2019 INVESTMENT OUTLOOK

Relative to recent history, the year 2018 was a more volatile and less predictable one for capital market participants. The year began full of promise as the economic expansion continued which provided a positive backdrop for all types of business and investment decisions. Good growth in foreign economies, increased domestic government spending, ongoing efforts to roll back regulation and a favorable interest rate environment all helped drive further gains in company profits. Corporate America's bottom line also benefitted from the tax cuts which pushed earnings growth to an estimated 21% for the full year. After a brief correction in stock prices as measured by the S&P 500, which fell over 10% from late January into early February, the equity market resumed its upward climb as the year unfolded. This continued into the fall when, by September 20th, the stock market had advanced nearly 14% from its lows earlier in the year.

Bullish sentiment gave way in late September as concerns began to mount ahead of the third quarter corporate earnings season. Over the course of the year, economic growth in some key overseas markets came in below expectations and Federal Reserve rate hikes in March, June, September and December dimmed investors' outlook as money, which had nearly been nearly free for almost a decade became less so. This not only removed some of the fuel that had propelled capital markets higher but also impacted the real economy as some key interest sensitive sectors including autos and housing weakened. During third quarter calls with investors, company management teams confirmed concerns over a coming slowdown in growth. After 2018's outsized increase in earnings, the current expectation is that aggregate profits will advance a far more modest 8% in 2019.

This outlook is clouded by a higher degree of uncertainty than has existed in some time. In addition to the worries noted above, rising trade tensions, less accommodative actions by several global central banks, a less predictable phase of Federal Reserve policy and the expectation that domestic politics may become more acrimonious in the New Year have shaken investors' confidence. A government shutdown as the year came to a close added to the unease. In short, capital markets like certainty and it would appear we will get less of that in the coming quarters. This realization led to a broad market decline in the past two plus months of the year leaving all of the popular market averages in negative territory for 2018 as shown below. For the broad based S&P 500, this is the first calendar year decline since 2008.

Equity Markets – 12/31/18

	Index Price Level	2018 Total Return
Dow 30 Industrials	23,327	-3.5%
S&P 500	2,507	-4.4%
NASDAQ Composite	6,635	-2.8%
MSCI All Country World Index ex-USA	255	-13.8%

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Outlook

Estimates for full year 2018 real GDP growth call for the U.S. economy to expand at a 3.0% rate or perhaps slightly better. This would be the first year since 2005, when it advanced 3.3%, that economic growth has exceeded 3.0%. Expectations are that the economy will make continued, albeit slower, progress in 2019 with a current target growth rate in the mid 2% range for the calendar year. If this were to be achieved, by July, this expansion would surpass the record long 120 month economic growth phase which began in March 1991 and ended a decade later. There are certainly reasons for optimism in the near term. Our consumer driven economy is underpinned by workers' prospects which look bright. When the Bureau of Labor Statistics releases its employment report later this week, it is expected that December will mark a record 99th consecutive month of job gains. Meanwhile, the unemployment rate should come in at or near a fifty year low having held steady at 3.7% for the past three months. Recently, there have been signs that the low unemployment rate is finally translating into higher wages for workers as average hourly earnings have risen at a 3.1% rate for the past two months, the highest rate since 2009. Importantly, small business optimism remains strong. The National Federation of Independent Business survey, which has been conducted monthly since 1986, hovers near record high levels. This survey tracks small business owners across ten metrics and offers a real time snapshot into the attitudes of these key decision makers. Small businesses employ over half of all workers in America and account for the vast majority of new job gains so a bullish outlook by these owners suggests an inclination to hire, invest, innovate and stir the "animal spirits" that drive economic growth. The Conference Board's Leading Economic Index also suggests a decent near term outlook. This index tracks a number of forward looking growth indicators and remains in an upward trend suggesting a recession is unlikely to commence in the first half of 2019.

Looking out a little further there are several reasons for caution. In December, the Federal Reserve raised its key lending rate for the fourth time in 2018. Since the Fed's campaign to normalize interest rates began in December 2015, after an unprecedented seven years with rates hovering near zero, the fed funds rate has been increased nine times to its current range of 2.25-2.50%. The lagged effects of higher borrowing costs will work their way into the economy this year and are one reason that growth is expected to slow in 2019. In fact, this has already been showing up in the data. Existing home sales, which historically account for over 85% of all home sales, have fallen on a year over year basis for nine consecutive months as rising house prices and higher mortgage costs keep prospective buyers on the sidelines. Other interest sensitive segments of the economy including autos and student loans are also trending in the wrong direction with delinquency and default rates rising.

Another reason to temper growth expectations in the coming year is that global economic activity is slowing. China, the world's second largest economy, will be challenged to repeat 2018's expected growth of 6.5% (lowest since 1990) in the current year. Meanwhile, Japan (3rd largest economy) and Germany (4th) have both experienced negative growth quarters recently. It is far from clear how the United Kingdom will follow through on its intention to exit the European Union but, at a minimum, the uncertainty around the process is likely to impede growth. Other important economies including Italy, Brazil, Russia, Turkey, Argentina, to name a few, all face various challenges to their growth prospects in the year ahead while already carrying worryingly high debt levels. Additionally, Saudi Arabia, along with many other oil producing nations, will be stressed if energy prices remain depressed. Brent crude prices have fallen 37% from their 2018 peak to a current price of about $54 per barrel, well below the level that allows most of these countries to balance their budgets. Ongoing riots in France and the resignation of India's central bank governor over government meddling in policy do little to inspire confidence in those countries.

It is against this challenging backdrop that the United States is attempting to rethink the global order including the appropriate role for the U.S. to play. Perhaps the leading example of this is reflected in the current standoff with China over trade, intellectual property rights and the militarization of islands in the South China Sea. Already both countries have imposed damaging tariffs on each other with little to show for it other than less trade, slower growth and higher prices. The U.S. imports more from China than vice versa and it has threatened to raise the ante with additional tariffs in the coming months. Should that occur, China can be expected to retaliate with non-tariff barriers such as restricting access to the Chinese market by American companies or by tying up U.S. firms in China with bureaucratic red tape. The two countries continue to talk while a ninety day truce is in effect before the additional American levies are imposed. Finding a solution to the impasse is in both countries' interests as no country wins a trade war while an escalation of current tensions would likely have negative global repercussions. Even if an agreement can be reached on trade, the disagreements over the U.S.'s accusation of intellectual property theft by China and the military expansion on disputed islands along critical global shipping lanes are likely to linger with no obvious endgame.

The U.S. president has also hit the reset button on trade in other parts of the world. The U.S. pulled out of the Trans-Pacific Partnership and completed a contentious renegotiation of NAFTA making it clear that the U.S. is willing to cede a portion of its global leadership role. More recent decisions to pull U.S. troops out of Syria and Afghanistan similarly highlight this country's willingness to pull back from global coalition efforts. While history will be the ultimate judge as to whether this new course of action makes sense, it is safe to say that it increases the range of potential outcomes on a host of issues with greater risks to the downside.

Investors would be wise to pay close attention to the global bond markets and central bank policy as the year unfolds. Simply put, no roadmap exists for the removal of nearly ten years of extremely accommodative policy the world has enjoyed since the last downturn. Indeed, uncertainty surrounding the Federal Reserve's intended course of action led to much of the volatility the market experienced in the closing weeks of 2018. In addition to cutting interest rates dramatically, global central banks expanded their balance sheets from roughly $5 trillion to over $17 trillion after the 2008-2009 crisis. Much of that money found its way into financial and other assets artificially inflating prices. The Fed has begun to pare back its balance sheet having brought it down to about $4.1 trillion from a peak of $4.6 trillion. Meanwhile, the European Central Bank announced its intention to phase out new asset purchases effective immediately. While the Japanese central bank is still actively purchasing new securities, those commitments have been cut by two-thirds since early 2017. It remains to be seen how bond markets will ultimately react to the having their most important marginal buyers step back their purchases though early signs are discouraging.

For instance, in this country lower rated corporate credits are already seeing their spreads over Treasuries widen meaningfully. While the Fed never purchased corporate bonds, injecting itself into the Treasury and government agency bond markets drove down yields in that sector and encouraged investors into searching for returns elsewhere, a trend that is now reversing. This could prove troublesome as a recent Morgan Stanley report estimated that more than half of all investment grade corporate bonds in the U.S. are rated BBB (up from 35% ten years ago) and so risk easily falling into junk territory should fundamental conditions deteriorate. This has occurred in an environment when the absolute level of total corporate debt outstanding as a percentage of GDP is now higher than it was at its peak following the 2008-2009 crisis. At the same time, U.S. companies are now carrying

higher debt to EBITDA ratios (a measure of risk to bondholders) than they were prior to the last downturn.

These developments are worth watching because signs of trouble in lower rated credit sectors can be a harbinger of things to come more broadly in the capital markets due to the global interconnectedness of the financial system. Furthermore, it is our view that the world economy is less well prepared to face a downturn in economic and financial market activity than investors appreciate. While bank balance sheets in the United States have undergone significant repair in the past decade, the same is not true of many financial concerns in Europe and Asia. Additionally, virtually every major national economy is more highly levered today than it was prior to the Great Recession and so the world will have fewer levers to pull should another global recession occur. Since 2007, total worldwide debt levels have risen approximately $80 trillion to $247 trillion. This represents about 320% of global GDP, up from about 280% a decade ago.

In the U.S., federal debt has expanded to about $22 trillion, up from $9 trillion a decade ago. This has pushed the debt to GDP ratio to a current 105%, up about forty percentage points over the past ten years. With a projected federal deficit of over $1 trillion this year and next, that unfavorable trend is expected to continue. Deficits such as are predicted in the coming years are unprecedented in good economic times when the nation should be paying down debt in preparation for more challenging times ahead. The nonpartisan Congressional Budget Office estimates that annual federal interest payments will rise to $915 billion by 2028 representing 13% of all federal outlays, about double the current total. At this rate, interest payments on the national debt would exceed what the government is expected to pay on Medicaid by 2020, defense by 2023 and on all nondefense discretionary spending by 2025. Clearly, this path is unsustainable and will require that some painful and unexpected spending cuts and tax increases will have to be implemented in the coming decade. Complicating this effort, the domestic political scene is as rancorous as it has been in decades so finding a near term solution is highly doubtful. In fact, in the current environment it is equally likely that political gridlock and a possible crisis in Washington will further erode investors' confidence.

In light of the many headwinds noted above, perhaps it is not surprising that that global capital markets have come under stress in recent months. Indeed, regular readers of this Investment Outlook will remember warnings in past quarters about many of the issues that are clearly now on investors' minds. A decade of easy money inflated asset prices to above average levels making them vulnerable to a pullback if conditions worsened or sentiment shifted. This was particularly true of many of the popular technology stocks which led the downturn late in 2018 and resulted in the NASDAQ experiencing its first bear market since 2008. Broad based technology stocks had previously led the market higher and, earlier in 2018, accounted for approximately 25% of the S&P 500, the highest percentage since the dot-com bubble of the late 1990s.

In another phenomenon reminiscent of those previous heady days, through September 30th of last year, approximately 83% of initial public offerings were made by companies that lost money in the twelve months leading up to their IPO, slightly above the previous record high level of just over 80% set in the year 2000. The private markets are flashing warning signals too. The first three quarters of 2018 saw private equity firms raise approximately $580 million of new money, the second highest level on record after 2017. This has led to the industry amassing an estimated $1.1 trillion waiting to be invested. With this surplus of funds, prices paid in private equity transactions are increasing, lowering expected returns. Meanwhile, leverage applied to buyouts increased to nearly seven times EBITDA in the third quarter, a worryingly high level. At the same time, an estimated 80% of these

loans have been issued as "covenant-lite" meaning they lack the typical covenants intended to protect investors.

Despite the broad list of concerns noted above and notwithstanding record high prices, company management teams and boards of directors remained extremely bullish on their own stocks' prospects. When the final numbers are totaled, it is believed that S&P 500 companies will have spent over $780 billion repurchasing their own shares in 2018, easily surpassing the previous record of approximately $590 billion set in 2007. Similarly, global merger and acquisition activity was particularly robust last year. An estimated $4.4 trillion of deals were announced in 2018, up nearly 20% versus prior year. The 2018 total is the third highest in history behind only the $4.7 trillion in 2015 and the record of nearly $5 trillion set in 2007 and is reflective of the boundless confidence in the marketplace.

Investment Conclusion

In his recent book, *Mastering the Market Cycle*, Howard Marks cautioned that "excessive optimism is a dangerous thing; that risk aversion is an essential ingredient for the market to be safe; and that overly generous capital markets ultimately lead to unwise financing, and thus danger for participants." He also noted that "widespread risk tolerance is the greatest harbinger of subsequent market declines." These warnings are worth heeding as the capital markets recently have been characterized by excessive optimism driven by a decade of easy money policies which have encouraged investors to become overly complacent about risks to the outlook. As we enter the New Year, a slowing rate of economic growth in the U.S. and abroad, the paring back of easy money policies around the world, global trade tensions, increasing political challenges and excessive debt levels all headline the list of concerns.

It is unknowable if the present stock market correction will turn into a run of the mill bear market or perhaps a more notable downturn as was experienced in 2000-2002 and again in 2008-2009. Therefore, it is critical to have a sound long term investment strategy in place that is divorced from the short term emotional behavior that often leads investors astray. It is important to have cash on hand in order to meet any reasonable near term needs that may arise. Higher than normal cash reserves are also recommended in the current environment to take advantage of the opportunities that are likely to result from ongoing volatility in stock prices. Rising interest rates make holding cash and high quality, short term bonds an attractive alternative for funds awaiting investment. Particularly for those funds for which a longer term time horizon is appropriate, volatility and the occasional market downturn are the successful investor's best allies. We have identified a number of ably run, profitable, soundly financed and sustainable growth businesses that can perform well over full market cycles as potential purchase candidates. Importantly, we will remain patient and only add stocks of those companies to client portfolios when their share prices reflect attractive long term investment opportunities. This time tested strategy has served our clients well for the nearly thirty years we have been in business and we expect that success to continue over the many market cycles to come.

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