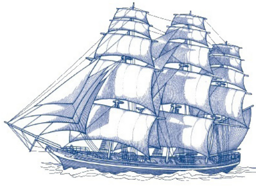
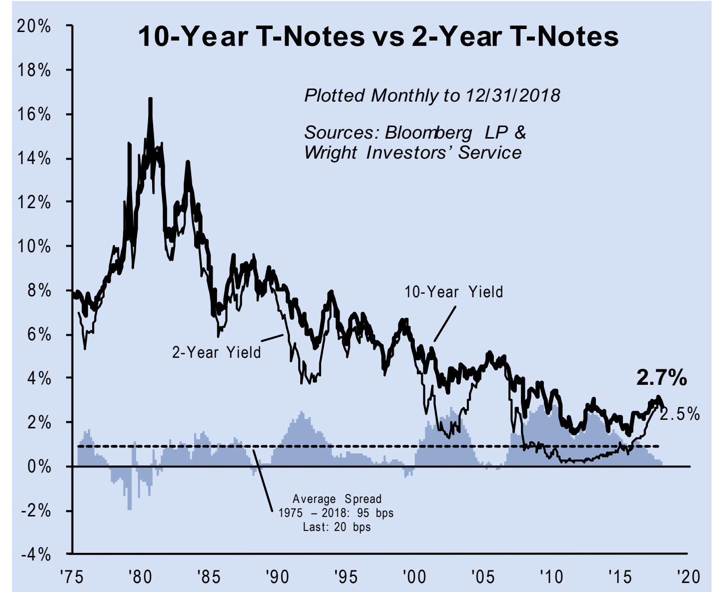


Quarterly Investment Report

January 2019

SUMMARY: ***Stocks declined in 2018, pushed down by tightening central bank monetary policies and their potential impact of slowing economic growth. Most of the major global averages suffered losses in the mid-teens during the fourth quarter, with most of the losses occurring in December. U.S. stocks recorded their worst annual performance in 10 years, while foreign stocks did much worse. Bonds had slightly positive returns in Q4 as investors sought safe haven assets, driving interest rates lower. The Federal Reserve faces growing pressure to pause raising interest rates in the face of volatile market activity and slowing economic growth.***

Following a rough fourth quarter, when all the major equity indexes dropped by double-digit percentages, U.S. stocks in 2018 recorded their worst performance since the global financial crisis 10 years ago. The S&P 500 lost 4.4% for full year 2018, including dividends, after plunging 13.5% in Q4, with more than half of the loss – 9.0% – occurring in December. The Dow Jones Industrial Average ended the year with a return of negative 3.5% after falling 11.3% in the fourth quarter and 8.6% in December alone. NASDAQ was the best performer for the year – down a relatively small 2.8% – but was the biggest loser late in the year, dropping 17.3% in Q4 and 9.4% in the final month, as investors fled the big tech and social media stocks that had led the market to record levels the past several years. Smaller cap stocks did even worse. The S&P 400 MidCaps lost 11.1% for the year after falling 17.3% in the fourth quarter and 11.3% in December, while the SmallCap 600 fell 8.5% for the full year following a 20.1% decline in Q4 and 12.1% in December. One of the few indicators that did show an increase was the VIX volatility index, which ended the year at 25.4, nearly triple the level where it ended 2017 and double where it closed the third quarter.



S&P 500 Sectors

Just three of the S&P 500's 11 sectors finished in the green for full year 2018, while 10 of them closed in the red in the fourth quarter and all 11 lost ground in December. Health care stocks were the best performers for the year, returning a

Global Investment Returns
In U.S. Dollars

	Q4 2018		YEAR 2018	
	Stocks	Bonds	Stocks	Bonds
U.S.	**-13.8%**	**1.6%**	**-5.0%**	**0.0%**
Canada	-15.3%	-2.7%	-17.2%	-6.0%
Mexico	-18.8%	-3.3%	-15.5%	-5.2%
Japan	**-14.2%**	**4.9%**	**-12.9%**	**3.7%**
Pacific ex Japan	-7.9%	2.5%	-10.3%	-2.4%
Australia	-10.0%	0.1%	-12.0%	-5.3%
China	-10.7%	3.9%	-18.9%	3.0%
Hong Kong	-4.5%	N/A	-7.8%	N/A
Europe	**-12.7%**	**-0.7%**	**-14.9%**	**-4.4%**
France	-15.0%	-3.4%	-12.8%	-5.9%
Germany	-15.5%	0.0%	-22.2%	-2.6%
Italy	-11.8%	-0.2%	-17.8%	-8.4%
Netherlands	-11.0%	-0.1%	-13.1%	-2.5%
Spain	-8.7%	-2.3%	-16.2%	N/A
Switzerland	-8.9%	0.6%	-9.1%	-1.0%
U.K.	-11.8%	-0.8%	-14.2%	-6.0%
World	**-13.4%**	**1.2%**	**-8.7%**	**-1.2%**
World ex U.S.	-12.8%	0.9%	-14.1%	-2.1%

Sources: MSCI Stock & Bloomberg Barclays Bond Indexes as of 12/31/2018

positive 6.5% despite an 8.7% loss in Q4. Utilities also managed to finish in positive territory for the year, up 4.1%, and were the only sector to record a gain in the final quarter (+1.4%) as investors were attracted to the safety of high dividend-paying stocks. On the negative side, energy stocks, reflecting the sharp drop in world oil prices, lost 18.1% last year after falling 23.8% in Q4 as crude prices plunged 38% in the quarter and 24.8% for the year, with the U.S. benchmark ending the year at about $45 a barrel, its lowest price since mid-2017. Materials stocks were the second worst performers for the year, losing 14.7%, while industrials and information technology stocks were next worst for the fourth quarter, both falling 17.3%.

Foreign Stocks

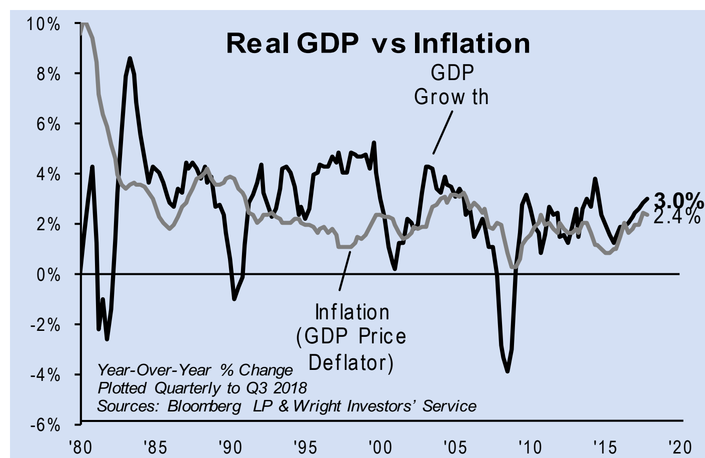
Foreign stocks fared worse than their American counterparts in US Dollars, with all the major national averages falling in the mid-teens. Eurozone stocks lost 15.1% for the year, with most of the loss (-13.1%) coming in the fourth quarter. Chinese stocks were the biggest losers, falling nearly 19% for the year, with half of the loss coming in the final quarter. Japanese stocks, which had been in positive territory entering the fourth quarter, ended the year down 12.9% after falling 14.2% in Q4. Emerging markets lost 14.6% for the year, half of it coming in Q4.

Bonds

Bonds, meanwhile, ended the year relatively flat after finishing strong in the fourth quarter, as interest rates dropped sharply on weaker economic news and bond prices soared as nervous investors sought the safety of fixed-income securities. The Bloomberg Barclays U.S. Bond Market Aggregate, which is heavily weighted with government securities, ended the year unchanged but up 1.6% for the fourth quarter as yields on longer-term Treasury bonds plunged late in the year. The yield on the benchmark 10-year note, for example, dropped 31 basis points in December and 38 bps in the fourth quarter, closing the year at 2.68%. That was down 56 bps from a peak of 3.24% in early November. Corporate and high-yield bonds both lost 2.1% for the year. Outside the U.S., the Bloomberg Barclays Global Aggregate ex U.S. also lost 2.1% for 2018 but returned a positive 0.9% in Q4 after gaining 2.2% in December. Gold also proved to be a safe haven asset late in the year, climbing 7.5% in Q4 thanks to a 5.0% rise in December, although it did end the full year down 2.1%.

U.S. Economy

The U.S. economy is showing some signs of slowdown, but nowhere close to falling into recession, as some prognosticators worry. The second and final revision of third quarter GDP came in at 3.4%, down from the previous estimate of 3.5% and the second quarter's 4.2% pace. Nevertheless, the current GDP growth compares favorably to the third quarter 2017 GDP which was a tepid 2.8%. Estimates for Q4 indicate economic growth falling into the 2.5% range, far from recessionary – i.e., negative – levels, but still enough to warrant Federal Reserve concern. The headline durable goods orders figure for November rose a weaker-than-expected 0.8%, well below the 1.4% forecast. When excluding the volatile transportation sector, orders were down 0.3%, instead of the 0.3% increase the Street was expecting. Core capital goods orders, a proxy for business investment, fell 0.6%, the third decline in the past four months, down from October's upwardly revised 0.5% increase and below the positive 0.3% forecast. Industrial production rose a stronger-than-expected 0.6%, driven by a 3.3% jump in utility production due to cold weather. Leading indicators rose 0.2%,



but that was offset by a downward revision in the October figure to minus 0.3%.

The Consumer

Consumers are starting to show reduced confidence in the economy despite a still robust jobs market and retail sales. The Conference Board's consumer confidence index dropped more than eight points in December to 128.1. While that's still a pretty strong figure based on historical levels, it's down nearly 10 points since October's reading of 137.9, which was the highest since 2000. While the actual readings suggest the economy "will continue expanding at a solid pace in the short-term," the recent declines indicate "increasing concern that the pace of economic growth will begin moderating in the first half of 2019," the firm said. Retail sales excluding gasoline and auto sales were up 0.5%. Consumer spending, a larger category, rose 0.4%, outpacing the 0.2% rise in incomes.

The jobs market shows no signs of slowing down. The economy added 312,000 jobs in December, well above expectations of 180,000 and the largest increase since last February. For the full year, nonfarm payrolls rose an average 220,000 a month, the best performance in three years. At the same time, average hourly earnings rose 0.4% for the month and 3.2% compared to a year earlier, the strongest annual gain in 10 years. The jobless rate rose to 3.9% from 3.7%, but that was largely due to more people looking for work. The labor participation rate rose to 63.1% from 62.9%.

Housing

The housing sector continued to lag behind the rest of the economy as high prices and higher interest rates reduced buyer traffic. Sales of existing homes – by far the largest category – rose a strong 1.9% in November compared to October to an annual rate of 5.32 million, but sales were still off by 7.0% versus a year earlier, the biggest year-over-year drop since May 2011. Yet home prices remained stubbornly high at a median $257,700, up 4.2% compared to November 2017. Pending home sales, a forward indicator, fell 0.7% for the month and 7.7% versus a year earlier, the 11th straight decline by that measure. Housing starts rose 3.2%, but that was skewed by a 22.4% jump in multifamily units; single-family starts, the biggest sector, fell nearly 5%, the third straight monthly drop. Not surprisingly, then, the National Association of Home Builders' confidence index dropped another four points in December to 56, its lowest level since March 2016, after falling eight points the previous month.

Inflation

Inflationary pressures remained subdued, helped by the steep drop in oil prices. The core personal consumption expenditures index – the Fed's favored consumer inflation measure, excluding food and energy prices – rose 0.1% in November, 1.9% on a year-on-year basis. Likewise, the core consumer price index rose 0.2% for the month, 2.2% YOY.

Investment Outlook

It would be fair to say that the Fed's stance will be important to the financial markets in the coming months. The Fed and its chairman, Jerome Powell, have been under extreme pressure to reconsider their relatively hawkish policies following nine rate increases since December 2015 that have pushed the federal funds target range to 2.25% and 2.5%. Critics, from President Trump on down, now want the Fed to either halt the rate hikes or consider loosening the monetary policy in light of heightened market volatility and weakening economic data.

It was probably too late for the Fed – even if it was so inclined – to back off from raising rates at its December meeting, given that it had signaled for months that a rate hike was coming, but investors are hoping for a more dovish Fed in the new year. Indeed, the Fed's post-meeting projections indicated a possibly less aggressive monetary policy going forward. The documents showed that 11 of the Fed's 17 members – down from seven at its previous meeting in September – now expect they will need to raise rates no more than two times this year, while six members – down from nine – anticipate the need to raise rates no more than once. Previously, the Fed had pretty much set expectations of as many as four rate hikes this year. That now appears to be off the table. Still, at his press conference following last month's meeting, Powell didn't provide much reason for optimism in that respect. "We have seen developments that may signal some softening, relative to what we were expecting a few months ago," he said, referring to economic growth. "In our view, these developments have not fundamentally altered the outlook." Nevertheless, we expect the Fed will closely monitor the situation and act accordingly. As it has said many times over the past several years, it remains "data dependent" and that monetary policy is not on a predetermined course, which may mean a wait-and-see attitude going forward, at least in the first half of this year.

The Fed isn't the only major central bank to watch closely. Also last month, the European Central Bank said its four-year bond purchasing program has come to an end. However, un-

like the Fed, the ECB is highly unlikely to begin raising interest rates or to start shrinking its mammoth securities portfolio. Rather, the bank confirmed that it would keep its key interest rates unchanged at least through next summer in light of reduced economic growth forecasts for the euro zone. "It's a climate of great uncertainty," ECB President Mario Draghi warned.

The Chinese economy, which shows signs of weakening, also bears watching. The government's official manufacturing purchasing managers index dropped into contraction territory in December, falling to 49.4 from 50.0 in November, its lowest reading in almost three years. However, the news may actually turn out to be a positive for the market and the global economy. The Chinese government is now likely to take even more drastic measures to boost the economy. At the same time, it may put more pressure on Beijing to reach a trade agreement with the U.S., the lack of which was a major drag on stock prices in 2018.

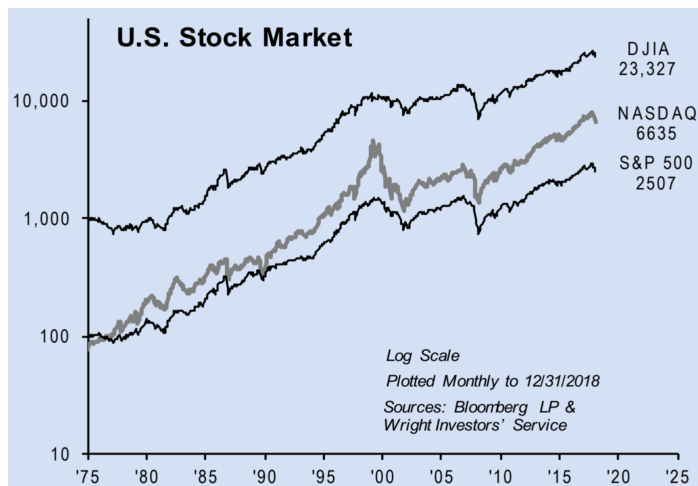
All things considered, we believe last month's stock selloff may have been overdone. The rise in interest rates by the Fed, while maybe not welcome in all quarters, shouldn't have taken anyone by surprise, as the Fed has well telegraphed its actions. The U.S. economy may not be hurtling toward recession, as the market selloff would seem to indicate. However, we expect the Fed to be more dovish in the new year if indicators of a slowing economy persist. The recent drops have taken only a small slice off the gains over the past 10 years. But they've also made stock prices cheaper, with the forward price-to-earnings ratio on the S&P 500 ending 2018 at 15.3, about midrange between the highest and lowest levels of the past seven years. Prospects of a trade deal with China look more promising, which should be bullish for the market. The changeover to a Democrat-led House may cause some stalemates but we could also see progress on a much-needed infrastructure stimulus bill. However, in the past, federal government gridlock, including temporary partial shutdowns, have generally been positive for the market. With regards to the Fed, Wright believes that Fed independence is critical to the smooth functioning of our economy as well as for the confidence that is essential for global investors in our capital markets. If the Fed remains data dependent, as they have stated often, then the current slew of economic data should cause them to be on hold, in our opinion. Still, we do expect market volatility to persist for a while. As a result, investors are well advised to maintain a well-diversified portfolio of high-quality dividend-paying stocks and bonds as we enter the new year.

January 2019

The U.S. Economy 2016–2019

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Notes
2016	Q1	1.5%	1.7%	-4.2%	0.2%	1.8%
	Q2	2.3%	2.1%	-3.6%	0.3%	1.5%
	Q3	1.9%	2.0%	-2.0%	0.3%	1.6%
	Q4	1.8%	1.5%	0.4%	0.5%	2.4%
2017	Q1	1.8%	1.6%	6.0%	0.8%	2.4%
	Q2	3.0%	1.3%	9.9%	1.0%	2.3%
	Q3	2.8%	1.4%	11.6%	1.0%	2.3%
	Q4	2.3%	2.1%	13.7%	1.4%	2.4%
2018	Q1	2.2%	2.2%	14.7%	1.7%	2.7%
	Q2	4.2%	2.1%	17.5%	1.9%	2.9%
	Q3	3.4%	1.6%	22.5%	2.2%	3.1%
	Q4 e	2.6%	1.9%	23.6%	2.4%	2.7%
2019	Q1 e	2.3%	1.9%	21.1%	2.9%	3.1%
	Q2 e	2.5%	1.9%	18.1%	3.0%	3.2%
	Q3 e	2.3%	2.1%	14.3%	3.1%	3.3%
	Q4 e	2.0%	2.1%	13.2%	3.2%	3.3%

e: Bloomberg Consensus Estimates; *: Annual Rates; #: Year-Over-Year Change in S&P500 EPS
Sources: Bloomberg LP, Wright Investors' Service



Copyright © 2019 by Wright Investors' Service, Inc., 2 Corporate Drive, Suite 770, Shelton, CT 06484-6238. This commentary does not constitute an offer to sell any securities or the solicitation of an offer to purchase any securities. All Rights Reserved. Except for quotations by established news media, no part of this publication may be reproduced, stored in retrieval systems, or transmitted, in any form or by any means or media, without prior written permission. Certain information contained in this letter constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," will," "should," "expect," "attempt," "anticipate," "project," "estimate, or "seek" or the negatives thereof or other variations thereon or comparable terminology. Statements and opinions in this publication are based on sources of information believed to be accurate and reliable, but the Advisor makes no representations or guarantees as to the accuracy or completeness thereof. Employees of the Advisor may purchase and sell securities subject to certain pre-clearance and reporting requirements and other procedures specified in its Code of Ethics. As required by the Investment Advisers Act of 1940, the Advisor will deliver its Brochure and Brochure Supplements, upon a written request from any of its advisory clients or any prospective clients. Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. Investment portfolios managed by the Advisor may consist of securities which vary significantly from those in the benchmark indexes listed above. Accordingly, results shown to those of such indexes may be of limited use. All statements that are not historical facts are forward-looking statements, including any statements that relate to future market conditions, results, operations, strategies or other future conditions or developments and any statements regarding objectives, opportunities, positioning or prospects. Forward-looking statements are necessarily based upon speculation, expectations, estimates and assumptions that are inherently unreliable and subject to significant business, economic and competitive uncertainties and contingencies. **Past performance is not indicative of future results.**