INVESTMENT STRATEGY UPDATE

ASCENTIAL
WEALTH ADVISORS
AN INDEPENDENT PRACTICE

MARKET REPORT

QUARTER 1 • 2019

MARKETS FRAGMENTED

After an abnormally calm year in 2017, equity markets felt like a roller coaster in 2018. Multiple factors overshadowed a strong economy and drove markets into correction territory (a drop of 10% or more) more than once during the year. Tariff wars, rising interest rates, and political instability in Washington all worked against the positive stimulus created by tax reform, leaving equity markets in the red for the year.

Foreign equity markets underperformed the US for the year, weighed heavily by tariff concerns, but fared better during the 4th quarter correction. The S&P 500 was down -9.03% in December and -13.52% for the fourth quarter, while the tech heavy NASDAQ was hit even harder, dropping -9.48% in December and -17.54% for the quarter. However, the MSCI Emerging Markets Index lost only -2.66% in December and -7.47% for the quarter, but closed the year with a loss of -14.58%.

Contrary to market behavior, the US economy appears to be on relatively strong footing, with unemployment at its lowest level since 1969, wages growing, low inflation and annual GDP growth around 3%. With the help of tax reform, corporate earnings were also very positive, up 32% year over year. Although GDP growth and corporate earnings growth are expected to slow slightly in 2019 they are not signaling recession is near, yet fear gripped equity markets particularly hard in December.

Despite market volatility, the Federal Reserve focused on the good economic data and raised interest rates again in December. Though the Fed increased its benchmark rate 4 times in 2018 (full 1.0% in total), in the end bond yields were pushed down by fearful investors. The yield on the 10-year US Treasury only moved from 2.46% at the beginning of 2018 to 2.69% at year-end, after touching a high of 3.24%. In fact, the aggregate bond index was negative until the very last trading day of the year. The year was also unusual in that cash posted the highest returns of any asset class.

Index	*2018 (through 12/31)*
S&P 500	-4.38
DJIA	-3.48
EAFE (Int'l)	-13.79
BC Ttl Bond	+0.01

Dow Jones Relative Risk Benchmarks

Conservative	-0.62
Moderate	-5.21
Aggressive	-9.45

BEING A LONG-TERM INVESTOR

The world today, especially the news media, tends to have a very short-term focus. It can be hard to be a long-term investor in such a world where you are bombarded with the headline of the day. No one can predict with certainty what will happen in the future - whether that is tomorrow or a decade from now. So what do we know?

We know that economies and markets have ups and downs, good and bad periods, but that they tend to bounce back.

We know that risk and return and are correlated, and that investors with diversified portfolios are generally rewarded for taking risk with higher long-term returns.

We know that taking more risk exposes investors to more volatility. It is this volatility combined with the short-term, fear-producing media messages, that can cause investors to lose their long-term focus and create a lot of anxiety.

What is a long-term investor to do? If you are experiencing anxiety due to market volatility, the first thing we suggest is turning off the television. That is not to say you should stick your head in the sand, rather that immersing yourself in the constant negative messaging is not helpful. We also welcome your phone calls, emails, or in person meetings to discuss these issues. Often it is extremely helpful for us to revisit your financial plan, and remind ourselves that we have stress tested for bad periods. In addition, we can offer some perspective beyond what is being touted in the daily headlines, and many times that is comforting. We are always watching what is going on in markets and trying to assess what we should do about it, if anything. Sometimes, the best course of action is to do nothing and wait for the storm to pass. We certainly do not enjoy market volatility any more than you, but it is the willingness to put up with volatility that defines our outcomes and makes good long-term investors.

"The investor's chief problem – and even his worst enemy – is likely to be himself."
– Benjamin Graham

2019 OUTLOOK

FIXED INCOME — With rates rising, prices for bonds fell for most of the year, with longer duration bonds hit hardest. The Fed has indicated that they will slow their pace for rate hikes, but a couple more rate increases are still expected in 2019. Based on this and the fact that yields remain well below historical averages, we feel that there remains room for rates to move higher, and continue to favor staying positioned with shorter maturities and alternatives as a risk-managed bond substitute. We are removing floating rate bonds from our recommendation, due to a general decline in quality and lower yields. Rising rates created enormous demand for floating rate, resulting in a potential mini-bubble in that market. We recommend adding convertible bonds - part of which will come from floating rate bonds and part from US equities. While the initial coupon rate may be lower due to the conversion feature, convertible bonds can offer income in addition to the possibility of higher upside potential if equity markets do well.

Our View — Reduce floating rate, add convertible bonds

US EQUITIES — The disconnect between US equity market weakness and the strong economy has left stocks much cheaper based on both current earnings and forward estimates. Typically, when markets divert from fundamentals, the impact is not lasting, and in this case the fundamentals remain encouraging. While we see opportunity, we are also cautious of an aging economic cycle and the potential impacts of tariffs that could change fundamentals. As a result, we recommend reducing US equities slightly and adding convertible bonds. Convertible bonds can offer some of the upside of equities but less downside due to the underlying bond. In addition, we favor balancing growth and value, partially as a defensive positioning and also because they now appear equally attractive from a valuation standpoint.

Our View — Balance growth and value, reduce exposure slightly for convertible bonds

INTERNATIONAL EQUITIES — Trade negotiations remain of high concern for foreign stocks. While a new agreement was reached in North America, a deal has yet to be reached between the US and China. Additional tariffs set to take effect in January 2019 have been put on hold pending further talks, but the Chinese economy is already feeling the impacts of tariffs with growth slowing. The Eurozone economy is experiencing its own struggles with Brexit and other issues related to its economic union. However, equity valuations are very attractive at current prices. We feel that there is value to be unlocked in foreign stocks, and that once a compromise is reached on trade, there is potential for a significant rebound.

Our View — Maintain current position, monitor trade negotiations

"The four most dangerous words in investing are: 'this time it's different.'"

– Sir John Templeton

"Be fearful when others are greedy. Be greedy when others are fearful."

– Warren Buffett

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