BlackDiamond Financial

INVESTMENT INSIGHTS

FOURTH QUARTER 2018

Key Topics

- Recent Market Performance
- Fed Raises Interest Rates but Lowers Expectations for Future Hikes
- Partial Yield Curve Inversion Should Not Fuel Recession Concerns

Stocks End Worst Year Since 2008

Volatility spiked in the fourth quarter and contributed to the largest quarterly decline in stock prices since 2008. Investor confidence deteriorated this quarter as concerns over rising interest rates, an inverting yield curve, the trade conflict with China, and the government shutdown increased. Despite these factors, the economy is still performing well, the unemployment rate is at an all-time low, and corporate earnings are expected to grow 7% in 2019.

After gaining 10.6% through the first three quarters of 2018, the S&P 500 index fell 13.5% in the fourth quarter, bringing it down 4.4% for the year. This was the first negative year for the S&P 500 since 2008. The forward Price to Earnings multiple (P/E) for the S&P 500 dropped from 18.2x at the beginning of the year to 14.2x by the end of the year – the second biggest annual P/E contraction in the last 40 years.

Other asset classes also performed poorly, including international and small company stocks. International stocks declined by 11.5% this quarter, contributing to a 14.2% decline for the year. This was a substantial reversal from the 27.2% gain for international stocks in 2017. The U.S. dollar strengthened by 4.2% in 2018, which contributed to lagging international stock prices. International stocks ended the year trading at a P/E multiple of 11.8x, a 16.9% discount to the S&P 500. Small company stocks were the worst performing asset class this quarter and dropped 20.2%. This was the seventh largest quarterly decline for the Russell 2000 since 1979. Subsequent to the prior ten largest quarterly declines for the Russell 2000, the index increased by an average of 130% over the next five years.

Comparative Returns

		Annualized Performance			
	Q4 2018	1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks[1]	-13.5%	-4.4%	9.3%	8.5%	13.1%
Small Cap U.S. Stocks[2]	-20.2%	-11.0%	7.4%	4.5%	12.0%
International Stocks[3]	-11.5%	-14.2%	4.5%	0.7%	6.6%
Real Estate[4]	-6.5%	-9.4%	2.3%	7.4%	12.0%
U.S. Bonds[5]	1.6%	0.0%	2.1%	2.5%	3.5%

(1) Measured by the S&P 500 index, which includes 500 of the largest U.S. companies in all sectors of the economy.
(2) Measured by the Russell 2000, which includes the 2000 smaller stocks of the Russell 3000 index.
(3) Measured by the MSCI ACWI ex-U.S. index, which includes large and mid-capitalization stocks from developed and emerging international markets.
(4) Measured by the MSCI U.S. REIT index, which includes domestic publicly traded real estate stocks.
(5) Measured by the Bloomberg Barclays Aggregate Bond index, which includes a representation of the performance of the entire U.S. investment grade bond market.

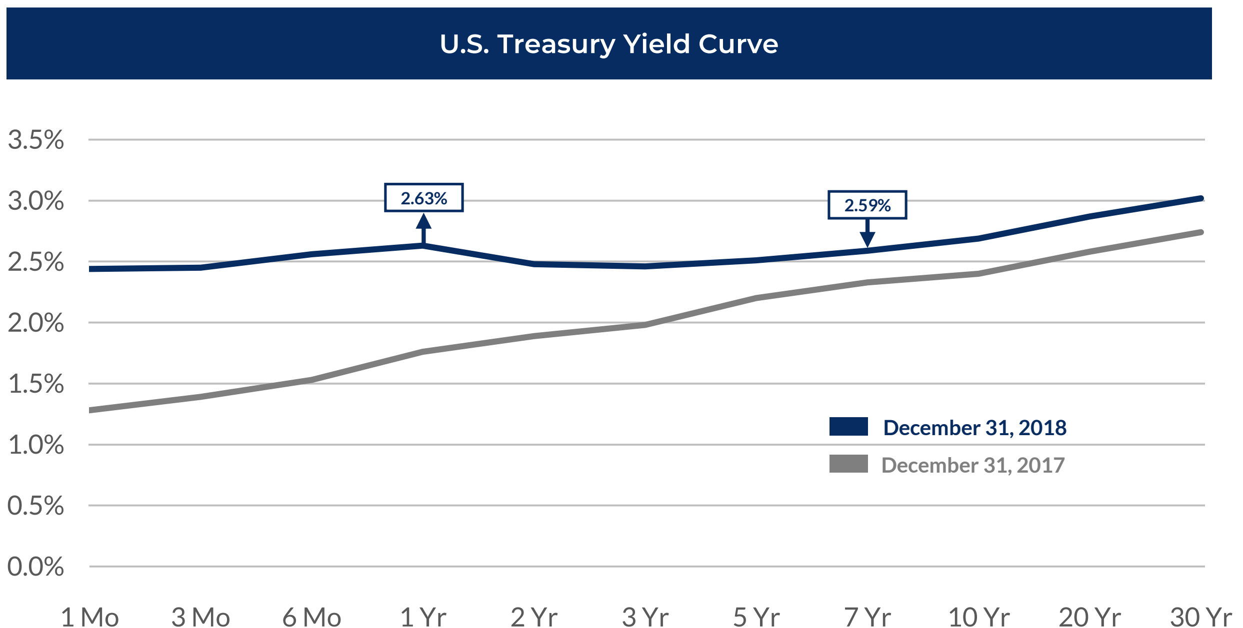
Fed Raises Interest Rates but Lowers Expectations for Future Hikes

At its December meeting, the Federal Reserve raised the Federal Funds rate by 0.25% to a range of 2.25% to 2.5%, which was the fourth 0.25% increase this year. This increase was widely expected by financial markets. However, Fed chair Jerome Powell's statement following the announcement was more hawkish than the market anticipated. Although the Fed lowered estimates for future rate hikes in 2019 from three to two, the stock market was hoping for a stronger indication that the Fed would refrain from future interest rate increases.

Concern over rising interest rates was a consistent theme for stocks this year and caused most of the stock market's volatility. Stock investors often fear higher interest rates because higher rates reduce economic growth and are often a leading indicator of recessions. The Fed's objective in raising interest rates is to orchestrate a "soft" landing where economic growth is maintained at a reasonable level but not at an unsustainable level where inflation increases dramatically. Historically, the Fed has achieved limited success when attempting to guide the economy to a soft landing. Instead, they often increase interest rates too quickly and contribute to recessionary forces that slow economic growth.

Partial Yield Curve Inversion Should Not Fuel Recession Concerns

By increasing short-term rates and asserting their desire to raise rates twice in 2019, the Fed's actions contributed to the yield curve becoming partially inverted from one to seven-year maturities. The yield curve is a graph measuring the yields for Treasury bonds from shorter to longer-term maturities. Typically, the yield curve is upward sloping – as bond maturity increases, so do yields. For example, a ten-year Treasury bond will normally have a higher yield than a two-year Treasury bond because investors usually require a higher return to lend funds for longer periods. It is rare, but when two-year Treasuries yield more than ten-year Treasuries, the yield curve is said to be inverted.

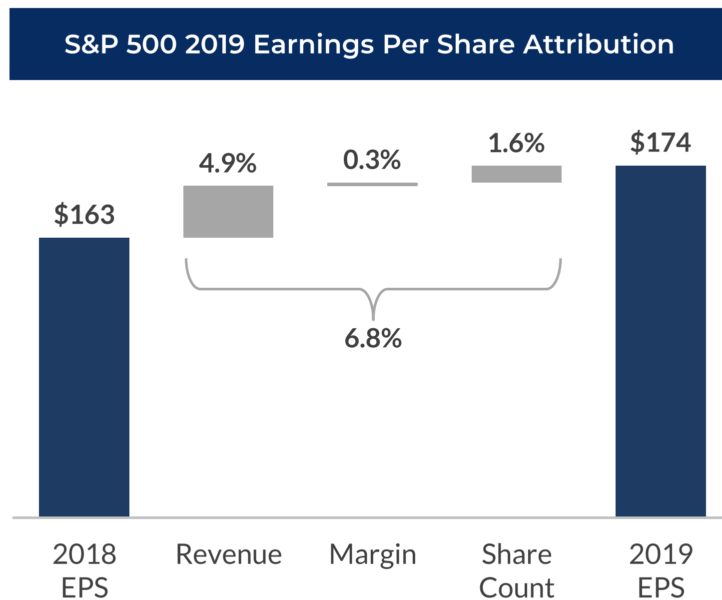


Source: U.S. Treasury as of December 31, 2018

The stock market has shown significant fear this quarter over the yield curve inverting because an inversion is often a precursor to a recession. In fact, the yield curve inverted before each of the last seven recessions. While this is an interesting correlation, it is not as important a factor as some people believe because:

- An inverted yield curve is often correlated with but is not a contributing factor, to a recession.
- Sometimes the yield curve inverts, but a recession does not occur.
- There can be a substantial delay between an inversion and a recession. The lag time has been between 6 months and 30 months.
- The yield curve is just one of many factors that indicate economic health and should not be weighted too heavily in one's decision making process.

Fortunately, a recession in 2019 still appears unlikely and the majority of economic indicators remain positive. S&P 500 earnings will not grow as quickly as in 2018, but are still expected to increase by 7% in 2019. In addition, a record number of people have jobs and the recent drop in oil prices will help put more discretionary cash in consumers' pockets. Furthermore, inflation appears tame, which may provide strong rationale for the Fed to further slow the pace of rising interest rates.



While the likelihood of a recession in 2019 is slim, the stock market is forward looking and will soon focus on 2020 economic growth and earnings expectations. The current consensus is that earnings will continue to grow in 2020, at an expected pace of 6%. However, the stock market will constantly assess new information in 2019 to formulate predictions on future earnings and the probability of a recession in 2020.

Since 2008, the Fed has done an excellent job steering the economy out of the recession and through prolonged growth. The Fed's continued stance that future rate hikes will be data dependent should give it the flexibility necessary to make prudent choices that will put the economy on a solid long-term path.

Source: Standard & Poor's and Credit Suisse as of December 18, 2018.

Matt Goette, CFA, CFP®, AIF®
President & Chief Investment Officer

Phone: (443) 918-7147
Email: mgoette@blackdfinancial.com

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CONTACT US

Baltimore

305 W Pennsylvania Ave.
Towson, MD 21204

Bend

780 NW York Drive, Suite 208
Bend, OR 97703

New York City

175 Varick St., Suite 349
New York, NY 10014

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