Stegent Equity Advisors Investment Letter

Market Review

January 2019

The fourth quarter of 2018 did not usher in the typical year-end rally that investors have come to expect in recent years. Global equity markets got off to a weak start, failed to recover and ultimately plummeted, as weak business indicators collided with perceived governmental policy risks with respect to the Federal Reserve. Commodity markets also felt the pain of lower oil prices, and fears that a global economic slowdown was beginning to spread to the United States from abroad. By the end of the quarter, equity markets were caught in the grips of a cyclical bear market and the only asset classes that yielded positive results were the traditional safe havens of bonds, cash and gold. The quarter was brutal in the short-term due to volatility, and the full-year result was extremely unusual in that very few, if any, major asset classes offered any gains. But in the final days of the year, the market reversed course and began rallying. As investors look forward to a new year, they're faced with deciding whether it is wise to keep playing defense, or if it's time to position for a new cyclical bull market that may have already begun.

Navigating A Cyclical Bear Market

We believe that stocks are currently caught in a shallow cyclical bear market, which will ultimately run its course early this year, and setup investors for a great chance to purchase new investments at better values than have been afforded in quite some time. There's no way to pinpoint exactly what tips the scales and ignites a sell-off, but the following are a few of the factors that contributed to markets reacting so violently during the recent fourth quarter.

Global Slowdown & Earnings Deceleration

Emotions can drive markets in the short-term, but major turns in the market often indicate the approach of a deterioration in the fundamental economic outlook. During the fourth quarter, evidence of a slowdown in the U.S. economy emerged as a wide swath of economic data began to reduce expectations. Earlier signs of slowing in housing and automobile sales finally leaked into manufacturing data, as well as other leading indicators of growth. To compound the weaker data, a sudden negative shift in bond valuation, higher volatility and general weakness in business growth all contributed to a tightening in financial conditions. It is very likely that some of the market's recent volatility was due to the global slowdown that appears to be spreading from the rest of the world to the U.S., along with evidence that corporate growth-rates had peaked. As companies reported their third quarter results, many of them had strong top line revenue and earnings growth, but were still punished in their stock price due to cautious growth forecasts. Corporations are citing global growth weakness, higher interest rates and trade imbalances that continue to put negative pressure on growth, materials costs and worldwide supply chains.

Federal Reserve Hiking into the Slowdown?

The Federal Reserve has now raised interest rates nine times in the latest market cycle (since 2008), and even though rates are still historically low, in the fourth quarter markets appeared to view continuing those rate hikes as a drag on growth. While the Fed has used a more gradual approach in raising rates this time, the fact that they have been tightening policy going into a global slowdown, and an ongoing trade war, appeared to tip the balance and turn a methodical tightening cycle into a choke point for markets. It's also important to note that the central bank has also been reducing its balance sheet, and some analysts believe that this tightening effect was also a big factor in driving volatility during the fourth quarter. Lastly, due to rising short-term interest rates, the yield on short-term bonds had finally begun to beat some long-term stock returns, which may have encouraged some investors to start shifting out of stocks and into bonds during the quarter. The only question now is how much longer will the Fed maintain its tightening policy? Early indications are that they will now take a wait-and-see attitude.

Trade War Biting

We wrote about the escalating trade war several quarters ago, and highlighted that the risk to growth might have more impact than most estimates suggested. The benign view is that the growth will only slow by an insignificant amount, given the current amount of goods involved, and the current tariff rates on those goods. We argued that the effect on world growth may be worse than expected, because of the importance of supply chains in a globalized world. During the fourth quarter there was a noticeable increase in the number of companies citing the trade war as a drag on earnings, and the market finally recognized that the trade dispute does matter for corporate America. Trade negotiations with China are ongoing, and it remains to be seen if a deal can be reached, or if tariffs will increase again following the temporary truce.

Complacent Sentiment & Narrowing U.S. Market

The markets trade in cycles of fear and greed, and there were some signs last year that U.S. markets were getting a little greedy. Big name companies in the Technology and Consumer Discretionary sectors had enjoyed a very profitable run since 2016, and by last year a very large portion of U.S. market returns were being driven by just a handful of these stocks, the so-called FAANG equities. This subset of the market got over-invested, overvalued, and over-represented in many of the U.S. stock indices. This set the market up for a problem when they finally turned negative in late 2018.

Positives Building

Wall Street endured the worst December since the 1930s, and the low point of the current market slide brought most U.S. markets into bear territory on Christmas Eve. Ever since hitting a low point that day, stocks have enjoyed a robust rally, which has some analysts believing that the cyclical bear market has already run its course, and a new bull market has arrived. On the plus side, the price damage done in late 2018 was substantial and has already cleared much of the price optimism that had built for several years late in the bull run. There have also been some positive developments occurring during the latest rally. The Federal Reserve has changed its tone and eased the rate hike schedule in response to the recent volatility. The U.S. and China have made some progress in trade conversations, and coming out of the G-20 meeting, China conceded on some level by agreeing to buy more agricultural products, end retaliatory tariffs and tone down some of their "Made in China 2025" rhetoric. Additionally, a solid U.S. employment report for December has stunted some of the fears of recession that were spreading prior to its release.

Risks Still Swirling

We won't deny that the highlighted positives have been enough to ignite an impressive rally in the stock market, but it is important to realize that the primary trend is currently still down, and there are still many risks that could ignite a fresh round of selling that would drive down prices further:

- The Fed has only implied they will pause rate hikes, and their own projections still imply two more rate hikes by the end of the year.
- Globally, the Brexit situation in the EU is very uncertain and will soon come to a head.

- China is still broadcasting worrisome economic signals, along with a variety of Asian economies that recently reported very weak manufacturing data.
- On the trade front, the market seems hopeful that the president may soon relent on trade policy, given his nervousness about market volatility. But while the trade rhetoric has eased, there is still risk that the U.S. imposes a higher rate on tariffs that have been deferred until March.
- Earnings season is about to heat up and recently several retail companies have lowered their forecasts, which may imply that the mighty consumer is starting to falter. Given that the consumer sector has been one of the healthier parts of the economy, this could be a warning that the U.S. economy is deteriorating more than is widely believed.
- Lastly, there is growing risk that the contentious political backdrop in Washington, along with the ongoing government shutdown, is just creating more uncertainty at an already fragile time.

Hunting for A Bottoming Process

There is a chance that the December market lows may represent the bottom for this cycle, but we don't think it's safe to put all of our cash to work just yet. After markets experience sharp selloffs, they normally go through a bottoming process before turning the corner and starting a new bull market. The process usually entails some time and some price choppiness, and typically culminates with the markets revisiting the most recent price bottom. Therefore, there is a decent probability the market will return to the December low and setup for a critical reset. If that does happen, it will be critical to evaluate the internal health of the market and confirm that the worst is over.

Budding Opportunities

The best thing that can be said about bear markets is that they create great longer-term buying opportunities. From that perspective, investors should be embracing occasional cyclical corrections. The current episode should be no different when a solid price bottom eventually forms. Since March 2009, U.S. stocks have been the place to be, and the S&P 500 Index has returned approximately 360% versus the MSCI All Country World Index ex-U.S. that has returned roughly 150%. This differential in performance has left U.S. stocks looking overvalued, or in the reverse, international markets now appear to be cheap.

But good value alone often isn't enough, and markets usually need a catalyst to help turn the tide and unlock an asset's potential. In this case, one of those catalysts could very well be an easier Federal Reserve policy and an eventual lift to global growth. If the Fed is forced to reverse policy due to decelerating growth rates and risks to future earnings growth, then it is plausible that the dollar will begin to fall. The dollar could also fall if global growth begins to pick back up. China has been enacting a slew of stimulus measures to combat weaker growth, and it's conceivable that if this continues, China could lift global growth out of its slump. No matter how it happens, should a weaker dollar materialize, it would help the total return of undervalued foreign stocks for U.S. investors. As markets search for a sustainable bottom, our hunch is that it will soon be time to boost our international stock inventory, as a new cycle may favor cheaper global stocks. For now, it still seems to be premature to be buying in front of a possible revisit of the recent lows, but it is not too early to begin thinking about what to buy when the turn does come.

Conclusion

The fourth quarter of 2018 was a rough one for markets, as a combination of weaker business fundamentals and policy missteps contributed to an unusual price drop in what is usually a great time of year for global bourses. The speed and depth of the recent drop was reflective of the convergence of many different factors, but ultimately highly-valued markets clashed with weakening data, and a new primary downtrend was born. We still believe the trend is down, and can't be sure at this point if markets have hit the low point for the cycle, or if fresh new lows are on the horizon. Our convictions lie with the idea that the markets will likely soon revisit the lows and give us valuable clues as to whether a solid bottom is being formed. We'll continue to monitor the evidence closely in coming months, as we hunt for a bottom. Should the U.S. business cycle take a turn for the worse, we may have to increase our defensive posture given that equity downturns during recessions take time to run their course and produce the most damage. But if our current non-recessionary view holds, and market data solidifies as the market drops, then it will likely be time to start taking advantage of some of the budding bargains that have developed during the cyclical bear market.

A Note about Billing

As you may recall, in 2018 we changed our billing account for fee deduction to be an IRA where possible because investment advisory fees are no longer deductible, unless they qualify as a business expense associated with employer sponsored retirement plans. In 2019 we need to change the billing account again because the IRS has issued guidance on fees charged to IRAs. In short, only fees applicable to the IRA may be deducted from the IRA. Accordingly, we will use the following rules when selecting the account to bill from:

1. Each IRA account will have the applicable fee deducted from the account.
2. Each Education IRA account will have the applicable fee deducted from the account.
3. Taxable accounts will have the applicable fee AND the fee for all other accounts under management deducted from the account.
4. If no taxable account exists at TD Ameritrade, then:
    a. Each Roth IRA will have the applicable fee deducted from the account.
    b. Each variable annuity will have the applicable fee deducted from the account, if SEA has been given POA for fee deduction.
    c. All remaining accounts held outside TD Ameritrade (529 plans, HSA plans, employer sponsored plans, restricted stock, alternative asset custodians, etc.) will be invoiced to you for payment from alternative resources.

Please ignore the above if you are mailing a check for your fee. This procedure will not be applicable to you. If you would like to change your billing procedure to the above, please let me know.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.