3'18	2018	2017
Utilities	0.5	1.3	3.8	12.1
Consumer Staples	-5.8	4.7	-8	12.9
Real Estate	-6.3	-0.7	-4.2	9.2
Health Care	-9.1	14.0	6.3	21.7
Materials	-12.8	-0.2	-14.7	23.8
Financials	-13.6	3.7	-12.9	21.8
Telecommunication Services	-14.9	2.4	-16.5	-5.5
Consumer Discretionary	-15.5	7.2	1.7	22.7
Information Technology	-17.7	8.4	-1.5	34.0
Industrials	-17.8	9.5	-13.0	23.8
Energy	-24.3	-0.3	-17.8	-1.2

Equity markets in the U.S. were hit hard as volatility returned after a placid 2017. The S&P 500 was down 13.5% in the 4th quarter. Small Caps were down more than 20% in the quarter. Cyclical sectors of the economy had some of the worst performance. The energy sector was down over 24% in the quarter as oil saw a more than 40% peak to trough move. The industrial and technology sectors are generally considered the most exposed to trade and were the second and third worst performers in the quarter, down 17.8% and 17.7% respectively. Utilities were the only place to hide as the traditionally defensive sector was up 0.5% in the quarter. For the year, Healthcare and Utilities were the winners while Energy and Materials companies were amongst the biggest losers.[8]

Corporate earnings in the U.S. saw robust growth in 2018 thanks mostly to tax reform that resulted in lower corporate tax rates but also to solid revenue growth and some operating margin improvement. For the first three quarters of the year, earnings growth averaged 28%[9] year over year. This year, 2019, will mark tax reforms first anniversary and year over year comparisons will be more difficult. We do expect corporate earnings to grow in '19 but at a more normal mid-single digit year over year growth rate.

[3] Source: JP Morgan
[4] Source: JP Morgan
[5] Source: JP Morgan
[6] Source: IMF
[7] Source: FACTSET
[8] Source: FACTSET
[9] Source: JP Morgan

The Wall Street consensus estimate is for earnings growth between 8-10%[10]. Our firm's estimate is more conservative at 5%[11] as we believe estimates will lower over the course of 2019. Most of that will come from positive revenue growth and we think operating margins most likely will be flat year over year. In summary, earnings growth should be positive in '19, but we will not see a repeat of the robust growth experienced in '18. With the pullback in equity markets in Q4 the valuation of equities has changed. We went from valuations in Q3 that were higher than normal to below-average valuations based on both trailing and forward earnings across many markets. Based on our 5% corporate earnings estimate, we entered 2019 seeing the S&P 500 valued at 14.7x '19 earnings. This compares with a 25-year average of 16.1x. As recently as September, we saw valuations close to 17.0x and we started 2018 at over 18.0x. While valuation is in no way a perfect timing mechanism, the change as a result of Q4's price dislocations has made U.S. equities more attractively priced entering 2019.[12]

Country - Index (USD)[13](%)	Q4 2018	Q3 2018	2018	2017
America - S&P 500	-13.5	7.3	-4.4	21.5
Brazil - Bovespa	15.0	5.8	-2.8	23.4
France - CAC 40	-15.1	4.0	-12.6	29.0
Japan - Nikkei 225	-15.2	3.7	-14.0	24.2
Europe - Stoxx 600	-14.0	1.1	-16.4	27.8
Europe - Stoxx 50	-12.7	1.0	-15.5	24.6
Germany - DAX	-14.8	0.7	-21.0	27.3
Emerging Markets - MSCI EM	-7.6	0.5	-15.3	37.1
India - Sensex	3.5	-0.3	-6.7	36.0
UK - FTSE 100	-12.1	-1.1	-14.0	21.3
Hong Komg - Hang Seng	-4.5	-1.2	-8.6	36.2
China - Shanghai	-11.3	-5.9	-19.7	54.5

Emerging Markets and Developed International equity markets had drastically different performance in 2018 than 2017. While everyone was singing their praises at this time last year, many investors today are feeling the sting of poor performance and contemplating whether they need these holdings at all. We believe in diversification from a global asset allocation standpoint and believe now is not the time to move away from that philosophy. Today, non-U.S. asset classes look dramatically better from a valuation standpoint than they have at any point in the last few years. Yes, there are near-term economic headwinds that must be considered to properly balance risk and reward, but price is important and when price dislocates as much as it has in some of these markets we must take notice.

Fixed Income Markets:

Bond Index Returns[14] (%)	Q4'18	Q3'18	2018	2017
20+ Year Treasury Bonds	4.5	-3.0	-1.7	9.1
Mortgage Bonds	2.1	-0.2	0.8	2.5
Core U.S Aggregate Bonds	1.8	-0.1	0.0	3.5
1-3 year Treasury Bonds	1.3	0.1	1.4	0.3
Emerging Markets Corporate Bonds	-0.3	1.1	-2.6	7.0
U.S. Investment Grade Corporate	-0.6	1.2	-3.8	7.0
Senior Floating Rate Loans	-3.9	2.0	-0.5	3.3
High Yield Corporate Bond	-4.4	2.9	-1.9	6.0
U.S. Preferred Stock	-5.8	-0.1	-4.4	8.0
Convertible Securities	-9.4	2.3	-1.8	15.6

[12] Source: JP Morgan
[13] Source: FACTSET
[14] Source: FACTSET
[10] Source: FACTSET
[11] Source: Shepherd Financial Partners

Much like the equity markets in 2018, the fixed income markets saw increased volatility. For most of the first three quarters of 2018, risk-on was in place as sectors like High Yield Bonds and variable rate Senior Loan Funds outperformed while safety assets like U.S. Treasuries trailed. That changed abruptly in Q4 as investors sought to de-risk their portfolios and high yield and senior loan funds suffered while Treasuries, especially bonds at the long end of the yield curve, did very well. This type price action makes sense as High Yield and Senior Loans are highly correlated to the equity markets. As the equity markets rolled over in Q4 it was natural to see a drop in the price of assets that are closely correlated. For the year, short-dated treasuries (under 3 years) and mortgage backed securities (MBS) were the winners with positive low single digit returns. The Barclays U.S. Aggregate bond index is primarily made up of treasuries and MBS securities which allowed this key bond benchmark to be flat on the year.

As we moved through 2018, we started to see some excesses on the corporate credit side of the fixed income markets. Low interest rates for the past 10+years has enticed corporations to be active participants in raising cash via bond issuance. Corporate debt today is at or above peaks of prior economic cycles. As typically seen late in economic cycles, the terms around some of the most recent debt offerings are highly skeptical and favor the corporation rather than the investor. The Bank Loan market has grown to become as big as the High-Yield Bond market. The Investment Grade Corporate Debt markets are dominated more today by companies rated BBB than any other time in history; we would debate whether BBB is the proper rating for most of that paper, or if it should be Junk. Early in Q4 we moved to address these concerns by reducing our overall exposure to corporate credit across our balanced strategies. We will continue to monitor developments as we move through 2019 to determine if further action might be needed to address these concerns.

Summary: Positioning for 2019

In summary, we continue to favor an overweight position in equities versus fixed income and domestic equities versus international. We think the Q4 price action in equities has presented an opportunity for investors with long-term investment horizons. While we are still underweight in Developed International and Emerging Markets, we think an opportunity exists today to move off those dramatic underweights. In Fixed Income, we have lowered our corporate credit exposure across the board. We will monitor developments in corporate credit for further action as we move through 2019. Our duration positioning is below benchmark as we expect higher interest rates in 2019, with a flat yield curve providing yields at the front-end of the curve that are attractive relative to longer-dated paper. As always, we will be active and flexible in our asset allocation, with all moves determined by which asset classes and securities have the best risk/return profile over the long-term. The return of volatility was the theme of 2018 and we expect average levels of volatility in 2019. While most people view this as a negative, as opportunistic long-term investors we view volatility as a chance to take advantage of dislocations and earn attractive returns, as long we feel the risk/return dynamics are balanced in our favor.

We will be reaching out to you in early 2019 and look forward to our discussion on your long-term investment goals and any concerns you may have about the market volatility we saw in the 4th quarter.

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* Forward Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12-months
** A basis point is commonly used to express differences in expenses or interest rates. 1bp=0.01%

Bloomberg Barclays U.S. aggregate bond: The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.
S&P 500: The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index.

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Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.
Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Floating-rate loans are often lower-quality debt securities and may involve greater risk of price changes and greater risk of default on interest and principal payments. The market for floating-rate loans is largely unregulated and these assets usually do not trade on an organized exchange. As a result, floating-rate loans can be relatively illiquid and hard to value.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

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