# AMB Newsletter
# 1st Quarter 2019

## Table of Contents



## 4th Quarter 2018 Review

Global markets experienced a difficult year in 2018. Equity and fixed income markets from around the globe faced headwinds stemming from a number of different factors including global trade tensions, Central Bank Monetary Policy, Middle East turmoil, investigation into the current US Administration and the threat of a global slowdown brought on by a culmination of these factors. In our opinion, all of these reasons played a part, but the trade tensions with China is the most profound. The US and China are the world's two largest economies, and trade tiffs between the two have a ripple effect that has major implications on the rest of the globe. These worries seemed to take hold in the 4th quarter as evidenced by the performance of the markets around the globe.

US equity markets, measured by the S&P 500, finished the quarter down 13.52% and down 4.38% on the year. Information Technology led the market lower and contributed 27% of the downside return. The market leaders for most of the year, (FAANG), had a rough 4th quarter, and with their current size, they were big detractors from the market cap weighted index. Noteworthy was the massive outperformance from the defensive sectors such as staples and utilities which showed there was a true flight to safety unlike sell-offs that we witnessed earlier in the year.

International developed equities fared better for the quarter but not by much. Our international counterparts posted a combined return measured by the MSCI EAFE of -12.50%. This was slightly better for the quarter; but for the year, the index was down 13.36%. Last quarter, we wrote that international markets seemed undervalued compared to the US; but based on recent economic trends, they may not be as cheap as they appear. This has come to fruition, as Eurozone economic growth continues to slow causing us to lower our current expectations of their equity markets going forward. In the 3rd quarter, the Eurozone came in at .2% which was well below the 1st and 2nd quarters. If this trend continues, we would expect Draghi to try and keep the Eurozone from falling into yet another economic recession with renewed stimulus.

Emerging market equities had another tough quarter but were relatively better than their developed counterparts. Emerging Markets, measured by the MSCI Emerging Markets Index was down 7.47% for the quarter and 14.58% for the year. The same factors that plagued Emerging markets at the beginning of the year were still in play in the 4th quarter. We do not expect emerging market strength to occur until we begin to see a real weakness in the US Dollar or growth around the globe starts to show signs of life. For now, we would rather be invested in the US equity markets.

Interest rates turned around in the 4th quarter as Central Bank policies moved to a more dovish stance. As equity markets began their decline on the thought of an upcoming global recession, Central Banks from around the world have walked back many of their hawkish comments to more of a "wait and see" type policy. In the US, Federal Reserve President Jerome Powell commented in the third quarter that monetary policy regarding rate hikes and balance sheet reduction was on autopilot. After the -13.52% quarter, his tune has changed. Powell is now admitting that the Fed is listening to the market and a more patient approach to balance sheet reduction and rate hikes may be in order. This is a massive change from what we were hearing just a few months ago. In our view, the short end of the curve is where we feel comfortable as investors are not currently rewarded for taking on additional interest rate risk.


## 1st Quarter 2019 Outlook

**Economy (Global)**

Global economic fears have been on the rise over the past few months, even as US Economic growth continues to impress. Slowdowns in the second half of the year in China, Japan and the Eurozone definitely spiked concerns of an impending global recession. This fear was wide ranging and could be seen in markets across the globe. For 2019, even with the recent global weakness, we expect the global expansion to continue, led by US growth. We do, however, see the divergence between US growth and the rest of the world closing. In our opinion, global DM growth and EM growth will move higher coupled with US growth moderating back down to around the 2.5% level.

The US economy is in the late-stage cycle of this current economic expansion and evidence of this can be seen in the equity markets. Volatility usually increases in the latter stages of economic cycles and it seems as though the trough for volatility was in 2017. Even though we are nearing the end of this cycle, we do not currently believe we will enter into a recession in the US in 2019. We believe the earliest we will see a recession will be the summer of 2020. Globally, we are more bullish on the economic conditions and believe the rest of the world is not as far into their economic cycle as the US. However, there are risks to this outlook namely Inflation, monetary policy and politics.

Inflation releases will be closely followed this year across the globe, as readings on inflation will give market participants an idea on how the Central Banks might act. In the US, the December Non-Farm payroll numbers came in well above expectations and with this, so did wage growth numbers. We have mentioned many times that if wage growth picks up, inflation may finally take hold. Wage growth has been absent during the entirety of this economic recovery; but if it picks up, we believe the Central Banks will act to stymie it. This may cause the world Central Banks to increase rates at a faster pace and possibly even increase the speed of their balance sheet reductions. These scenarios could bring economic growth to a standstill.

Central Bank monetary policy around the globe has been heavily involved in economic growth projections since the financial crisis. Their actions have a direct impact on the money supply which can either promote or hamper growth. In 2019, we expect the US Federal Reserve to hike rates twice, which is half the number of times the market expected at the end of the 3rd quarter. We also believe, they will be taking a "wait and see" approach going forward to try and gauge the actual health of the financial conditions unlike the "autopilot" comment the Fed Chair made last year. A more dovish Fed could help ease recession fears in the US. The same will probably be seen from both the EU and UK, as we expect both to raise rates at some point in 2019 as both are paying very close attention to the financial data. The Bank of Japan will be the most dovish of the major central banks and we do not expect Shinzo Abe to hike rates in 2019. If we do get a more dovish tone from the world central banks, we believe global recession fears will be eased and could see the equity markets perform well globally.

Politics will always play a role in economic conditions. Geopolitical turmoil reigned in 2018 due to trade tiffs between the US and "everybody" and because of impeachment rumors of the current US President. Politics are a major uncertainty and that has never been as true as it is today. We do not expect the current political environment to change in 2019; but if we do begin to see a light at the end of the tunnel, it would be a welcomed sign and markets would react in a positive way in our opinion.

# AMB Newsletter
# 1st Quarter 2019

**<u>US Equity Market</u>**

The US equity market through the first 9 months of the year had been strong returning 10.57%, measured by the S&P 500. However, the 4th quarter was a much different story with the market ending down 4.38% on the year. We were positive on the market heading into the 4th quarter although we wrote the following: “Even with the number of positives, the picture is not all rosy and there are a number of headwinds that could hurt performance going forward. Political concerns are a major issue. We expect the midterm elections in November to be a volatile time for the markets; and depending on the outcome, we could see major swings to either the up or downside. Inflation expectations are currently on the rise which will increase the cost of company inputs. Only so much can be passed on to the consumer before margins begin to squeeze. Wage growth expectations have increased and could also damper margins. Geopolitical concerns will continue especially on the trade front. These concerns will increase uncertainties and could cause markets to pause.” In retrospect, the markets did more than just pause; the market completely reversed course and gave market participants one of the worst quarters in recent memory.

Taking a look back at our positive view on US equity markets going into the 4th quarter of 2018, we feel our vision is still intact. Since the summer of 2016, we believed future market performance would be driven by top and bottom line growth instead of monetary policy. Even with the trade spats, earnings and revenues have continued to grow. We do believe the downward market action is the function of the belief that there will be a squeeze on earnings and margins. This move seems to be overdone as most market moves are. Heading into 2019, we believe we will once again see growth on both the top and bottom line even with the more difficult comps of 2018.

We continue to believe the bull market is still intact; however, there is room for caution. Some economic indicators have begun to flash a warning sign that a recession is near. We have seen outlook warnings from some of the largest companies in the US such as Apple, FedEx and Ford. These warnings are definitely something that we take note of but it is imperative we also take a look at the reasoning behind the warning. All three are worried about a slowdown in sales outside of the US causing Trade Spats. In our view, if the US can come to an agreement and end the current trade uncertainties, it could lead to a major market move higher and will help alleviate concerns over an impending global recession. If not, we would expect the market action to resemble 2018 very closely.

AMB believes the stock market should move higher in 2019 but this outlook could change depending on a number of factors such as trade conflicts and monetary policy. We believe quality companies will begin to outperform. This trend started at the end of 2018 and we expect it to continue. Even with the recent downward revisions of the corporate profits, we believe they will still show growth in 2019 and if that is the case, the market overshot to the downside. We will be paying close attention to 4th quarter earnings and comments made by management. If our thoughts change, we will act as we are not afraid of admitting when a call is incorrect.


**US Fixed Income**

In the 3rd quarter we wrote, "We believe the curve will resume its flattening pattern in the 4th quarter and on into 2019. We continue to believe the intermediate to longer end will stay subdued as the front end moves higher. Listed below are a few reasons why we believe this.

- ''Wage growth has shown signs of life this year, but we have still not seen a trend for higher wages develop.

  *Consumer spending is the growth engine of the US, and without rising wages, we do not believe inflation will take hold.*

- ''Rates in the US remain at premiums compared to other developed nations.

  *Even though we have seen foreign investors step away from treasuries recently, we believe their appetite for our higher yielding debt will return.*

- ''Increasing amount of debt could strangle growth.

  *Corporate and government debt in the US continues to increase. As this happens, future growth potential diminishes. This could drive growth and inflation expectations lower leading to lower rates.*

- "US dollar is continuing to strengthen.

  *A strong dollar hurts corporate earnings growth and will also dampen inflation as import prices decline. If inflation expectations start to diminish, rates will follow.*

- ''FOMC remains hawkish.

  *Continued rate hikes may begin to hamper growth as borrowing slows."*

These thoughts came to fruition in the 4th quarter as the optimism on the global economy seemed to dissipate. Couple that with a continued hawkish posture from the Fed, and there was a recipe for a major move in rates. The curve began to flatten quite dramatically even inverting at the front end. This move, like equity markets, was overdone in our view.

Overall, we believe it is a good time to move out of lower credit and into high quality credits. The credit markets have been flashing warning signs; and with the massive amount of corporate debt on the books, a major economic downturn could turn ugly fast. We still like the belly of the curve but investing on the front end does make more sense now than it did a year ago. We would currently stay away from the long end as one is not being rewarded for the increased interest rate risk that would be taken on.

As always, investors should remember why we invest in fixed income. It is not the growth engine of portfolios, yet it brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

# AMB Newsletter
# 1st Quarter 2019

## Conclusion

Volatility was a major theme in global markets throughout 2018, and we expect it will continue this year. Even though it is a new year, we are going to see the same headwinds that affected markets this year as we did last year. Currently, none of those issues have been solved which creates continued uncertainty that will certainly play a part in market performance throughout the year. Despite these headwinds, we believe equity markets will provide growth in 2019, while fixed income will provide stability as rates remain relatively stable. We look forward to working with you in 2019 and as always, we appreciate the opportunity to help you achieve your financial goals.

**Matthew J. Roach, CFA ®**

**Director of Portfolio Management**