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Economic & Market Summary
January 2019

The US economy posted solid results in 2018. Driven by healthy consumer spending and a resurgence in business investment, GDP grew 3.0% over the last four quarters - well above the post-recession trend of about 2%. Strong job gains drove unemployment down to an 18 year low and inflation remains benign. Entering the new year, cautionary signals have emerged. The housing market and manufacturing activity have softened. The yield curve, or the difference between short-term and long-term interest rates, has flattened – a sign of potential weakness. The spread between corporate and US government bonds has widened and the stock market has corrected. Economic growth will likely continue in 2019 but at a more moderate pace.

A potential trade war with China is the biggest near-term threat. Tariffs hurt economic growth by inflating prices, stifling competition, and creating uncertainty that hinders capital investment. The 90 day pause on raising tariffs on Chinese imports, the new agreement with Canada and Mexico, and ongoing talks with the European Union suggest Washington is willing to negotiate. We are cautiously optimistic a mutually beneficial deal will be struck with China as each side recognizes the potentially disruptive consequences of a trade war.

The Federal Reserve is guiding monetary policy towards a "neutral" level. What the neutral level looks like is debatable. Some worry the Fed's steady interest rate increases combined with its balance sheet reductions will drain liquidity too quickly thus damaging the economy. However, we believe the Fed is now signaling more willingness to be flexible regarding future rate increases. Also, Chairman Powell's policy approach strikes us as more pragmatic and less ideological than his immediate predecessors.

Market volatility has returned in earnest. The S&P 500 declined 19.8% from its September peak and finished 2018 down 4.4%. Over the summer, exuberance for high-flying technology stocks was at its peak as investors extrapolated unsustainably strong growth. To us, the recent sell-off represents a reality check for those stocks that attained an aura of invincibility. The proliferation of passive investment strategies helped perpetuate this aura because index funds must own every stock in the index irrespective of quality and valuation. Furthermore, algorithmic traders can amplify instability by trading around short-term price momentum which is typically divorced from economic or company fundamentals. When lofty valuations return to earth, the landing is rarely smooth.

Looking ahead, 2019 will probably be another volatile year due to trade politicking, anxiety over Fed policy, a slowdown in China and Europe, and general unease over how much longer the US economic expansion can continue. Consensus 2019 earnings estimates call for 9% growth. This seems somewhat aspirational given the lapping of tax reform, rising labor costs, a strengthening US dollar, and a moderating global economy. The recent drop in stock prices may already be discounting slower earnings growth in the coming year. During market corrections, it's important to remember that equity investing is a long-term endeavor. In the short-term, stock prices gyrate in tandem with investors' emotions - namely fear and greed. In the long-term, prices reflect companies' fundamentals (i.e. revenue, earnings, free cash flow, and dividends). A deep understanding of what drives and sustains these fundamentals gives us the conviction to weather temporary price declines and capitalize on opportunities as they emerge.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.