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ECONOMIC & MARKET UPDATE

For most of the year it looked as though 2018 would provide investors with a positive experience. Then, much to our disappointment, sometime within the last couple of months something happened. It was as if a switch was flipped, leading to a December that was the worst for stock investors in decades, resulting in negative returns for the full year. Bond investors who limited themselves to high-quality bonds fared better, earning slightly positive returns from municipal and corporate bonds.

> "The stock market has forecast nine of the last five recessions."
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> Paul Samuelson, Economist

Paul Samuelson, the first American economist to win the Nobel Prize in economics, usually dealt in serious matters with serious words. However, he also possessed a sharp wit, as evidenced by the above quip in which he mocks the stock market and its inability to consistently predict recessions. The quote was made in a 1966 article in Newsweek, and subsequent history has proven him to be even more prescient: 13 bear markets have "predicted" the last seven recessions.

We open with this quote because of recent events. As the stock market turned down sharply late in the year and approached a bear market, many investors and commentators began to assume that the market action was predicting a recession. Perhaps, perhaps not, but it should be remembered that the stock market is not the economy, and while the two tend to move in concert over longer periods of time, over shorter periods they do not correlate well. Let's take a look at the economy and markets with an eye to whether the recent downturn in stocks is ominous.

THE ECONOMY An assessment of current domestic economic fundamentals reveals quite a few positives. In 2018 the economy produced at least 3% growth in real Gross Domestic Product (GDP) due to steady consumer demand and fiscal stimulus. Unemployment at 3.7% is at a five-decade low, there have been 98 consecutive quarters of job growth, inflation is well contained at around 2%, and interest rates remain low in historical context. It was a very successful year for the domestic economy, ending the year with each of its four structural elements in good condition.

The positive glow of the domestic economy is dimmed somewhat by what is happening in the global economy. Activity is less robust in Germany and Japan, as both experienced negative GDP growth for a quarter, Chinese growth is slowing, Brexit is a challenge for Great Britain, and France is in the midst of economic protest. There is concern that these negative developments in the rest of the world will infect our economy. To date, the evidence to support such fears is mixed, but the trend certainly bears watching.

A successful 2018, yes, but where does the economy go from here? The most significant issue with the economy, in our opinion, is a slowing trend that over the next couple of years is expected to take us back to 2% real GDP growth, a rate of growth that persisted for the first eight years of the current economic recovery/expansion. From the peak of 4.2% GDP growth in the second quarter of 2018, to the 3.5% GDP growth of the third quarter, to 2.5% estimated growth in the fourth quarter, there is a perceptible trend of slowing growth. Looking out further, both the Federal Reserve (Fed) and International Monetary Fund (IMF) are forecasting a longer term, sustainable growth rate of 1.8% for the U.S. economy. These longer-term projections seem reasonable based on what we know about labor force growth and productivity, the two engines of economic growth. Such a forecast does not disturb us, for roughly 2% GDP growth can provide a constructive environment for companies to conduct their businesses, as long as the lower rate of growth is accompanied by low inflation and interest rates. Even though we find this scenario acceptable, many investors are having trouble adjusting to this change in the outlook

THE STOCK MARKET The implication of the previous paragraph is that we do not believe a recession is on the immediate horizon. Based on economic fundamentals, the economy looks fine right now. However, even though we earlier poked fun at the stock market's forecasting record, it is worth keeping in mind that stocks are forward looking, and when they turn down on more than a casual basis, one is well advised to consider the message.

From its peak on September 20, the stock market as measured by the S&P 500 declined just under 20% to its lowest level on December 24. It has become common to label declines of greater than 10% as "corrections" and declines of greater than 20% as "bear markets." These are arbitrary descriptors, and in the end it really does not matter what they are called. The real difference between them is the amount of time they last. Bear markets are assumed to last a lot longer and, as noted above, are normally associated with recessions, though not necessarily. Whatever they are called, these declines indicate a shift in thinking by investors as economic and financial developments occur. But all investors do not shift their thinking at the same time or at the same speed. It takes time for a consensus of opinion to form, and while it is in the process of forming, volatility can occur. At some point, investors get adjusted to a changed view of the future, and consensus does form. When it does, markets generally stabilize.

In our view, the stock market is currently in such an adjustment phase. To put it another way, the market is being recalibrated to reflect a different view of the future, namely, one of slower rather than faster growth. However, the process of recalibration may be such that it overestimates the degree of change that is likely, and in the process creates opportunities for the investor. We hope this is what is happening now. Assuming a recession does not develop, a lot of value has been created in the stock market. We have gone a full year when earnings of companies advanced sharply while stock prices declined, in the process reducing price-to-earnings ratios and potentially creating value. As a matter of fact, price-to-earnings ratios are now at a four-year low, residing at about 15 times expected earnings.

THE BOND MARKET Like the stock market, the bond market is also forward looking but is usually more closely tethered to movements in the economy. The yield curve, a line that depicts various yields for different maturities of similarly rated bonds, is considered one of the better recession forecasting tools. Because of a flattening trend of the yield curve, it is suggesting slower growth ahead, but not a recession. Some parts of the curve have actually inverted, where shorter-term maturities have higher yields than longer maturities. But in most of the crucial areas of the curve it is not yet suggesting that economic stress is on the way. For instance, the two-year U.S. Treasury note is currently yielding 2.52%, which is 15 basis points of yield higher than federal funds. Normally, if recession fears were high, the two-year yield would be much lower than federal funds in anticipation of Fed interest rate cuts, as was the case before the last recession.

Regarding the future course of bond yields, we expect them to be influenced primarily by Fed policy and longer-term inflation expectations. The Fed has obviously taken note of the volatile environment and is giving signs of being open to a change in policy. Mainly, this means allowing their policy to be data dependent as opposed to a fixed path. Meanwhile, inflation and inflation expectations remain well anchored at around 2% or less. Putting these two factors together, we believe it is prudent to assume some further increases in longer-term interest rates, but not too much. We continue to believe the benchmark ten-year U.S. Treasury note will have difficulty rising beyond 4% in this cycle.

OUR VIEW There is much to consider regarding the economy and markets, but at this time we believe the balance of factors suggests that we are in a stock market correction, and we are not likely to have a recession soon. The correction is occurring in the context of change that is underway in the economy, change that investors are being forced to deal with. But change is not necessarily a bad thing, particularly if the change is pointing to a more sustainable rate of economic growth. If an economy is growing at a rate beyond its capacity, unfavorable conditions can develop, such as higher interest rates and inflation, speculation, and excessive risk taking. On the other hand, an economy that grows in line with its potential has a much better chance of staying on a steady path.

This economic recovery/expansion is now in its tenth year, and we hope it can continue for a few more years, at least. We believe there is a decent chance that it can. It will depend to a large extent on the Fed and how it executes policy, as well as investor and consumer attitudes, which need to remain positive. In the end, if the economic fundamentals roll out in a favorable manner, this stock market correction will take care of itself.

While we are expressing cautious optimism in our outlook it does not mean that we are unaware of risks to the environment. Commentators with more negative views than ours could produce a long list of things to be concerned about. We are well aware of these issues, and we take them seriously, but we also recognize that the investment environment is never perfect and that risk is a part of the investment equation. It is always present in one form or another, and for investors seeking attractive returns, there are no certain outcomes. But, we also believe that the best means of mitigating risk and limiting the range of outcomes is through quality. We consider quality to be an essential element in our stock and bond selections. You should expect us to continue to undergird the portfolio with the highest quality stocks and bonds we can find.