JJ BURNS

"What are the drums saying, Eli? Good news or bad?" ***Opening lines of "Bomba, the Jungle Boy" (1949)***

Our 2017 review began, "What a great year for investors." This year, we would have to note that 2018 was a disappointing year for investors. Pretty much everything that went right in 2017 reversed in 2018, and only bonds provided any solace as a punishing final quarter pushed equity markets well into negative territory. In fact, the S&P posted its worst December return in over 50 years, and December has historically been one of the index's best months. Investors were harmed by tax-loss selling, thin trading volume – which left extreme moves to the so-called 'algorithmic [program] traders' – and a recognition of discomfort with the policy and political issues that markets had long ignored. All U.S. stocks endured a 'bear' market during the correction that ended Christmas Eve; international stocks also declined, but by lesser amounts. High-yield and some investment-grade bonds also declined, but high-quality government and municipal bonds provided a correlating safe haven. Here are the results:

Index Returns

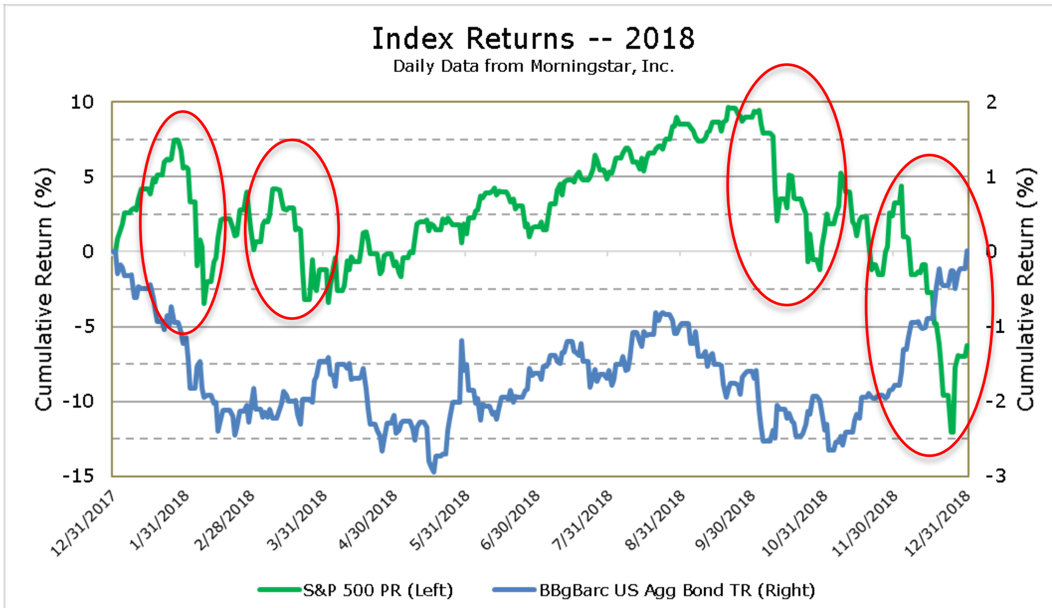
as of 12/31/2018

Index	Q4 2018	YEAR 2018	YEAR 2017	Two Years 2018 - 19
FIXED INCOME				
BbgBarclays US HY 2% Issuer Cap	<4.54%>	<2.08%>	7.50%	2.60%
BbgBarclays Municipal	1.69%	1.28%	5.45%	3.34%
BbgBarclays Global Aggregate	1.74%	1.76%	3.04%	2.40%
BbgBarclays US Agg Bond	1.64%	0.01%	3.54%	1.76%
U.S. STOCKS				
Russell 1000 [Large-cap Stocks]	<13.82%>	<4.78%>	21.69%	7.64%
Russell 2000 [Small-cap Stocks]	<20.20%>	<11.01%>	14.65%	1.00%
S&P 500	<13.52%>	<4.38%>	21.83%	7.93%
INTERNATIONAL STOCKS				
MSCI ACWI Ex USA NR [All Stocks]	<11.46%>	<14.20%>	27.19%	4.47%
MSCI EAFE NR [Developed Markets]	<12.54%>	<13.79%>	25.03%	3.82%
MSCI EM NR [Emerging Markets]	<7.47%>	<14.58%>	37.28%	8.29%
REAL ASSETS				
U.S. Dollar	1.09%	4.40%	<9.87%>	<3.00%>
Morningstar US Real Asset Index	<6.94%>	<3.33%>	3.41%	<0.02%>
Bloomberg Commodity	<9.41%>	<11.25%>	1.70%	<4.99%>
S&P GSCI Crude Oil Spot	<38.01%>	<24.84%>	12.47%	<8.06%>
S&P United States REIT	<6.09%>	<3.79%>	4.33%	0.19%
S&P Global Ex US REIT	<4.46%>	<6.52%>	16.72%	4.46%

Source: Morningstar, Inc. USD data with dividends and interest
Two Years 2018 - 19' data are ANNUALIZED returns.

“We'll have all sorts of crazy signals. And you'd be a damned fool if you didn't look for things you weren't expecting, because that's probably what you're going to see first.”
Rainer Weiss, *physicist*

Investors’ expectations for 2018 were for continued synchronous global growth, continuing positive equity-market returns, some gradual losses in bonds as rates rose, and a relatively stable political environment. That was how the year started; however, rate-hike concerns set in almost immediately. Bonds fell, stocks began to sell off, and the rest of the year compounded on those fears. The S&P 500, which peaked near 10% on a price-return basis, posted four (4) sharp drawdowns; bonds, which were down about 2.5% at one point in the year, began to rebound and provided a haven from the equity sell-offs.



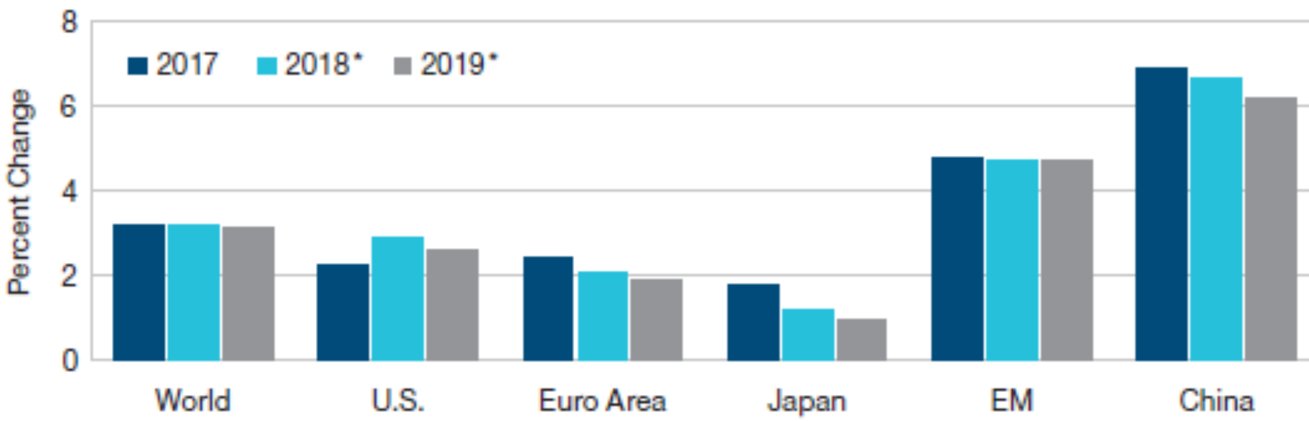
Clearly, the 4th quarter gyrations were unsettling, and brought forward many of the economic and interest-rate concerns that were in the back of investors’ minds. We think that some of these concerns warrant attention but aren’t supported by data and are still too early to spook the markets. Here’s a summary of our thinking:

First, we think that global growth will be positive, but at a lower level than in 2018. It’s difficult to accept that just one year ago, consensus estimates were for a strong year for many economies. Policy concerns, political flareups and elections have dampened expectations, but not to the point of recession. Here’s a look at economic cycle updates and a regional forecast:

Source: T. Rowe Price.

Note that key economies are 'plateauing' (the U.S., Japan, India), China is restructuring, and the U.K. and Australia are dealing with Brexit issues and the China slowdown, respectively. These issues aside, projections for growth are still positive for the year:

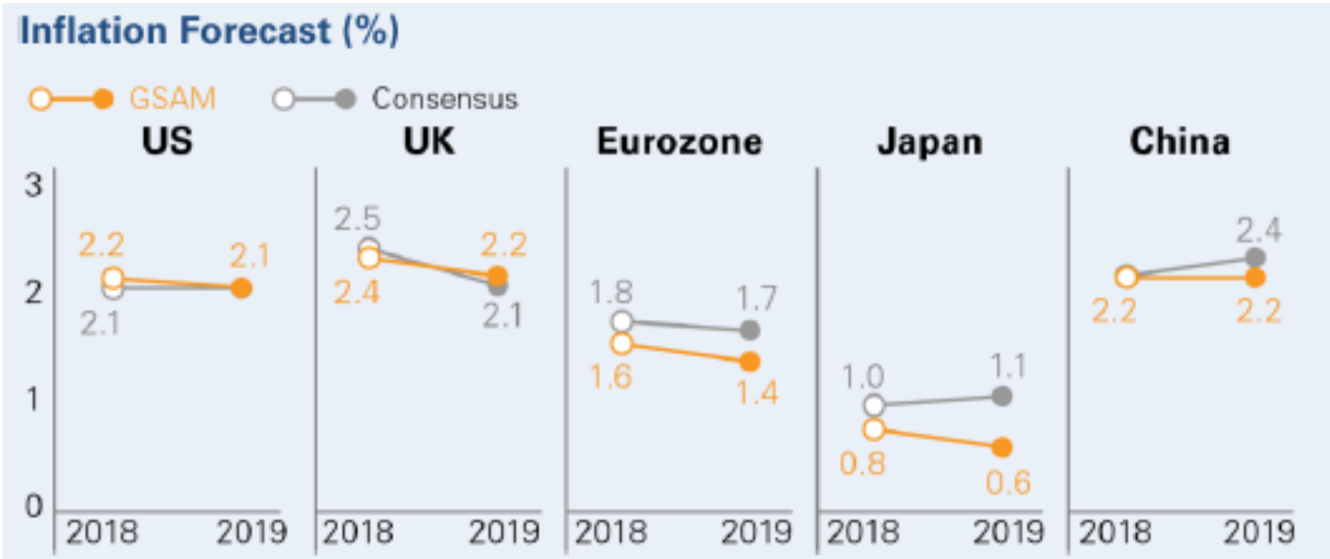
Actual and projected real GDP growth
As of October 2018



Source: IMF/Haver Analytics.
*IMF projection.

SOURCE: T. Rowe

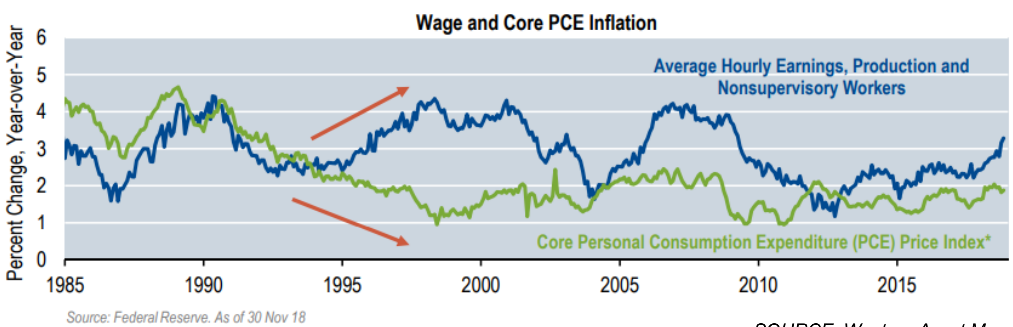
One issue that we think is sometimes overlooked when thinking about growth is the low level of global inflation. Central banks focus on inflation and unemployment as their two key targets; as this graph shows, inflation in key regions is benign for the moment. Oil's drop last year has left prices well below its pre-2014 peak north of $100 per barrel. Supply imbalances are contributing to a surfeit, and this key economic input is helping tame inflationary pressures.



Source: GSAM, Bloomberg. As of December 4, 2018. US is personal consumption expenditures (PCE) index. All others are consumer price index (CPI).

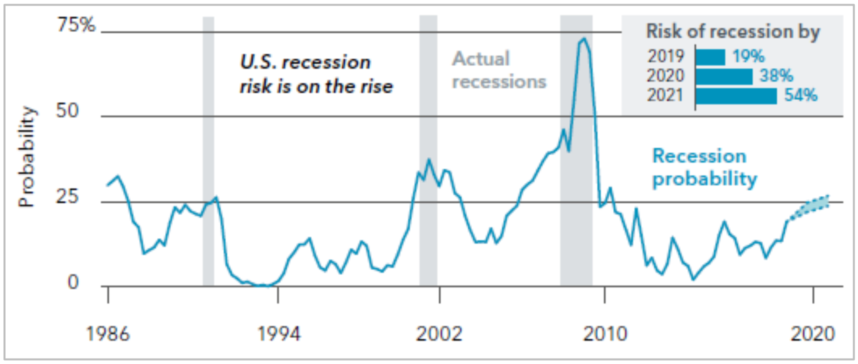
SOURCE: Goldman Sachs

One inflationary concern that is closely watched by the U.S. Fed is wage growth. Perceived overheating in this area may cause margins to suffer and the Fed to raise rates faster than expected, a clear economic risk. U.S. wages appear to be growing, but not at an excessive rate, and, given the years of low real-wage growth, the Fed may let the number 'run hot' (i.e. above a target level). One additional consideration is that above-trend wage growth is good for consumer sentiment and spending, which are key growth underpinnings.



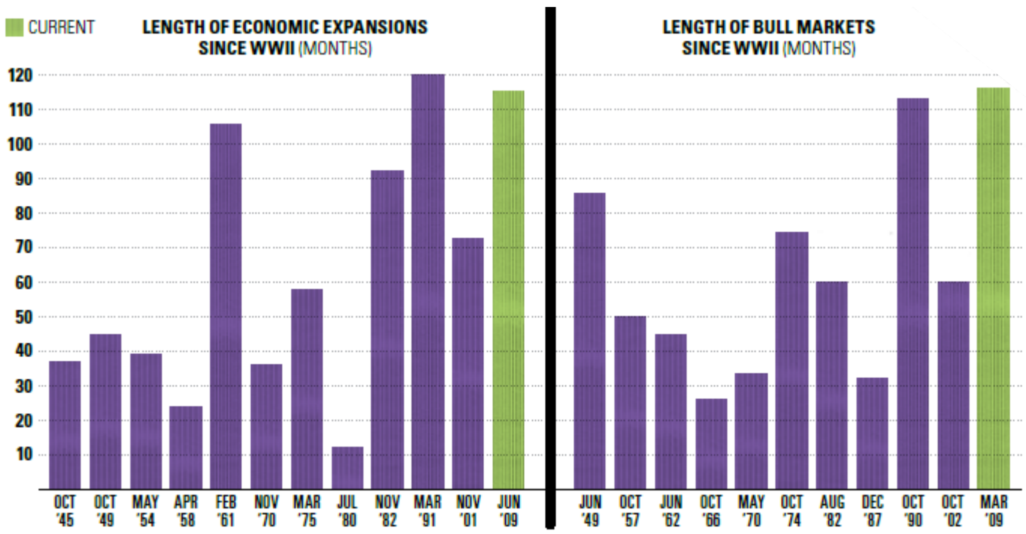
SOURCE: Western Asset Management

Recent Fed actions and public comments, as well as a sudden fascination with the concept of an inverted yield curve in the financial media, have sparked fears of a recession. It is common knowledge that recessions are impossible to predict, but that doesn't prevent pundits from trying. We don't see a recession on the near horizon, and other data offer some support on this view:



SOURCE: BlackRock

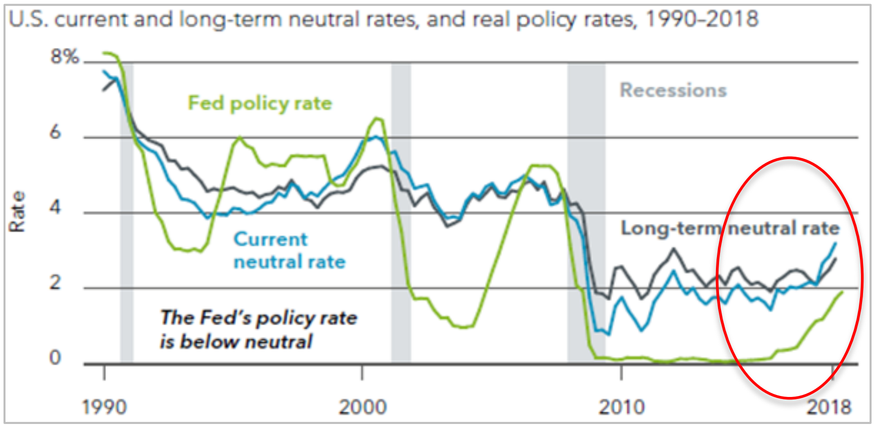
A final comment on the U.S. economy and stocks: we are still in one of the longest post-war expansions and bull markets. Signals may indicate moderation or contraction, but these are *not* givens.



Source: LPL Research, NBER, FactSet 11/30/18; economic expansions are based on GDP growth, bull markets on S&P 500 returns.

"Sometimes we wait for thunderclaps, drumrolls, and clarion calls to alert us to what's important when, actually, it's most often the subtle and persistent signals around us that make the most difference." Gen. Martin Dempsey, *former Chairman of the Joint Chiefs of Staff*

Since their zero-rate response to the Global Financial Crisis, it has been expected that the Fed would raise short-term rates at some point due to economic strength. That has been the policy for two years, and the cost of capital has been affected by rate hikes and balance-sheet reduction. A yield-curve inversion (where short-term yields are higher than long-term yields) has not occurred and may not for some time. Further, inversion does *not* indicate an imminent recession. What it usually signals is a still-growing, though late-stage, economic expansion. The Fed has indicated that they will pause to re-evaluate their regime when the 'neutral' Fed Funds rate is achieved (~3.00 – 3.50%), which we think is a prudent stance.



SOURCE: BlackRock

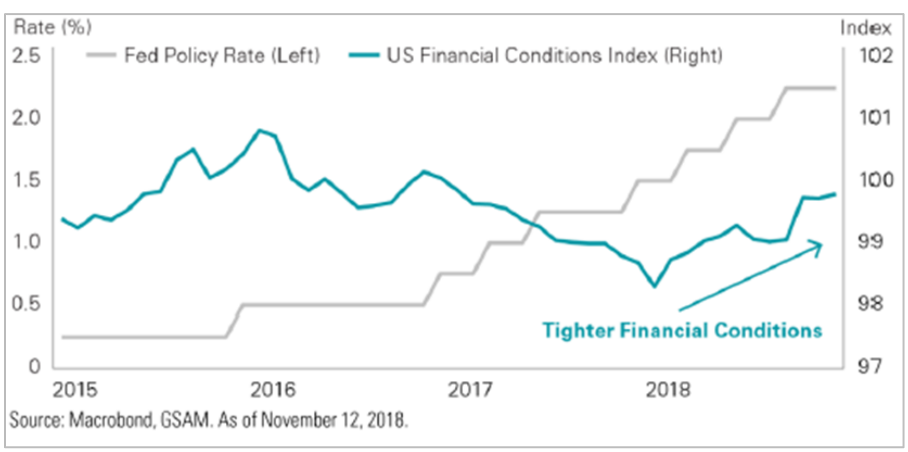
We also think context is extremely important with respect to central bank activity and suggest that the proper framing for current rate increases is future rate *decreases*. Here's how the Fed has managed Fed-Funds rate reductions in the recent past:

Begin Date	Rate	End Date	Rate	Change
Jan. 1990	8.25%	Sep. 1992	3.00%	↓5.25%
May 2000	6.50%	Jun. 2003	1.00%	↓5.50%
Jun. 2006	5.25%	Dec. 2008	~0.00%	↓5.25%

Important takeaways from this data are:

- The Fed Funds rate at the start of each reduction cycle was greater than 5.00%,
- Each rate-decrease cycle saw rates lowered by at least 5.25 percentage points, and
- The Fed lowered rates by an amount significantly greater than the actual *current* level of the Fed Funds rate.

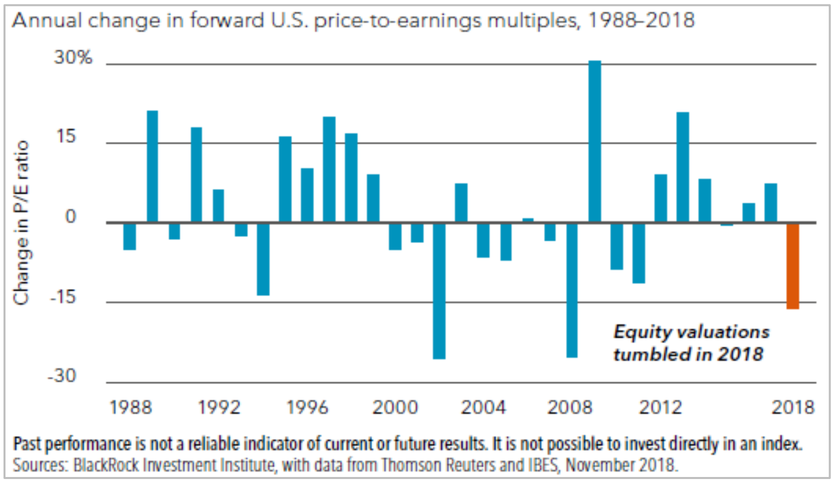
While recognizing that it's difficult to do, we think the Fed may be able to engineer a 'soft landing' at the end of this growth cycle. This would lead to a re-pricing of risk assets but may lead to a longer expansion at lower growth rates than are currently projected by the Trump administration. Investors will have to determine which outcome is preferable: lower growth for longer, or higher short-term growth that leads to a 'hard landing' recovery. We can see that the Fed is currently engineering a gradual tightening of financial conditions at this point in the growth cycle:



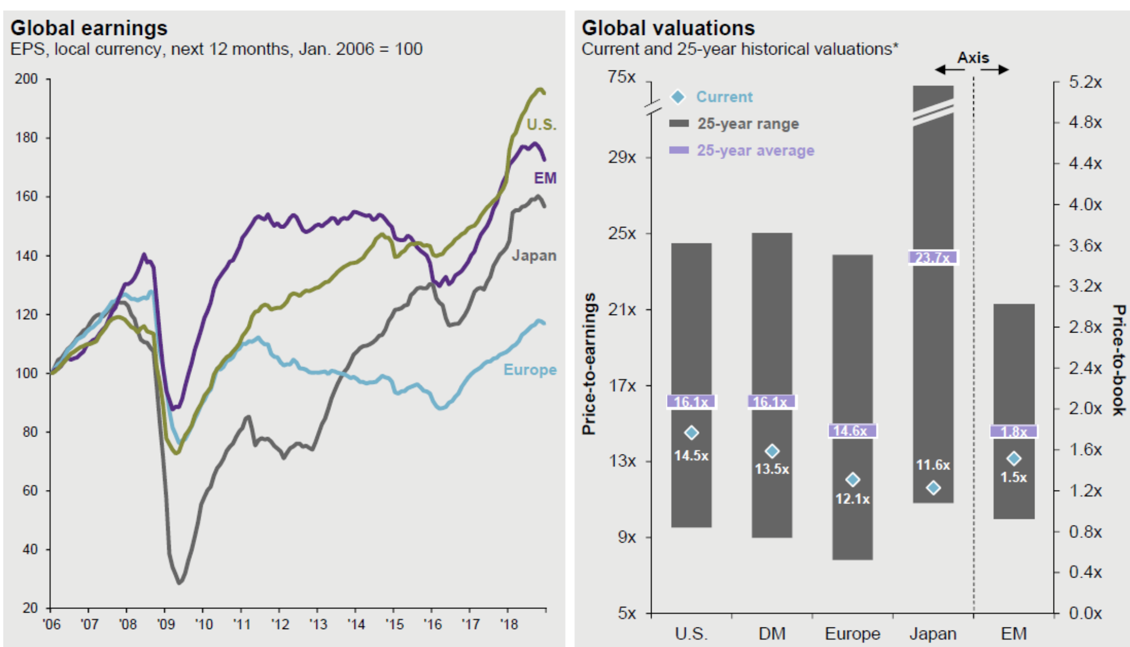
SOURCE: Goldman Sachs

“I know the signs of scaredness.” **Michael Jordan**, ***former NBA player***

The stock market embodies all investors’ hopes and fears. As famed value investor Benjamin Graham said, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” The December sell-off was an unexpected and unwanted gift during the holiday season, but it may have proven more valuable than investors realize. A much-needed dose of reality was injected into all forward discussions of markets and growth, as well as a recognition of the headwinds that geopolitics are whipping up. The sell-off also adjusted valuations and expectations, and this has provided global stock and fixed-income opportunities for the new year.



As we see below, earnings estimates and valuations have come in over the quarter and the year:



Source: FactSet, MSCI, Standard & Poor’s, Thomson Reuters, J.P. Morgan Asset Management.

As Ben Graham noted above, stocks are *long-term* assets, and short-term fluctuations reveal nothing except heightened emotions. Value is created over time, not in a single day or by a single trade. This does not mean that every stock is a buy today, of course, but it does indicate that re-evaluation of economic conditions and company dynamics may lead to more global opportunities.

“Distinguishing the signal from the noise requires both scientific knowledge and self-knowledge.” **Nate Silver,** ***founder and editor-in-chief of FiveThirtyEight***

Some of our expectations for 2018 failed to materialize. Our analysis indicated that there are several key reasons for this, notably that investors re-priced a bit more policy risk into their longer-term assumptions. Based on our review of relevant data, we (again) expect the global recovery to continue, albeit at a slower pace than previously expected. We (again) expect a continuing expansion in the U.S. and abroad, and think that:

- The U.S. economy will grow at a slower pace due to a lessening of the Trump tax-cut effects and rising deficits, trade issues and slightly higher interest rates;

- The Fed will likely raise rates one to two times in 2019, as they see tamer inflation and become more concerned with upsetting markets as opposed to rapidly hiking rates; the U.S. 10-year Treasury will rise (absent a crisis) and trade in a range of 3.00 – 3.50%;

- Growth in other regions will be modest in developed markets, especially Europe. Emerging markets will likely be higher; valuations are becoming compelling values. Interest rates will begin to trend higher in other regions due to central-bank activity.

- China, the world’s second-most influential economy, will make a strong move to settle trade disputes with the U.S., but the effects will be reflected in market sentiment well before the respective economies.

Our major concerns for 2019 are focused on two things: policy and politics, and behavior. The recent elections have brought U.S. government partisanship to new heights, with the promise of more conflict and acrimony to come. Populism and ‘strong-man’ governments are cropping up in every region, prompting fractious relations around the globe. We see simplistic economic solutions and nationalism dictating policy rather than rational planning and acknowledgment of shared interests. It’s sometimes difficult to see how strong forward-looking decisions will be made in this environment, but markets are resilient, and we think cooler heads will prevail.

We think a more important focus than any data analysis in the coming year is behavior. The recent sell-off has provoked confusion and fear in investors. We often refer to the Four Horsemen of the Investing Apocalypse – Fear, Greed, Hope and Ignorance – and see them stampeding toward us now. Investors *fear* that the market will crash or their wealth will disappear, *hope* that their portfolios are relatively unscathed, and *ignore* their financial plans and the reason(s) for their asset allocation. As always, we remind our clients to review their circumstances and any changes in their lives to sharpen focus on the things they can control. It’s important that we reallocate the portfolio based on changing life event not market emotions. Understanding what might be ahead and how to prepare for it will help manage the distress market fluctuations may cause and prevent ill-timed decisions. If changes are warranted to a plan or portfolio, we can help make those adjustments and ideally steer the Four Horsemen away.

As always, we welcome your comments, questions and feedback. We wish you and your families a healthy, happy and prosperous new year.

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Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. The Barclays U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Citi World Government Bond Index (WGBI) provides a broad benchmark for the global sovereign fixed income market. It measures the performance of fixed-rate, local currency, investment grade sovereign bonds, currently includes sovereign debt from over 20 countries denominated in a variety of currencies.

The Morningstar® US Real Asset Index is a diversified portfolio of four different asset classes that have historically displayed high sensitivity to inflation. Real assets are defined as TIPS, commodity futures-based strategies, real estate investment trusts, and inflation-sensitive equities such as upstream commodity stocks and master limited partnerships

The S&P U.S. REIT Index defines and measures the investable universe of publicly traded real estate investment trusts domiciled in the United States. The S&P Global REITis a comprehensive benchmark of publicly traded equity REITs listed in both developed and emerging markets. The S&P 500® index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The MSCI ACWI index captures large and mid-cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries.

The Bloomberg Commodity Total Return index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. The index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity.