2018 – A Year that was Squandered

By Bob Deitrick and Justin Braun
January 1st, 2019

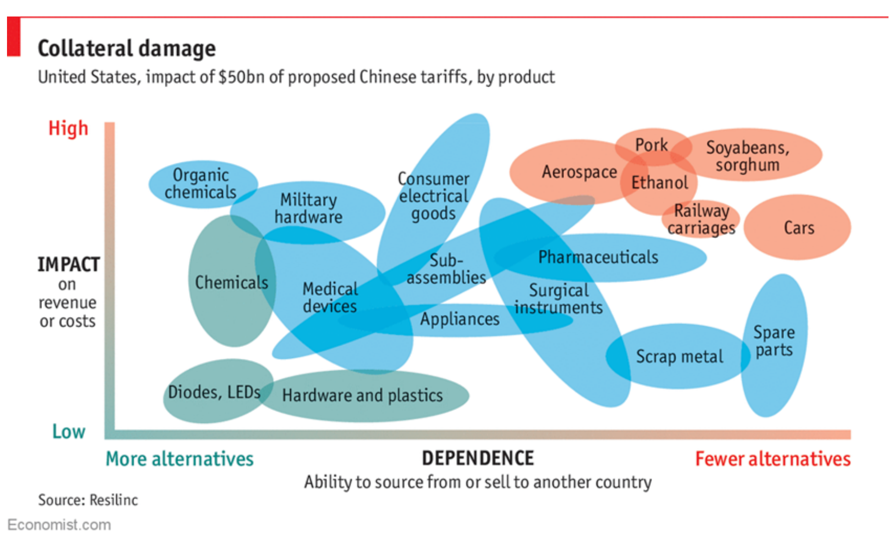
Happy New Year!!

January of 2018 took off like a rocket after the tax bill passed the month before. By February 1st, the major indices were up between 5% to 8% - a great start to the New Year. However, that momentum faded on February 1st with news that President Trump was initiating tariffs on Chinese steel and aluminum. This began a trade war the likes of which we've not seen since The Great Depression.

Tariffs are nothing more than taxes. They decrease the number of mutually beneficial transactions which take place and they are worse for consumers given how elastic world supply is. Tariffs lead to inefficient economic outcomes as well. The trade war has squandered the potential stock market gains we should have seen as a result of the tax bill passed a year ago.

Our primary concern are these enduring trade wars. The market was optimistic on December 3rd after President Trump's meeting with Chinese President Xi Jinping. However, stocks sold off the next day as we learned that little progress was made. Peter Navarro, Trump's trade advisor, remarked recently that a trade deal with China would take longer than three months. That sent the market into a tailspin. The President originally told us: "trade wars are good, and easy to win."

The greatest threat the bull market is the growing impact of this trade war with China. We do need to do something about China, but there are better ways to do it. The trade war is stifling American industry and agriculture and it is straining China - US relations. We believe that the United States benefits from free trade and the Trump administration needs to find a resolution with China and make it a priority. These tariffs have disrupted the supply chain around the world impacting technology, logistics, autos, agriculture, aerospace and manufacturing companies.



You have heard us say often that the markets need stability and predictability. Having said that, the two-weeks prior to Christmas had enough precarious news to fill six months. On Wednesday the 19th, the Fed hiked rates for the fourth time this year, as we expected; however, they came in with a hawkish tone for 2019 which troubled the markets. President Trump then pulled our troops out of Syria – sans telling the Pentagon or his staff. This sent the markets down further. That Thursday, Defense Secretary Mattis resigned with a letter that rebuked the President. Trump's decision to withdrawal troops from Syria alarmed national security experts around the globe. The Saturday before Christmas, Trump's lead ISIS envoy, Brett McGurk, quit in protest also.

Thursday presented further unease as the President announced he would recant his decision to sign a clean CR to keep the government open. The CR or continuing resolution had been passed unanimously by the Senate to keep the government running - something Trump had agreed upon two days prior. He insisted on $5 billion for his border wall or he would keep the government shut down. The government shut down the Saturday prior to Christmas. That weekend, Trump's Treasury secretary, Steven Mnuchin, undertook cleanup efforts which damaged market sentiment on Christmas Eve. All in all, the last few weeks have been chaotic, and the market has responded in kind.

Unexpectedly, the 4 major stock indices closed out 2018 with the worst year

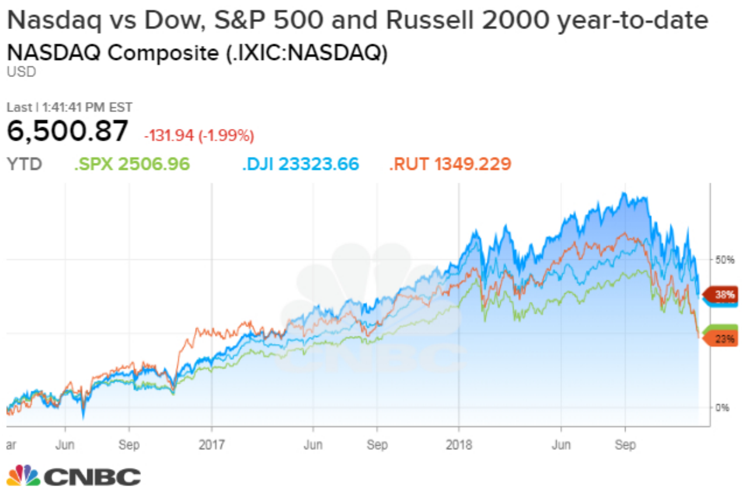
since the 2008 financial crisis and worst December since 1931.

On Christmas Day, President Trump blamed the Democrats for not funding his border wall and he faulted the Fed remarking: "The only problem our economy has is the Fed." However, this is inaccurate. President Trump appointed Fed Chair Jerome Powell and he instructed his new Fed chair to normalize rates - which he is doing. The Federal Reserve Board of Governors did confuse markets, however, with its' forecast for lower growth coupled with a commitment to continue tightening. All this clutter is hurting the market as investors need clarity - not confusion.

As we commence 2019, the American economy faces a quandary. Trump's behavior and leadership style have unsettled Wall Street and Washington. For much of the President's tenure, surging stocks created an aura of economic well-being that made his conduct appear entertaining. After Trump and congressional Republicans passed a large, deficit-financed tax cut one year ago – the market was optimistic entering 2018 and so were we. However, shifting market winds have placed the president's leadership under a more punitive spotlight.

GDP, which was 4.2 percent in the 2nd quarter, will not likely be sustained moving forward. We predict the trade war will slow economic growth this year with the odds of recession rising in 2020. The administration's approach to trade conflicts — threatening deeper tariffs, then backing off for negotiations, then threatening again, has extended uncertainty about the global economic outlook.

The question Steven and I are striving to ascertain, in real time, is whether what is taking place is a retracement, analogous to that of 2011 – or something more serious. We are optimists, but there's a lot of discouraging news on the horizon. The market is in a no man's land as we broke through major support levels last month. December was akin to an earthquake — the initial quake may have been 7.8, but there may be aftershocks, which can be disruptive as well.



<u>December is historically a positive month for stocks. However, the news cycle took over the market and we experienced the worst December performance since the Great Depression.</u>

Recession is not on the immediate horizon; however, fears the Fed will make a policy mistake in tandem with a chaotic state of affairs in Washington may bring one - unintentionally. The uncertainty surrounding the trade negotiations and a weakening Chinese economy have worried investors fearing a global slowdown will envelope the U.S. Another concern are earnings. Market consensus is for a 7.5% growth in 2019 in S&P 500 earnings, down from 20%+ this year. We have shaved our growth forecast down but believe 2019 could be positive - if the trade war ends soon.

Going into 2019, we're cautious. A little good news would go a long way but there are plenty of obstacles ahead. Some of that follow:

- ***President Trump faces legal peril on seven different fronts as we move into 2019.***
- ***Nancy Pelosi and the Dems will take over the house this week on January 3rd.***
- ***We do not have a trade deal with China or with Europe worked out yet.***
- ***The Mueller Report, which has yet to come out, is due in February of this year.***

We believe the market will bottom when everyone is sufficiently negative. However, we recommend moving some funds to cash and to the safer ports of the stock market - like the S&P aristocrats which have consistently increased their dividends as well as stocks that have been oversold like Amazon, Netflix and Apple.

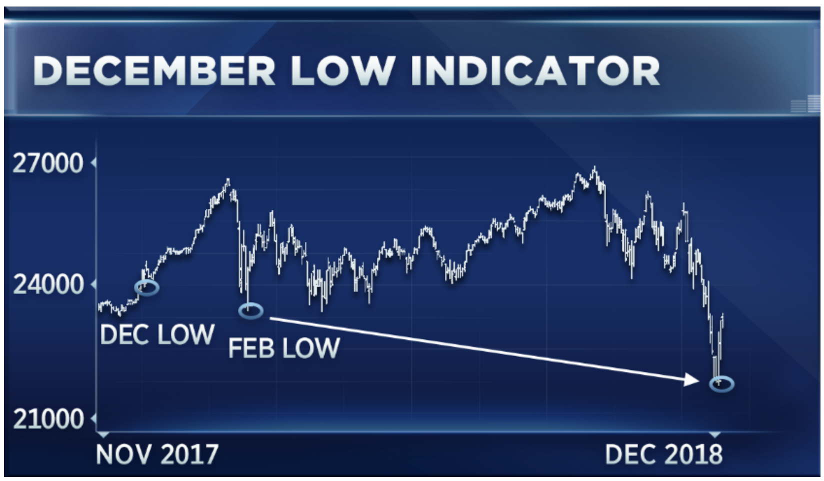
In December, the market was trading on headlines - not fundamentals. Steven and I are fundamentalists and the fundamentals remain sound, but the negative headline sentiment is feeding on itself - as selling begets more selling.

<u>There is opportunity in volatility. We intend to sell those underperforming assets in 2018 and reallocate to stocks that have been beaten up or oversold.</u>

This bull market may not be over. Longer term secular bull cycles, like this one, tend to last 12 to 17 years. The 1949 to 1966 bull, the 1982 to 2000 are both examples of this. We are 9.75 years into this cycle and may potentially have more years remaining.

The S&P 500 hit a (Damien Omen 2) intraday low of 666.79 on March 6th of 2009, the bottom that marked the beginning of this bull cycle. Since then, that index has rallied over 375%. The S&P 500 briefly dipped into bear market territory on December 19th, down more than 20 percent from the 52-week high. However, we didn't close at those lows, which would have marked the end of the bull cycle. We remain cautious, yet hopeful, moving into 2019; however, one thing could change our tune. We had a washout on the breadth of the market in December, and if those lows get taken out this quarter, the bull market is likely over.

The Dow reached an intra-day low of 21,713 the day after Christmas. We are currently a 7.4% drop from touching that level again. That December indicator signals a possible market downturn, if the late-year low on the Dow is followed by a "lower low" in the first quarter – that will end this bull cycle.



If we do NOT see further lows this quarter, the markets could move higher as we believe that earnings should come in better than expected in 2019. If the S&P attains its' operating earnings estimate for 2019, depending on what multiple you consign, we see the S&P at 3000. That implies a 21% upside return from current levels – which would be a new record.

Having said that, the political and headline risk in the market needs to improve. We need both sides of the aisle in Washington to focus on statesmanship and what is best for the country - not partisanship. The Dems need to stay away from impeachment talk and focus on working cooperatively with the President, and the President needs to follow suit as well. Trump and Congress need to get the government re-opened soon. Finally, the China-US trade negotiations need to see a compromise both parties can live with. Pragmatism and statesmanship would go a long way toward fixing this market. Time will tell. Please call us at any time and we will be in touch soon to review this letter, your questions and to set your next appointment. Happy New Year to you and Your Family!