

December 20, 2018

Dear Valued Client,

On the heels of the Federal Reserve Board's decision to raise interest rates a quarter point yesterday, we thought it a good time to reach out to our clients. There have been two major issues hovering over markets in recent months, rate policy and trade tensions. After yesterday's Fed meeting, markets have more clarity regarding rate policy into 2019. While the market may have expected the Fed to "dot-plot" only one increase next year, the projection of two increases confirms the Fed's confidence in our economy. This is a good sign for investors as history has repeatedly shown that as economic fundamentals tend to prevail when it comes to market performance. Trade tensions are yet to resolve, and as such we anticipate continued volatility into 2019. With an eye on China and the notion that we do in-fact anticipate a resolution, we encourage everyone to remember that as investors, the long-view matters the most and that the best course of action is to stick to the course. Highlighted in our "volatility perspective" below, what we've experienced in 2018 is very much in line with what is considered average volatility. A focus on the fundamentals and our financial plan helps us endure the headlines and near term bumps.

Oversold conditions may support a bounce. Higher selling volume, credit spread widening, falling Treasury yields, and weakness in transports and semiconductors presented strong evidence of investor disappointment with the Fed announcement yesterday. Many price-based metrics suggest we may get a bounce, including just 22% of S&P 500 stocks sitting above their 200-day moving average, advancing volume drying up, more extreme put/call readings, and increasing use of cash as a safe-haven. With the S&P 500 near 2500, the next support level is 2450, followed by 2375; resistance on the upside is 2650/2700.

Volatility perspective. The average annual peak-to-trough decline since 1980 has been 14%, very close to what investors have had to stomach in 2018. Average volatility feels worse than average but putting market swings in context can be reassuring. In a midterm election year, the average decline is slightly larger (16%), while even in up years, the average peak-to-trough decline has been 11%. Keep in mind that since WWII, the S&P 500 has never declined in the 12 months following a midterm election (18 for 18), and no recession has occurred when earnings rise, as we expect in 2019-our forecast calls for a 6-7% increase in S&P 500 earnings next year.

Non-recessionary bears are rare and not much worse than this. Over the past 40 years, the S&P 500 has experienced only one decline >20% that was not accompanied by a recession based on closing prices and that was 1987. It did come very close three times, falling 19% peak-to-trough in 1978, 1998, and 2011. No one can predict with certainty how far this latest selloff will go but fundamentals, including a low probability of recession in 2019, and historical perspective suggest much of this selloff may be behind us.

Valuations have come down significantly. The benefit of market declines is of course that stocks get cheaper. How much cheaper have they gotten? After trading at a price-to-earnings ratio (PE) just under 19 only 11 months ago (based on next 12 month's consensus earnings estimates from FactSet), the S&P 500 PE has fallen to 15, slightly below the long-term average. Given low inflation and still-low interest rates, and our still positive earnings growth outlook, we believe stocks are below fair value.

