JANUARY 2019

DEAR DIARY

What a year it's been. After the roaring performance of the tech stocks in 2017, 2018 carried on with tech leadership only to see it falter by June. 2018 was a difficult year to make money, a year of scant returns and even losses in most asset classes. After the big year in 2017 it is hard not to be disappointed. At the same time I shouldn't be too surprised the market's momentum came to a halt with only dividends and interest contributing to the pot. In a December 2017 Investment Thoughts, I remember writing:

"While we feel constructive about the US and global economy through 2018, the business cycle will be maturing at a time of tighter monetary policy colliding with high stock prices. Current earnings expectations seem overly optimistic as is investor sentiment. If the S&P was your favorite restaurant and prices on the menu kept going up, at what point would you stop going (putting in new money) and go elsewhere. It is important for investors to understand an expensive stock market increases the risk to a portfolio as the probability of a sell off or lower future returns increases with the price of the market. Household stock holdings, as percent of household financial assets, are at historical levels suggesting full equity allocations. We believe it is timely to recalibrate one's equity exposure to be in line with a prudent assessment of personal risk tolerances." The question was when, not if, a test would take place.

U.S. Markets

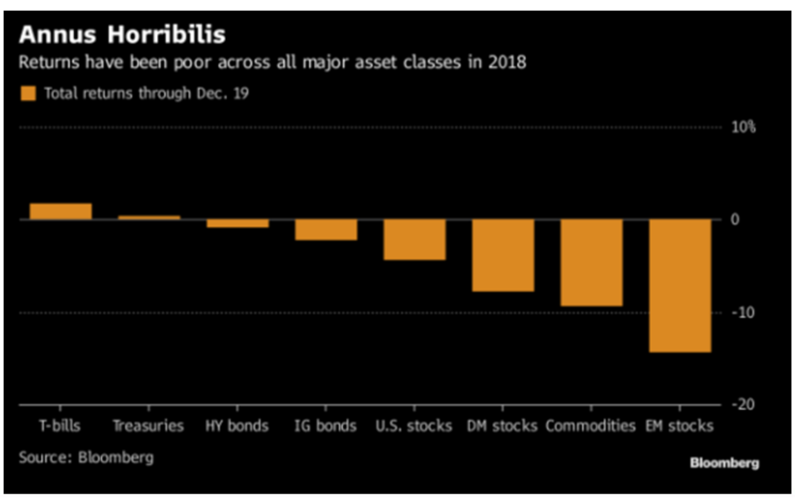
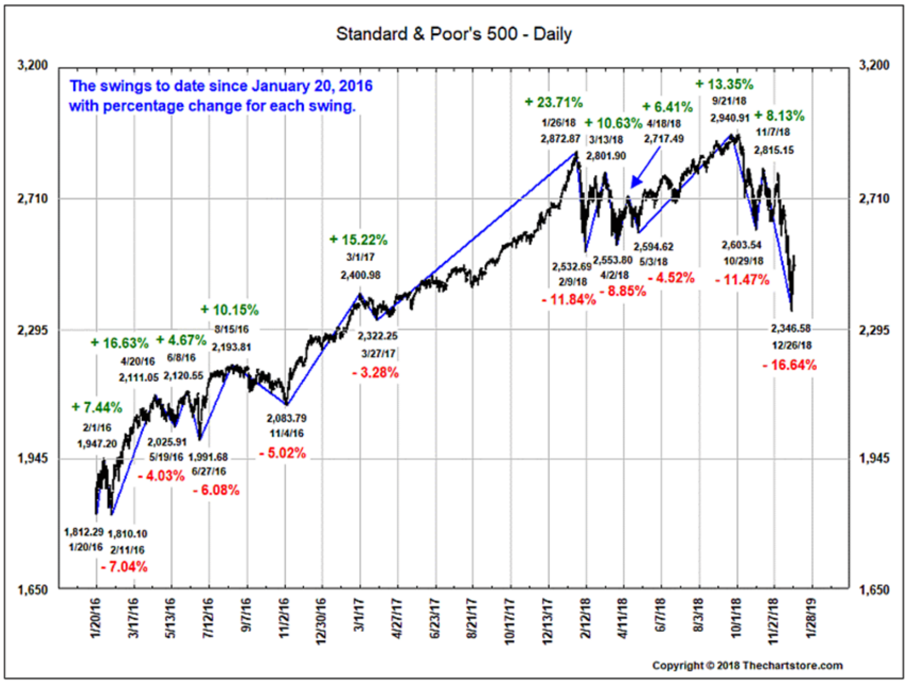


Chart #2



But wasn't the surge in after-tax earnings from the tax cut and from repatriated assets held abroad enough to justify stock prices at new highs? The answer is… it's complicated. The surging profits from tax cuts should have gone into capital investment to sustain future growth and efficiency. However, even though real assets were cheaper than the stock market value of those assets, companies bought back their stock instead in order to boost reported earnings. At the same time, corporations have taken on more debt, in some instances to levels exceeding those of 2007. Earnings were up sharply for 2018 but earnings quality deteriorated. After tax profits were growing faster than revenue. When the S&P 500 peaked in October the market had already priced in those earnings. A momentum driven market needs only a change in sentiment or confidence to spark a change in trend. In this case the spark came from a reversal of the Federal Reserve's easy money policies begun after the 2017 Credit Crisis. So-called quantitative easing has become quantitative tightening. Asset price inflation has become asset price deflation. Why? Because the market feels the tighter monetary policies are a mistake on the Fed's part. Tightening financial conditions too much threatens the continuation of the economy's expansion and may even cause a recession. It is true that the real economy should drive asset prices and it should not rely on Fed stimulus. The problem arises when asset prices have reached an overvalued level, often called a bubble, and a loss of confidence brings on selling. The weak global economy, most importantly China, fans fears that US growth will be pulled lower thus causing 2019 earnings to slow. Higher wages and interest rates will mute, to a degree, lingering tax cut benefits.

Chart #3 shows that there were *no asset classes with a return greater than 5%* this year, a low mark since 1972. The small blue dot at the far right of the graph just barely registers compared to all the past levels. Within the S&P 500, healthcare stocks topped performance at +5.01% followed by utility stocks at 3.91%. All other sectors were in the red.

Chart #3

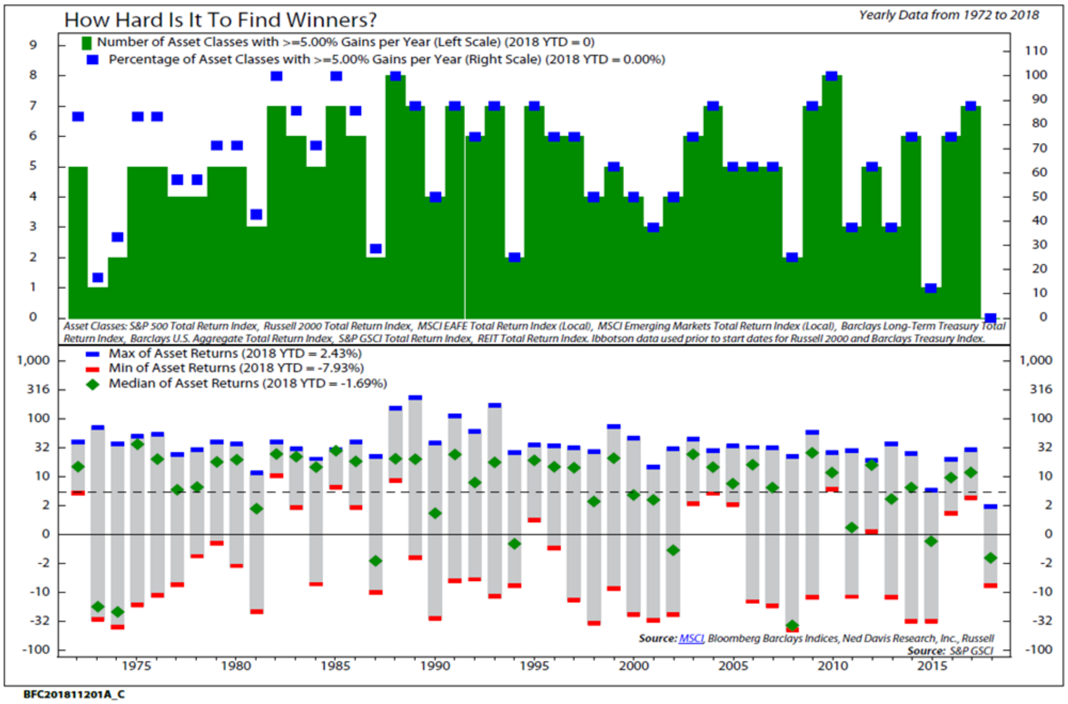
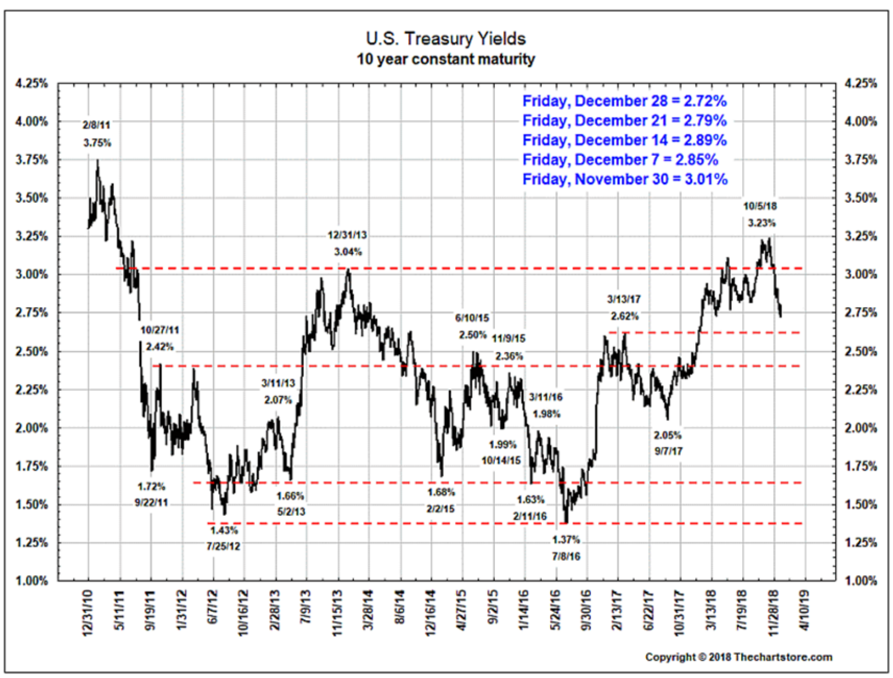


Chart #4

Lower Ten year bond yields offer a forecast of slower growth and perhaps some possibility the Fed will be less aggressive in 2019 than previously expected.



Investment Implications:

Has the recent sell off in US stocks (along with global equity markets) brought prices low enough to restore value? That is, from this price level can new money buy stocks with the view of achieving attractive future returns? The answer is easier for a dividend investor seeking income as falling share prices bring obvious yield increases. For example, a $5.90 dividend from IBM at $150=4%, but at $115 it is 5%. When the yield of 2.75% on a 10-year government bond is compared to a 5% dividend thought to be secure, many investors will be drawn to the stock. It is a more difficult job to identify a true point of value with a stock trading solely on future earnings. What will the earnings be worth in today's dollars given unknown interest rates and inflation? It is a more difficult analysis, but it leads to bottom up research on an individual company more than a generalized macroeconomic judgement. This is called stock picking and within every market cycle, both up and down, individual values can be found. This is a time of stock picking rather than buying into a trend to catch the big wave. There are surely many days ahead where market confidence will be found wanting, resulting in further price volatility as investors try to take the true measure of the economy. I still expect the real economy to continue its slow expansion in 2019 and believe it is too early to call a recession imminent. More positively, China may restore some of its growth by the second half of 2019 which would boost global markets. Progress with the trade war is a possible catalyst though unbundling this issue from the geopolitical aspects of China's ascension in the world makes it less likely. As I wrote in December 2017 above, investors should have the correct equity exposure for their risk tolerance. The latest market drop is a rude awakening from several positive years and is a good reminder of what it is possible when sentiment moves to an extreme. It now seems stocks can outperform bonds in 2019. A feared bear market in bonds seems in abeyance with global growth slowing. With bond yields likely cresting in the New Year, I favor dividend growth stocks as the most obvious value. For those with greater risk tolerance and a long investment horizon, attractive values can be found in international markets that have sustained dramatic declines relative to the US. Ledyard has developed a separate Global Strategy to offer clients that exposure.

The best years are the years to come. Let a profitable one come soon! Times are always uncertain. What fun would it be if we knew the future?

Happy New Year!

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