MARQUIS
Wealth Management Group
Personalized Financial Services

Fourth Quarter 2018 Market Review & 2019 Outlook

January 2019

Executive Summary

- Stock markets declined materially in the fourth quarter, pushing all the major market indices into negative territory for 2018. Alternatives and bond markets offered some refuge from the storm in equities in the fourth quarter, but were also nearly uniformly negative for the year. (Pages 1 & 2)
- The accelerating declines and resulting narrative of fear and recession in December reminded us of the similar quick, sharp declines in the bond market in 2013 that was dubbed the "taper tantrum". In that episode, policy announcements and economic data were broadly misconstrued, but markets recovered relatively quickly. (Pages 2 & 3)
- While the risk of economic recession is currently quite low, policy mistakes around the UK exit from the EU (Brexit), and the US/China trade negotiations could significantly curtail or raise the risk of recession, depending on the outcome(s). (Page 3)
- Stock market valuations have fallen significantly, and appear more favorable for longer term returns, particularly in international markets (Pages 3 & 4)
- We recommend maintaining our current portfolio allocations at or near the midpoint of long term ranges for stocks, underweighting bonds, and including alternatives. As 2019 progresses, we could look to make material shifts in the bond allocation for the first time in a while. (Pages 4 & 5)

Fourth Quarter 2018 Financial Markets Review

Stock market performance was decidedly negative in the fourth quarter, as markets across the globe declined precipitously, pushing full year returns negative across the board for the first time since 2008. Managed Futures trend following strategies also declined, but far less than did stock markets, thus offering investors some protection. Below are selected index total returns for the fourth quarter and one year periods as of 12/31/2018:

- Large company US stocks, as measured by the S&P 500 index, declined (13.5%) in the fourth quarter, and finished the year with a (4.4%) loss.
- Small company US stocks, as measured by the Russell 2000 index, declined (20.2%) in the fourth quarter and finished the year with an (11.0%) loss.
- International stocks, as measured by the MSCI All Country World (Excluding US) index, declined (11.5%) in the fourth quarter and ended the year down (14.2%).
- Commodity prices (oil, gold, metals, grains, etc.) declined (15.4%) in the fourth quarter and ended the year down (11.0%).
- Managed Futures Strategies, as measured by the Credit Suisse Managed Futures Index, declined (3.7%) in the fourth quarter, and ended the year down (6.7%).

The US investment grade bond market, as measured by the Bloomberg Barclay's US Aggregate Bond Index, fulfilled its historical role as a portfolio stabilizer amidst the broad based decline in stock markets, earning a 1.6% total return in the fourth quarter. This nearly perfectly erased the losses accumulated during the first nine months of the year, bringing the full year total return to 0.01%. Long term bonds significantly outperformed shorter term bonds as long term interest rates fell while short term interest rates increased. The more credit sensitive bond sectors were caught up in the sell-off of risk assets, and declined the most in the quarter. Below are the sector total returns within the bond market for the fourth quarter and one year periods:

- Short Term US Treasury Bonds earned 0.6% in the fourth quarter and 1.9% for the year.
- Long Term US Treasury Bonds earned 4.2% in the fourth quarter which cut the full year decline to (1.8%).
- US Investment Grade Corporate Bonds were flat in the fourth quarter, and finished the year down (2.1%).
- US High Yield Bonds declined (4.7%) in the fourth quarter, finishing the year down (2.3%).
- US Floating Rate Bank Loans declined (3.5%) in the fourth quarter, but still earned 0.4% for the year.
- US Municipal Bonds earned 1.7% in the fourth quarter and 1.3% for the year.
- Developed Market Foreign Government Bonds earned 2.1% in the fourth quarter but finished the year down (0.8%).

Market Commentary

Financial market activity turned decidedly hostile in the final quarter of 2018, as risky assets declined substantially in October, stabilized in November, and then accelerated to the downside in December. All in all, the fourth quarter produced meaningfully negative returns across most asset classes, and headlines in the financial press in early January pronounced 2018 as "the worst year in the stock market since 2008." While technically true, we think that's a bit sensationalistic as the 2018 (4.4%) decline in the S&P 500 Index is still a very far cry from the 2008 (37.0%) meltdown. Perhaps more responsibly, the headlines could have read "the first negative year in the stock market since 2008". Either way, its been a very long time since the US stock market had a negative year, and the nature of the market's sharp downturn in the fourth quarter made it feel worse.

The stock market movements in the fourth quarter of 2018 reminded us a lot of the bond market movements in mid-2013 during the so-called "taper tantrum". You may recall that episode was triggered by Federal Reserve Chairman Ben Bernanke saying he thought it might soon be time to "taper" (or gradually reduce) the amount of the central bank's ongoing purchases of US Treasury bonds and mortgage securities. The bond market impulsively reacted as if the announcement had instead conveyed that the Fed was considering immediately ceasing all bond purchases and outright bond sales were imminent. In response, long term US Treasury bond declined (10.9%) in a period of three months from May to July that year. In reality, the Federal Reserve continued to purchase new bonds (at a reducing rate) through late 2014, held its balance sheet steady through late 2017, and only materially began letting bonds mature without reinvesting the proceeds in 2018. After throwing its “tantrum” in the summer of 2013, bond markets rebounded over the following months, and within a year it was as if the “tantrum” had never even occurred.

The parallel in the present context would be the economic data released in the fourth quarter that showed a still healthy, but slowing, US economy and/or the “flattening” of the yield curve, where longer term and shorter term interest rates have converged, but long term rates remain somewhat higher. In this episode, the market reacted as if the economy had already rolled over into recession, and the yield curve had already “inverted” so that short term interest rates were actually higher than longer term interest rates. **To be clear, both of these scenarios hold significant negative implications for financial markets, and we pay close attention to the possibility of each happening, but they haven’t yet occurred.** Markets seem to have come to this same realization in early 2019, as the S&P 500 index has regained a little more than half of the decline since its high point reached in late September.

The key will be how long economic growth continues, and every serious data source we read currently expects growth to continue (but at a slower pace than in 2018) at least through this year, if not for a few more years. There are also several significant externalities that could serve to extend or cut short the economic momentum, depending on how or if they are resolved. In our opinion, the two most important are the trade dispute with China, and the United Kingdom’s pending exit from the European Union. These are both active issues early in the year, with a “self-imposed” March 1 deadline for the United States to reach an agreement with China before tariffs on Chinese exports to the U.S. are scheduled to increase to 25%; and a March 29 deadline for the United Kingdom to approve a deal to leave the European Union in a pre-negotiated way or exit chaotically with no deal. Needless to say, investors are watching the news flow related to these two events quite closely, and the market is reacting to each whisper of positive or negative movement. It might be an understatement to write that we expect markets to remain particularly volatile (up or down) through the end of March.

If there is a silver lining to the stock market declining last year, it’s that market valuations are presently much more favorable than they were at the end of 2017. Using the S&P 500 index as an example, corporate earnings grew about 27% in 2018 (based on expectations for 4th quarter earnings, which are currently being reported) while the stock market declined by about 4% - both moves (lower in price and higher in earnings) reduced the P/E ratio to just above the long term average of 16.3x, as shown in the table below, updated through the middle of January. **This marks the lowest market valuation (most favorable for investors) for the S&P 500 Index since the middle of 2013, and is a welcome development for long term investors. Put simply, lower market valuations present much lower hurdles for reasonable future returns than do higher market valuations.**

Recent S&P 500 Index Measures

	Index Value	Index Earnings[1]	P/E Ratio
12/31/2017	2,674	109.88	24.3x
3/31/2018	2,641	115.44	22.9x
6/30/2018	2,718	122.48	22.2x
9/30/2018	2,914	130.39	22.4x
12/31/2018	2,507	139.85	17.9x
1/15/2019	2,610	139.85	18.7x

[1] Trailing twelve months

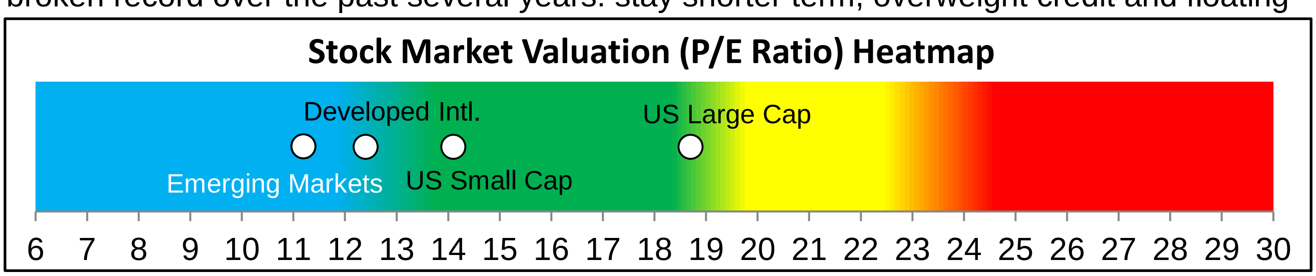
Potential S&P 500 Values 12/31/2019			
	Year-End P/E Ratio		
Earnings Growth	16.2x	18.7x	21.2x
6% (Long-term Avg.)	2,406	2,768	3,143
11% (S&P Estimate)	2,532	2,913	3,307

In the same way that we can divide the current market level by the current composite earnings amount to arrive at the current valuation, we can also multiply expected future earnings by a given valuation to forecast potential future market levels. Using this approach, we have produced several possibilities for the potential S&P 500 Index values at the end of 2019 in the above table. S&P analysts currently expect earnings growth of 11% in 2019 which, while a significant reduction from 2018's tax-cut fueled earnings surge, is still materially faster than the long-term average of 6% growth. We don't claim any forecasting ability for the 500-plus companies that make up the index, so we have simply used the S&P analyst expectation for one scenario and the long-term growth rate for another. As for the valuation inputs, the easiest place to start is to use the current market valuation of 18.7x. We also adjusted that downward 2.5 points to the long-term average of 16.2x and upward by a similar amount to produce two additional scenarios. The six outcomes range from about 2,400 (a loss of about 8% from the 12/31/18 market level) to about 3,300 (a gain of about 26%). There are certainly numerous other possibilities, but the conclusion we draw is that after last year's significant reduction in market valuation from an elevated level, the risk/reward possibilities for 2019 are balanced much more favorably, and the upside could be two to three times greater than the downside. The truth, as in most things, is likely somewhere in the middle.

Portfolio Positioning

Market valuations have similarly declined in other areas of the stock market, as compared to a year ago. Referencing the Stock Market Heatmap at the bottom of the page, there are no longer any of the major markets we track in either the yellow or red "caution" or "overheated" zones. International markets, both developed and emerging, have fallen below their long term averages into the blue "cold" zones that generally mark good long term buying opportunities. Thus, in recommending overall portfolio positioning, we are balancing reasonable to low market valuations against the backdrop of slowing global growth to recommend clients maintain overall neutral stock allocations at or near the midpoint of their long term ranges. **We do not believe this is a time to become overly aggressive, but neither is it a time to become overly defensive.** In short, the risks to both the downside and the upside seem pretty balanced. For more aggressive or opportunistic clients, international markets, and in particular emerging markets may present very attractive opportunities to add or maintain an overweight position compared with domestic stocks.

Our recommendations for positioning the bond side of client portfolios has been a bit of a broken record over the past several years: stay shorter term, overweight credit and floating



rate bank loans, and overweight our international bond manager. That positioning helped insulate client portfolios from the worst effects of the interest rate increase last year, but also led to moderately increased exposure to a decline in the credit markets right at the end of the year, particular in the floating rate bank loan sector. That decline appears to have been a short-term technical pricing dislocation that has largely reversed itself in just as quick a fashion in the first three weeks of 2019. Looking forward to 2019, expectations are for the US Federal Reserve to slow the pace of rate increases compared to 2018, and most forecasters agree the Fed is nearing the "neutral" rate, which will likely signify the end of rate increases for this cycle. If and as that point is reached, we will look to reposition our bond portfolios to eliminate the overweight to credit and floating rate bank loans, and return to a more normal core weighting in US Treasury Bonds. We do not feel that time has come yet, and so recommend maintaining bond portfolios as they are for now, but that time will likely come at some point this year. For more conservative clients, we may begin making that transition earlier in the year as an extra precaution against further stock market declines.

Our allocations to alternatives – the managed futures mutual funds and/or the gold ETF – both protected portfolios against the worst of the stock market volatility in October and December. While the managed futures funds contributed to relative performance by losing less than the market, gold was one of the very few assets that actually increased in value during the fourth quarter. 2018 was a challenging year for these positions, as they all fell in value, but they displayed their merit in December in particular, as they all earned positive returns in the midst of a severely monthly decline in the global stock markets. We expect to maintain these positions at a small, but important allocation of the overall client portfolio.

We recognize that 2018 was not a good year in the financial markets, and the significant market decline in December likely cast a shadow over what is normally joyous time of year. We think it is important to remember that the careful long term planning we provide, and our resulting investment recommendations are designed knowing there will be times that are uncomfortable. We believe our most important role may be to help you remain focused on the long term and not overreact to short-term volatility. We appreciate the trust you place in us to help guide you towards achieving your long term objectives, and we wish you a healthy, happy, and more prosperous New Year. Please do not hesitate to contact us if you have any questions, or if you would like to schedule a meeting to review your goals or portfolio in detail.

Best Regards,

Rick

Richard Krichbaum, CFP®, MBA
President

Trevor

Trevor Whitley, CFA, CFP®, AIF®
Partner, Financial Advisor

Brian

Brian O'Connell, CFP®
Partner, Financial Advisor

Kim

Kim Sands, MSM, AIF®
Client Services Manager

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