Wealth Advisory Group, Inc.
A Registered Investment Advisory Firm

Wealth Advisory Group – 2018 Review and 2019 Outlook

Economic and Market Review

"It was the best of times, it was the worst of times" The famous opening words from the Charles Dickens' novel, A Tale of Two Cities, seems very apropos when looking at the current economic and market conditions. In 2018, the U.S. economy continued the second longest expansion ever with some of the strongest growth of the current cycle, meanwhile investors suffered through one of the more lackluster years from a return perspective.

Economy – U.S. economic growth continues into a 10th year with few noticeable signs of excess or slowing. The consumer, which drives 70% of the US economy, remains healthy with low unemployment, solid wage gains and a good balance sheet. Cyclical parts of the economy (housing, motor vehicles, business investment and inventories) are solid and not showing signs of excess. Employment continues to be a bright spot with low unemployment, plentiful job openings and moderate wage increases. Housing is showing some signs of slowing in high cost areas, likely induced by the rise in mortgage rates.

Globally there appears to be some signs of slowing growth in the developed markets and a more precipitous drop in China. Trade tensions may account for some of the uncertainty and it is important to remember that most countries have a greater reliance on trade than the U.S. and are, therefore, disproportionally impacted by the uncertainty of trade disputes.

Interest rates – Interest rates across the maturity and credit spectrum increased in 2018 as the Fed continued to raise rates seeking to normalize monetary policy. The Fed has also been reducing the bond holdings on their balance sheet putting additional upward pressure on bond yields. Fed policy was not without detractors as low inflation and potential economic slowing has brought recent and future rate increases into question.

Markets – Volatility returned to the equity markets in 2018 with two significant downturns during the year (10% in Jan/Feb & 19% late in the year). In the end, the U.S. stock market was down modestly (S&P 500 -4.3%). Growth stocks (Russell Growth -1.5%) were down less than Value (Russell Value -8.3%) and Small stocks performed even worse (Russell 2000 -11.0%). International stocks were among the worst performing asset classes with developed and emerging markets down nearly 15%.

Fixed income struggled as rising rates and increasing credit concerns weighed on bond prices. The benchmark bond measure, the Bloomberg Barclays US Aggregate Index, was in negative territory all year and just squeezed out a positive return (+0.01%) on the last day of the year.

During 2018, very few investment options delivered positive results, with both stocks and bonds suffering predominantly negative returns, so even well allocated portfolios were modestly down for the year. With the increase in interest rates, especially on the short end of the yield curve, Cash became a viable investment choice again and returned 1.8% in 2018.

Commodities & Currencies – Crude Oil ended the year at $45 per barrel, down 25% from the beginning of the year and $30 from the highs at the beginning of the 4th quarter. Other commodities were also soft during the year as slowing global growth dampened demand. The U.S. Dollar remained strong as interest rate differentials favored holding dollars.

Outlook

Reconciling the dichotomy between economic results and financial markets will be critical for investors as 2019 unfolds. While the markets may be foreshadowing a more ominous scenario, the economic results and forecasts point to continued growth, albeit at slightly lower levels.

Economy – The strong economic pace of 2018 is not sustainable. The fiscal "sugar high" of the tax cuts will wane in 2019, however, U.S. economic fundamentals remain on solid footing and able to support moderate growth. The consumer is benefiting from a strong job market, decent wage gains and lower energy cost due to the decline of Crude Oil. Cyclical parts of the economy are neither overheated nor in danger of significant slowing. Economic forecasters and quantitative "Nowcasts" point to GDP estimates of 2.5% for the 4th quarter of 2018, slowing back to the pre-2018 level of 2.0% in 2019.

Global growth in 2019 is more tenuous as trade tensions loom. Many nations rely heavily on trade and are more significantly impacted by the current trade squabbles. China has substantial exposure to trade and many unresolved issues with its largest trading partner, uncertainty that may explain the dramatic slowdown in their economic activity. Any trade deal that is reached would be viewed positively by the markets and it is important to remember that the U.S. is negotiating from a position of strength and should be able to consummate an agreement which addresses the primary issues of intellectual property and ownership rights.

Markets will be driven by how these two major questions, economic growth and trade, play out in 2019.

Equity Markets – While the U.S. stock market has not technically reached the required 20% decline (only 19.8%) for bear market status, it has certainly felt like one. Bear markets without a recession are relatively rare and an economic slump does not appear eminent. Valuations have gone from moderately expensive to moderately cheap compared to historic norms. U.S. companies produced the most vigorous mid-cycle earnings growth in history with E.P.S. growth of 25% in 2018 fueled by lower tax rates and strong demand. Looking forward, the earnings growth picture is less robust with estimates of 8 to 10% for 2019. When combined with the now attractive valuations, we see potential for stock market returns in line with historic norms of 5 to 10%. Small cap stocks and international issues represent particularly good opportunities at this point.

Fixed Income – Higher interest rates have made fixed income investments more competitive and may explain some of the volatility in the equity markets. While the Feds efforts to raise rates may be tempered, plentiful bond supply could force rates higher. Potential for deteriorating credit conditions means investors should limit exposure to lower quality. Short term, high quality issues are the most attractive segment of the bond market.

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