STOKES CAPITAL ADVISORS, LLC

Market Commentary
December 31, 2018

Quarterly Market Review

U.S. equities recorded their worst quarterly performance in over seven years with the S&P 500 Index declining -13.5% as investors raised concerns over the slowing global economy. Compounding the negative sentiment, the Federal Reserve raised interest rates and gave no indication of an end or pause anytime soon. In addition, trade tensions with China, concerns over peak earnings growth and dysfunction in Washington added to the selloff pushing equity indices in negative territory for the year.

Suffering the most in the selloff were “momentum stocks” that were so loved by investors for such a long time. With valuations already stretched and market sentiment turning negative, the decline in these stocks was even more pronounced than other areas of the market.

Small-cap equities, after setting record highs in September and logging 12 consecutive positive quarters, posted their worst quarterly performance since the 2008 Financial Crisis. While less sensitive to global macro headwinds such as currency translation and trade wars, small-caps remain hyper-sensitive to domestic economic growth concerns.

Foreign equities, already in negative territory for the year, added to losses during the quarter with many regions entering a bear market, defined as a 20% decline or more. Slowing economic growth in China and Europe coupled with tariff concerns fueled the negative outlook for non-U.S. equities.

Brent crude oil entered a bear market during the quarter falling 34% as a weaker outlook for global growth raised questions about demand for the benchmark commodity. In addition, continued increases in U.S. shale production replaces global supply cuts from OPEC and other Countries.

Master Limited Partnerships declined over 17% for the quarter following oil prices lower and finishing the year down 12.4%, making Q4 the worst quarter for the energy midstream sector in over three years when oil collapsed 50%. The selloff appears to be more sentiment driven as there was no evidence of any deterioration in company fundamentals such as earnings, cashflows or distributions.

Turning to the credit markets, bonds underperformed cash equivalents for the first time since the 2008 Financial Crisis. The Federal Reserve raising interest rates for the ninth time this cycle has improved the yield on short duration bonds and cash equivalents, while intermediate term securities and longer dated maturities managed to provide only minor gains for 2018. In addition, the risk-off sentiment in equities spilled over into the credit markets during the quarter as widening spreads forced high yield bonds into negative territory for the year while U.S. Treasuries and other save haven assets outperformed.

Global Economic Outlook

United States: After a modest slowdown in the third quarter, the economy appears to be maintaining a robust, even if likely slightly softening, growth momentum in the fourth quarter, buttressed primarily by upbeat private spending thanks to the winter holiday season. Indeed, consumer confidence remained elevated in November, while retail sales data in the same month signaled private consumption growth will accelerate somewhat in Q4 compared to the previous quarter. This should further be supported by steady job gains in the labor market, fanning upward wage pressures. However, a subdued housing sector should continue to weigh on the economy. On the trade front, the meeting between Donald Trump and Xi Jinping in early December yielded a 90-day truce. This ensured no new tariffs will be enacted during the period, which should limit disruptions in business activity for the time being. Indeed, despite concerns about tariffs, the manufacturing sector gained steam in November thanks to solid domestic demand. Nevertheless, the reprieve could be short-lived; the U.S. is set to increase the rate on existing tariffs from 10% to 25% on 2 March, in the likely event that trade talks fail to produce a substantive agreement.

Eurozone: Detailed data confirmed that broad-based malaise drove the Eurozone economy to slow notably in the third quarter, with growth recording the softest reading in four years. Notably, export growth contracted amid cooling global trade, while the industrial sector was also hurt as the automobile sector was disrupted by new emissions tests. Available data for the fourth quarter points to mixed momentum. In October, industrial production rebounded and the unemployment rate was stable. However, sentiment slid in November and the composite PMI plunged to a four-year low in December. In the political arena, European leaders agreed to make a common-budget for the Eurozone on 14 December, accepting a slimmed-down version of an idea touted by French President Emmanuel Macron. The budget would be used to spur investment and reduce economic disparity among economies and is a sign of renewed life in Eurozone reforms. Most of the difficult decisions regarding the budget, including its size, have yet to be agreed upon and a proper proposal is expected in June. The budget could face lengthy negotiations to pass given the differing views among heads of states over the matter.

Japan: The economy fared worse than initially reported in the third quarter as strong typhoons and a powerful earthquake severely disrupted economic activity. The economy is, however, expected to return to growth in the fourth quarter as supply chains recover from the natural disasters. The manufacturing PMI averaged slightly higher in Q4 than in Q3, while confidence among large manufacturing firms steadied at relatively high levels in the same period. Moreover, the Tankan survey—an economic survey of Japanese businesses conducted by the Bank of Japan (BoJ)—showed that large firms are planning to noticeably increase capital spending in the fiscal year.

China: A reprieve in trade tensions materialized at the G20 summit in early December, when the two economic superpowers agreed to a 90-day truce on new tariffs. However, major discrepancies between the two sides' positions on key trade issues cast doubts over the armistice. Meanwhile, the economy continues to grapple with slower growth dynamics. Following a softer Q3 GDP reading, data for Q4 tells a similar narrative. A weak turnout in retail sales in October, despite the increase in the minimum threshold for paying personal income taxes on 1 October, and a drop in new yuan loans in the same month point to a slowing domestic economy. Nevertheless, stronger industrial production and a pick-up in fixed-asset investment in October suggest some of the government's stimulus measures have begun to feed through.

Investment Strategy & Outlook

During 2018, markets transitioned away from the low-volatility, mid-cycle phase that had persisted for years to a late-cycle environment marred with episodes of higher volatility. In 2019, further maturing in the U.S. and global business cycles is likely to heighten uncertainties with the removal of Central Bank policy accommodation producing elevated levels of volatility for investors.

I have argued for some time now that the U.S. economy has entered the later stage of the economic expansion, a view that has now become the consensus. But late-cycle phases "don't die of old age, they are murdered" according to former Fed Chair Bernanke referring to past Central Bank policy errors. I would agree with this statement and believe the Federal Reserve is the single greatest threat to the current expansion. Ironically, it was the Fed that started the longest expansion on record dating back to 2009.

Of course, there are several other concerns that investors must navigate in 2019, including a possible earnings recession, a trade war with China and slowing global economic growth. But it's not likely to be all bad news for investors in 2019. The selloff in Q4 brought valuations down to attractive levels, recent jobs data confirmed the U.S. economy has legs and dovish comments from Fed Chair Powell provided a lift to markets at the start of the new year.

However, investors should be prepared for more episodes of volatility as global Central Banks continue to augment monetary policy and late cycle pressures challenge corporate profits and economic growth. In addition, diverging global capital markets and lower asset correlations provide fertile ground for active investment managers and strategists. Furthermore, this backdrop favors value-oriented investors and dividend paying stocks and will be less favorable for growth/momentum investors and non-dividend payers.

Performance Scorecard

Benchmark Description	Q4	YTD
Barclays Aggregate Bond Index	1.64%	0.01%
S&P 500 Index	-13.52%	-4.38%
NASDAQ Dividend Achievers Index	-11.03%	-1.98%
Russell 2000 Index	-20.20%	-11.01%
Alerian MLP Index	-17.30%	-12.42%
U.K. FTSE 100 Index	-11.75%	-14.07%
German DAX Index	-15.12%	-22.16%
China SCI 300 Index	-12.22%	-27.57%
Japan Nikkei 225 Index	-14.39%	-8.48%
MSCI Emerging Markets USD	-7.40%	-14.25%