Investors Trust
Investment and Trust Services

2019 Market Outlook

As we are preparing this piece in mid-December 2018, there is a lot of fear in the marketplace….fear about US-Chinese trade relations, fear of rising interest rates, fear of a global economic slowdown. This fear has led to a significant increase in volatility over the past couple of months; indeed, it seems like 1% daily moves in the equity market have become commonplace, often to the downside. After so many years of experience investing in the markets, we respect rises in market volatility, as they can be a signal for forthcoming economic weakness that can lead to more precipitous declines in the market. Our experience has also taught us that the equity markets are often wrong on a short-term basis, as fear begets more fear, whether it is founded or not. As the famous economist Paul Samuelson once said, "The stock market has forecast nine of the last five recessions," meaning that the stock market often declines out of fear of a forthcoming recession that never materializes. Most recently, this occurred in early 2016 when the market fell ~12% in 5-6 weeks, yet actually finished the year up about 12%. We believe the recent market turmoil is yet another attempt at the market predicting an economic recession that will not materialize, at least not in 2019.

In the face of the recent declines in the market, it is hard to come out with a bullish forecast for 2019 and not sound crazy. Well, let's cut to the chase: **while both political and economic risks have recently increased, we are optimistic on both the economy and the equity market for 2019.** That doesn't mean the path will be smooth (it rarely is), and we fully expect some bumps and bruises along the way. Indeed, 2018 was a year highlighted by the return of volatility, which we expect to continue in 2019. We are taking steps to address the rise in volatility (discussed below), but we are constructive on the markets for the following reasons:

1. The US economy is quite healthy, and we expect that to continue in 2019.
2. Corporate profits should post good growth in 2019.
3. Valuations are below historical averages in large part due to the current fear in the market.

We will unpack each of those reasons below.

Regarding the fixed income markets, we expect continued upward pressure on interest rates. But with the Fed now suggesting that rates are near "normal" levels (i.e. no longer at artificially low, post-financial crisis levels), the upward pressure will likely be less than it has been.

In order to understand where we are going, we think it is important to understand where we have been, so a brief review of 2018 is in order.

"…we are optimistic on both the economy and the equity market for 2019."

Bob Fontana, CFA
Chief Investment Officer

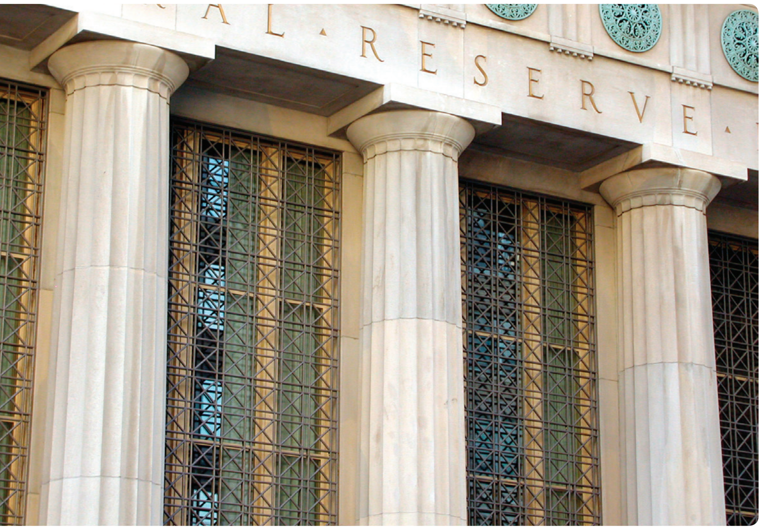
Adam Morgan, CFA
Director of Investment Strategy

Contents

2018 in Review – The Return of Market Volatility

As is always the case, there were many newsworthy events that took place throughout the year. Maybe it is the company we keep or our preferred choice in news outlets, but it does seem that much of the news we witnessed in 2018 related to matters economic in nature. In fact, when considering that economics is often referred to as the "dismal science," this year may have been about as exciting as it gets. **Ultimately, the most important headline to us in 2018 was the return of market volatility.** There were several key things that impacted market volatility in 2018 including:

- As the year began, so too did the Tax Cut and Jobs Act. Nearly voted on down party lines by Congress, the bill and its effects continue to be a source of heated debate. It certainly resulted in stronger economic growth and a big boost to corporate profits. But did it only provide a one-time sugar high, or was it a more substantive bill that could have more lasting impacts?
- President Trump met with many foreign leaders throughout the year and in many of those meetings, the topic of trade was front and center. The term "trade war" seems to have been a permanent fixture in the cable news lexicon. While the negotiating and trade debates promise to continue into 2019 and likely beyond, the meetings and discussions did yield a new trade agreement between the United States, Mexico, and Canada, not-so-creatively called USMCA. Unfortunately, so far trade talks haven't gone as well with China and our European allies, and as a result, some investors worry that tariffs could threaten a rather dramatic run in US corporate earnings growth.
- Speaking of debate, no one debates quite as well as the British Parliament. And they spent nearly the entire year debating exactly how they plan to sever their relationship with the European Union following the so-called "Brexit" vote from a couple of years ago.
- As that union continues to break away, one may have begun to repair as North Korean leader, Kim Jong Un, and the President of South Korea, Moon Jae-In, met at a historic summit in Pyongyang.
- Throw in a congressional melee over a Supreme Court nominee and a few critical presidential tweets of the Federal Reserve Bank and you have yourself an interesting year, to say the least.



But the key headline for 2018 was the return of volatility. Volatility is the amount and rate by which prices rise then fall, or fall then rise. We have all seen the news headlines reporting market volatility typically accompanied by words like "turmoil" or "meltdown" in large red font with a photo of a disheveled businessman, apparently having just endured a really bad day at the stock exchange. Those photos got a lot of use this year as both the stock and bond markets witnessed a significant increase in volatility. While most of us know that markets, by their very nature, can be volatile, our memory after a couple years of muted volatility tends to get a little forgetful, causing the return of volatility to be more unsettling than it likely should be. Indeed, it is during periods of volatility that casual investors tend to pay more attention and sometime look to take action. So let's talk about our outlook and the actions we will be taking in the months and years ahead.

Our Outlook for 2019

We expect volatility to continue in 2019. Indeed, it is quite possible that volatility is actually higher in 2019 than in 2018, especially as the market starts to anticipate what could transpire in 2020 (i.e. a presidential election year). Note that a rise in volatility does *not* mean that we think the markets will fall for the year; rather, it means that we think the ups and downs may be more frequent.

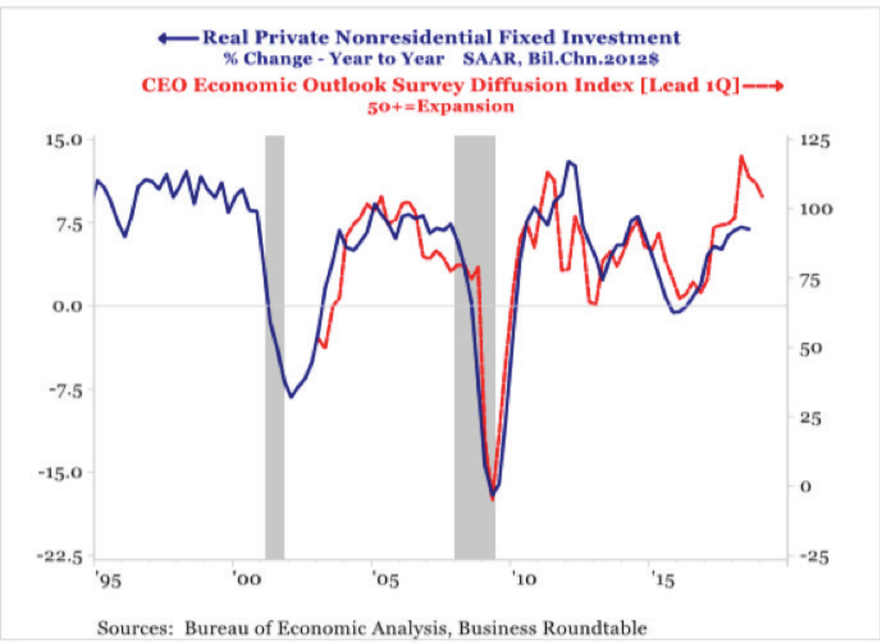
In spite of the recent fear in the market, we are optimistic on our outlook for 2019 for both the US economy and markets. Yes, we recognize that being bullish in the face of what feels like daily market declines may seem crazy. But, as we have noted on numerous occasions in the past, equity prices over time are driven primarily by corporate earnings growth and the underlying economic backdrop that is supportive of healthy earnings growth. We believe that both of those should be present for 2019. In addition, as a result of the recent pullback in the market, valuation levels have fallen to below their historical norms. In a best-case scenario, markets could rise nicely in 2019 from current levels; at the very least, we think that current valuation levels mitigate the potential downside for the market. Let's discuss each of these areas as it relates to our outlook for 2019.

> **"...equity prices over time are driven primarily by corporate earnings growth and the underlying economic backdrop..."**

The US Economy Remains Quite Healthy

As we close 2018, it looks like the US economy will grow at 3.0%+ for the year, the best level of economic growth since 2005. For 2019, current economic forecasts suggest growth of 2.5%, which we believe is reasonable. On a downside basis, we believe that growth could dip as low as about 2.0% in 2019 if indeed all proposed tariffs with China go fully into

Chart 1: Confidence Crucial for Cycle Longevity



"The Index remained at a historically high value, reflecting a strong CEO outlook for the U.S. economy. However, Q4 marks the third consecutive quarter in which the Index declined from the previous quarter, reinforcing the importance of removing barriers to trade, including tariffs, and continuing to advance domestic policies to stimulate hiring, capital investment and economic growth."

– Business Roundtable, 12/7/2018

effect (we don't think they will). While we would prefer having higher growth than lower growth, we simply cannot develop a reasonable scenario that results in the US entering an economic recession in 2019. A common perception on Wall Street is that the benefits from the tax cuts have already run their course in the economy. We fundamentally disagree with that view. On the contrary, while the impact from the tax bill had an outsized impact in 2018 because it was simply the first year that the cuts went into effect, those tax cuts will remain in place going forward, and many companies have fundamentally altered their investment plans as a result of the tax bill. The positive impacts from those investments still have plenty of room to run, with a likely notably positive impact in 2019.

That doesn't mean that things are all rosy; on the contrary, business confidence, while still relatively high, has come down in recent quarters as uncertainty around trade, tariffs, and interest rates have caused CEO's to pause. Indeed, as Chart 1 shows, a decline in CEO confidence could put plans for capital investment at risk, and those expenditures are important in order to improve the productivity of US companies, especially as wage pressures have started to increase.

But we believe that there is a high likelihood that the issues impacting business confidence currently will be favorably resolved. Why?

- Federal Reserve Chairman Jerome Powell has recently suggested that the Fed is likely to reduce its pace of interest rate hikes given concerns in the market that rates may have gone too high. This does not mean that rates won't go higher; it means that the Fed will be very careful in raising rates if such a hike could derail the US economy. It appears that the Fed does not want to put the US economy on track to enter a recession. While that should seem obvious to most of us, Wall Street has been concerned that the Fed was deliberately trying to slow the pace of economic growth. If the Fed slows its pace of rate hikes, that should be positive for businesses and the economy.
- While a more debatable position, we believe that President Trump will ultimately strike a deal with China such that the currently proposed tariffs will not go into effect. While his style is unorthodox for a US President, President Trump is, in his heart, a businessman, and he wants to get a deal done. He wants that deal to be the best possible deal for the US, which is why the rhetoric around trade has been so unsettling. We point to the ugly rhetoric that was used against both Mexico and Canada before a deal was ultimately reached. While it will not be easy and the headlines through the negotiating process will likely be unsettling, we believe that it is in both countries' best interest to get some kind of deal done.

Is it possible that there is something within the economy or financial system that will reveal itself at some point in the future? Of course. If that does indeed happen, we will adjust accordingly.

Chart 2: Earnings Growth for S&P 500 - 2012-2019E

2012	2013	2014	2015	2016	2017	2018E	2019E
6.4%	4.8%	6.6%	-0.5%	1.3%	11.5%	22.4%	8.7%

Average Earnings Growth 2012-2017 = 5.0%

Corporate Profits Should Post Healthy Growth in 2019

Corporate profits for 2018 should be up roughly 22%, buoyed by the corporate tax cuts that went into effect at the beginning of the year. That level of growth is not sustainable, nor did anyone expect it to be. However, excluding the tax cuts, corporate profit growth would still be a relatively robust 14% or so for the year. That 14% would be the best growth since 2011 as we were coming out of the financial crisis of 2008-2009. So the backdrop for corporate earnings growth has been quite good.

For 2019, Wall Street currently is projecting earnings growth for the S&P 500 of 8.7%. That is down from the double-digit growth of the past two years, and even down from estimates exceeding 10% a couple of months ago. But make no mistake, that is still a very healthy level. Putting this projected growth in context, look at Chart 2 below, which shows that the average earnings growth from 2012-2017 was only 5.0%. So growth of 8.7% is quite good.

We actually are taking a more conservative stance than the current Wall Street consensus on the level of earnings growth for 2019. We have run various scenarios for earnings growth in 2019, and our base case projects growth of 6.5%, which is better than the recent average growth rate. If there is a negative economic surprise, we still think corporate earnings growth should be around 2.0% in 2019, and if there is a positive surprise, earnings growth could easily come in around 10.0%. Barring some type of external shock, it is hard for us to develop a reasonable scenario where corporate profits do not grow.

Valuation Levels are Currently Below Historical Averages

The historical average valuation for the S&P 500 is 16x projected earnings per share (EPS). The market is currently trading at 15.0x projected earnings for 2019. From a downside perspective, that valuation level is important. We have noted in the past that the valuation levels were meaningfully higher prior to the last two major market declines in 2000 (~29x) and 2008 (~24x), so the valuation risk in the market today is much lower than those levels. We share this again for those that may be increasingly nervous about a market crash type of event, as we view such an event as unlikely given the economic backdrop, expected corporate earnings growth, and valuation levels.

As it relates to our outlook for 2019, we believe it is hard to justify the market trading at below historical norms in the face of positive earnings growth and a healthy economic backdrop. In fact, we believe that if our base case earnings outlook is correct, or if the earnings growth comes in better than we expect, the market could trade at levels higher than its historical averages. Chart 3 below shows our different scenarios of earnings growth in 2019 and what those earnings levels may imply for the overall market.

Chart 3:

Situation	Projected 2019 S&P 500 Earnings	Projected 2019 % EPS Growth	Implied S&P 500 Level
Negative Surprise	$164.75	2.0%	2,636
Base Case	$172.00	6.5%	2,924
Positive Surprise	$177.75	10.0%	3,022

Fixed Income Outlook for 2019

For the past few years, we have argued that interest rates should be higher given the underlying strength of the US economy. Indeed, following the 2008-2009 financial crisis, the Fed specifically engaged in keeping rates artificially low to help the economy get out from the weight of that crisis. While many may debate the consequences of that action, the effort worked, as the growth of the US economy is arguably once again the envy of the world.

The Fed has recently suggested that the current level of interest rates is near what it views as the "neutral" rate for the economy. That is Fed-speak which translates into "Interest rates are about right for what the economy is doing." That is potentially a notable shift in view, as even a few months ago, Wall Street was expecting as many as four Fed rate hikes in 2019. While the Fed will always review the economic data to determine what it should do related to rates, this new posture suggests that the Fed's bias has changed from raising rates gradually to sitting tight. It does not mean that the Fed will keep rates unchanged in 2019, but it does mean that they may not be as inclined to raise rates as they had been in the past.

As noted above, our outlook for the US economy is largely positive. Thus far, inflation across the economy has been relatively tame, and recent declines in energy prices should help keep inflation in check. As a result of the Fed's position and our view on the economy, we expect the upward pressure on interest rates to be more muted in 2019. Our current view is that the yield on the US 10-Year Treasury will likely settle around 3.50% in 2019.

Actions We are Taking to Address Market Volatility

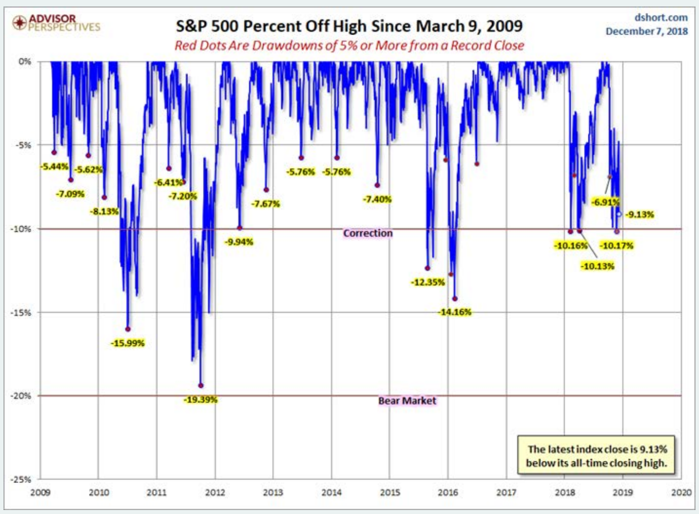
Given our current outlook and our expectation for volatility to continue in 2019, what are we doing about it? Let's first put the recent return of market volatility into perspective. Forgive us if we use some technical investment jargon more than usual here, but we think it is important for you to understand what we are doing.

Since this current bull market began in March of 2009, the stock market has experienced a pullback of at least 5% of its value, over twenty times, but none of those occurred in 2017. See Chart 4 below. So while the amount of volatility in 2018 is noteworthy, so too was the lack of volatility the year prior. The S&P 500 volatility index, commonly known as the VIX, is the widest accepted measure of stock market volatility. The VIX recorded its lowest average level in 2017 since the inception of the index in 1986. This means that 2017 was the least volatile year in recent recorded history. In fact, there were only 8 times during 2017 when the S&P 500 has moved more than even 1%. In 2018 by sharp contrast, the S&P 500 moved either up or down by more than 1% over 50 times. Although we have until recently not faced much market volatility, it is not an uncommon phenomenon, and the level of volatility in this year's market is actually not abnormal. In fact, the market has experienced a 10% pullback in roughly half of all calendar years and yet has finished in positive territory roughly 75% of the time. Volatility is simply an inherent characteristic of stock market behavior and we invest with an expectation that it will continue.

2019 Market Outlook

The first thing to know is that **we do not prepare for periods of volatility during periods of volatility**. All of our clients begin a relationship with us by reviewing their personal financial profile so that we can develop the Strategic Asset Allocation that is most appropriate for them. This involves striking the right balance of stocks, bonds, and cash that best meet our client's individual long-term investment goals. This is not an exercise that we undertake in preparation for years when the stock market moves only higher but rather an exercise that proves its value over a market cycle which includes years when the stock market exhibits a higher degree of volatility.

Chart 4:



Furthermore, we select investments with an eye toward managing risk. Our single stock strategies range from a growth strategy known in the investment management industry as GARP, or Growth-At-a-Reasonable-Price, and a Blue Chip Dividend strategy that focuses on companies that are growing their dividends while retaining a healthy balance sheet. This means that a purposeful consideration of how turbulent investment markets can be is embedded in the way that we select stocks. During years like 2017, some often ask us why we do not chase some of the higher-priced, more aggressive stocks that tend to dominate the headlines. We do not get those questions as often in years like 2018.

The best, most proven way, to reduce the effects of increased market volatility is through diversification. We have always taken advantage of the power of diversification by focusing client investments across different types of industries and business sectors. Different businesses and industries behave differently at different points in the business cycle. In recent months and going forward into 2019, we will be heightening our focus on diversifying across additional asset classes and investment geographies. This allows us the opportunity to take advantage of a correlation benefit that is a naturally inherent characteristic of the stock market. While there is volatility present in all types of investments, asset classes typically do not move in lock-step with one another. In other words, the price behaviors of various asset classes are not perfectly correlated. Therefore, by investing in multiple asset classes, the total portfolio can be less volatile even when the broader US market is more so. So while the degree of volatility may ebb and flow from year to year, the presence of volatility is a constant. Investing with an eye on volatility is the best way to prepare for yet another year in the market.