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Investment Briefing

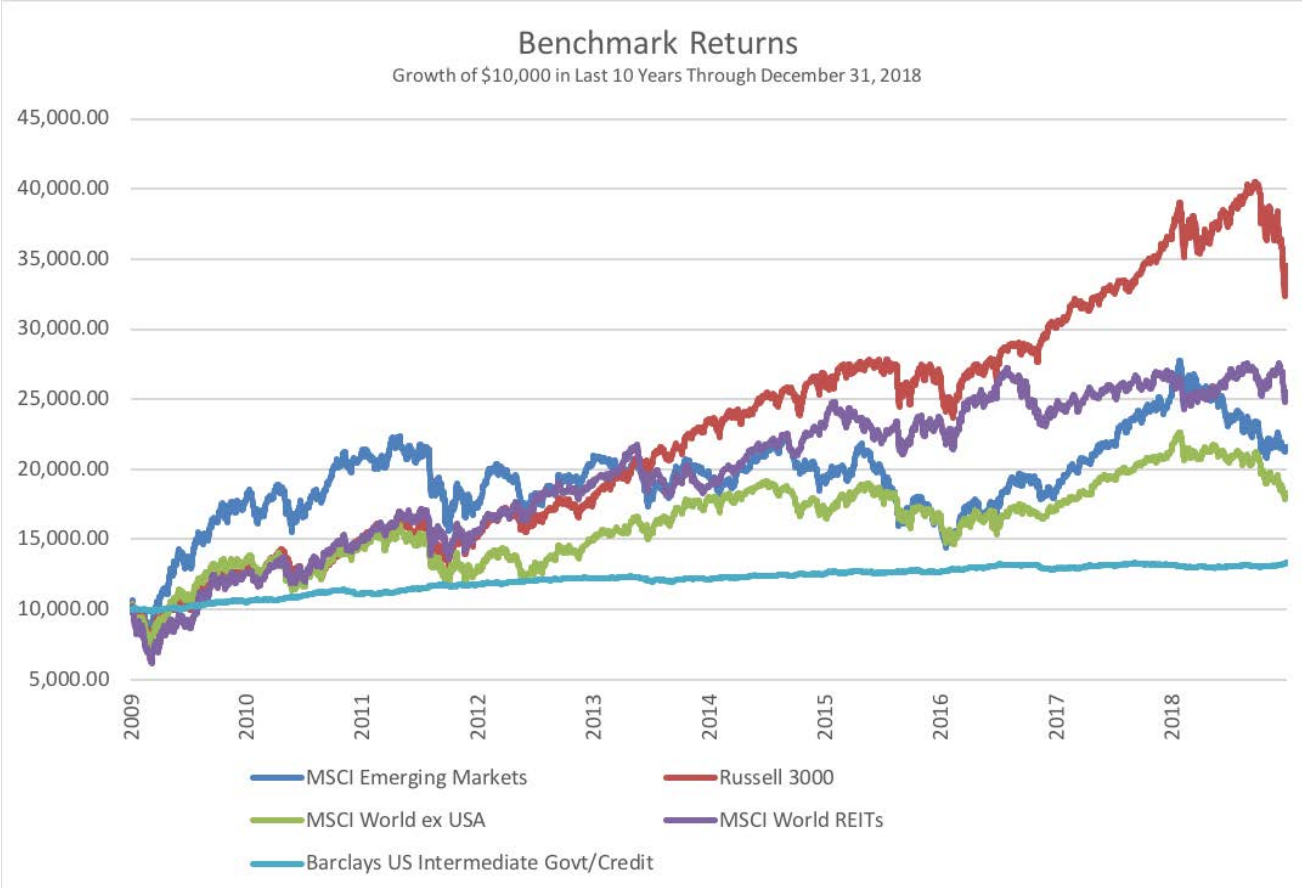
Fourth Quarter 2018

Introduction

Most stock markets were lower in the fourth quarter, erasing gains from earlier in the year.

As the table below shows, U.S. stocks had a rough time in Q4 while bonds were up nicely. Emerging Markets and Real Estate Investment Trusts (REITs) were down, but not nearly as much as other stocks. Looking longer term, Bonds are showing their stability while U.S. stocks still hold the prize for being the best performer.

Asset Class[1]	4th Quarter	12 Months	5 Years (annualized)	10 Years (annualized)
U.S. Stocks (Russell 3000)	-14.30%	-5.24%	7.91%	13.18%
International Developed (MSCI World ex U.S.)	-12.78%	-14.09%	0.34%	6.24%
Emerging Markets (MSCI EM)	-7.47%	-14.58%	1.65%	8.02%
Real Estate Investment Trusts (MSCI World REITs)	-4.53%	-5.04%	6.27%	9.82%
Taxable Bonds (Barclays U.S. Intermediate Gov/Credit)	1.65%	0.88%	1.86%	2.90%
Municipal Bonds (Barclays Municipal 1-10 Yr. Blend)	1.61%	1.64%	2.42%	3.30%

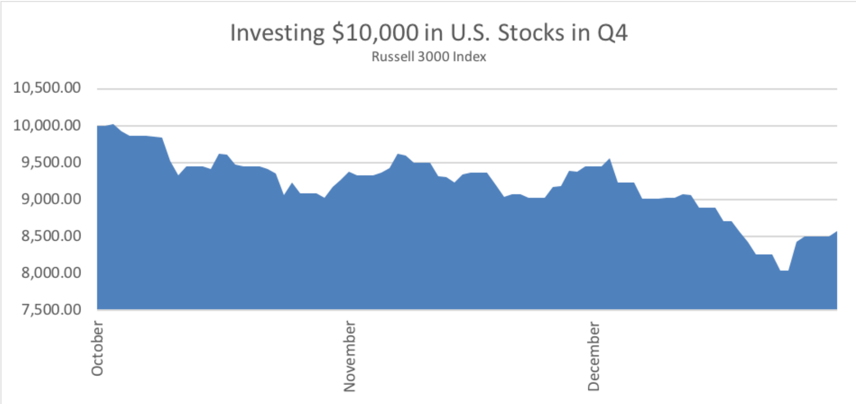


References

1. Return data and charts are from Morningstar Direct.

U.S. Stocks: Rattling Cages

Although the U.S. economy continued humming along, the stock market started to anticipate less growth in the future.



Employment stayed high and inflation stayed low, but we all know that this can't go on forever. Increasing concern about global economic trends contributed to the downbeat tone in U.S. markets.

Probably the most concerning event, however, came from the Federal Reserve, which continued their message about increasing rates through 2019. Not that the message was surprising, but the market needs to adjust when monetary incentives, like artificially low interest rates, are taken away. The Fed changed its tone a little during Q4, and stocks hung on every word (more about this under Bonds). The short-term effects from the fiscal stimulus of 2017's tax cuts are also lessening.

There was a shift in the market as the it began to anticipate a slowdown. That shift was from growth stocks to value stocks. While both were down for the quarter, value was down considerably less primarily

because value stocks hadn’t risen as far. Also, the stocks of smaller companies fell more than the stocks of large companies in Q4. Some refer to this phenomenon as “risk off” meaning that investors are concerned enough about the future that they want to lessen their more speculative investments, like highly-valued growth stocks and stocks of smaller companies.

Is our future all doom and gloom? No, in fact there are a number of reasons that the stock market could recover nicely in 2019. They include:

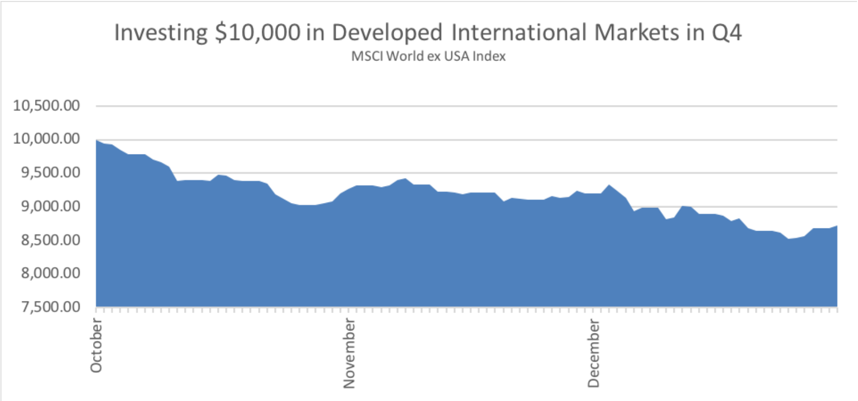
- The possibility that the U.S. and China will finalize a trade deal. China needs us to buy their goods more than we need them and a deal will eventually come to pass. Note that China’s trade surplus with us hit a record $34 billion in September.
- The price of oil has dropped again, falling from about $74 per barrel to under $50 per barrel in Q4. Since most of us are dependent on oil for many of our goods and services, a drop in price should lead to lower prices for consumers and higher profits for companies.
- Inflation is still low, and there is little reason to believe that it will spiral out of control any time soon. The Federal Reserve continues to withdraw monetary stimulus through higher interest rates and reducing the amount of bonds it holds on its balance sheet. What this means is that when the economy slows, the Fed will have tools it can easily use to hopefully reduce the depth of the slowdown without triggering excessive inflation.
- Finally, as we’ve been saying for quite a while, employment remains strong with the unemployment at only 3.7%. According to the Labor Department, available jobs in the U.S. last summer outnumbered workers by 902,000, the largest gap in 17 years.

In summary, the decline in the U.S. stock market in Q4 was not unexpected because we knew that eventually the market’s high valuations would begin to flag. Those valuations are now closer to most historic averages.

With a still strong economy and rising corporate earnings, the U.S. market should eventually resume an upward trend.

International Developed Stocks: Open Cages

Challenges also weighed heavily on international developed markets, which also dropped, but not by as much as the U.S. stock market.



Slowing economies in Germany and Japan, trade disputes with the U.S., and shifts in France and the U.K. were all concerns reflected in reduced prices.

The same shift, with value outperforming growth, was also part of international returns. Small company stocks also had larger losses than large companies. All of this said, there were some significant positives for these stocks:

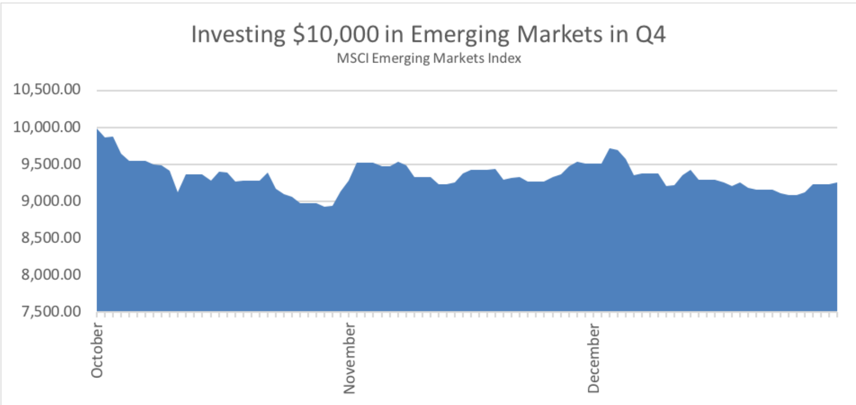
- The U.S. dollar finally showed some weakness against international currencies. This could be because our economy is not growing as robustly as it was, the Federal Reserve backing down slightly from future rate increases, or for many other reasons.

- The International Monetary Fund's (IMF) economists are still predicting growth of 3.7% for the global economy in 2019. Not quite as high as it was, but still a healthy number.
- Cheap oil also benefits most international economies as it does for the U.S.
- Inflation remains at bay in most economies, so the risk of central banks suddenly increasing interest rates is relatively low.
- Canada, Germany, Italy, and some Asian countries are working on fiscal stimulus packages similar to the tax cuts the U.S. implemented in 2017.
- Just as unemployment is low in the U.S., it is relatively low around most of the globe. The IMF reports that worldwide unemployment for advanced economies was at 5.2% in October (the latest data available), compared to 5.6% in 2017.

Summing up, international developed economies showed some slowing in Q4 which, as in the U.S., had to come eventually. However, a weakening dollar, cheap oil, growing employment, and fiscal stimulus should eventually lead to higher stock prices.

Emerging Markets: Escaping

While China struggled with a slowing economy and continuing trade spats, Emerging Markets as a whole did relatively well in Q4, although still producing a loss.



We don’t want to put too much of a positive spin on this, though, because EM was the laggard for the year.

In addition to being beaten down earlier in the year, another reason for EM's lower loss in Q4 was that thier currencies held their values against the U.S. dollar better than their developed country counterparts.

Other positives that lessened the pain in EM were:

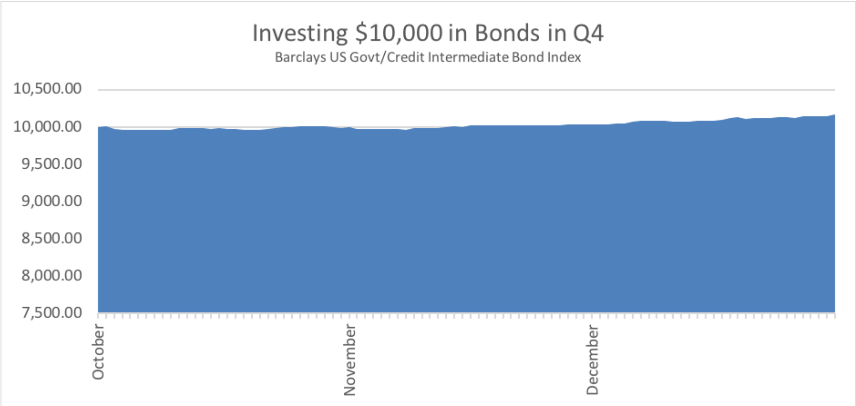
- China’s central bank cut reserve requirements hoping to boost lending. Her policymakers also said they would cut tax rates and continue to provide monetary stimulus in 2019.
- Brazil elected a new conservative President who promised to stop government corruption, which has dogged the country for several administrations.

- Turkey’s private sector agreed to drop prices by 10% in order to combat inflation.
- Mexico, Canada, and the U.S. signed a new trade pact.

EM stocks are typically more volatile and have longer periods of under- or over-performing than its developed brethren.

Bonds: Confined but Happy

While bonds don't have the potential growth that stocks do, bond holders enjoy considerably more certainty when stock markets stumble. This is reflected in both the Q4 numbers and returns for all of 2018.



The bond market had already expected rates to rise and those increases were priced into the market. When stock markets started to slide, demand for bonds increased, raising prices and decreasing yields.

This increased demand also generated a signal that very much concerned stock investors: an inverted yield curve for some bond maturities. A normal yield curve is drawn when longer-term interest rates are higher than shorter-term rates. When demand for bonds increases, especially due to a worried and weak stock market, the money from the stock market shifts to bonds and those shifts generally go to longer term bonds as the chance of a recession increases. An increase for demand in longer-term bonds increases their prices, forcing their

yields down. Eventually, the demand for longer-term bonds brings their yields down lower than short-term bonds. This inverts the yield curve (higher short-term rates than long-term rates), which is a classic indication of an upcoming recession.

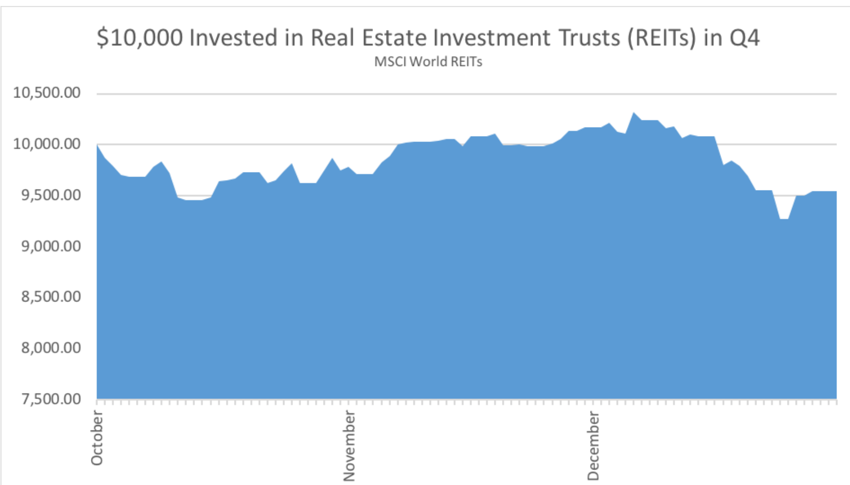
Of course, predicting the future isn't as easy as just looking at relative bond prices. A flattened or inverted yield curve has preceded many recessions, but not all, and the timing has varied greatly from the time of inversion to the time of a recession.

Given all of this, Jerome Powell, Chairman of the Federal Reserve, has become more careful in his statements. Suffice it to say that interest rates may not be increasing as rapidly as thought a year ago. Low interest rates not only benefit the bond market (bond prices rise when interest rates fall), but also any sector that requires heavy borrowing, like residential construction and sales, or industrial companies that want to finance new plant and equipment, etc.

In summary, the stabilizing properties of bonds were appreciated by most investors in Q4. Looking forward, the Fed is now saying that interest rates will rise in 2019, but not as much as was thought earlier.

Real Estate – Owning the Cage

With the prospects of a slowing economy, many real estate markets had a lackluster 2018.



While real estate securities had a lower loss for the year than some other asset classes, increasing interest rates and shifts in the sector held back some growth prospects.

Real estate investment trusts (REITs) comprise many different types of real estate including office buildings, shopping malls, warehouses, and apartment buildings. They all need prodigious amounts of capital, so borrowing is generally necessary. Offsetting this increase in rates, three factors seemed to have helped limit the losses in REITs:

- The economy continued to grow which continues to require new and improved apartment construction, and increasing demands for office space, warehouses, etc.

- The reality of increasing interest rates and the prospect of further rate hikes led REITs to be comparatively undervalued at the beginning of 2018.
- By its nature, real estate also tends to be a defensive investment and a place that money seeking shelter goes when the economy begins to slow.

Real estate in general has had good returns since its correction in the financial crisis and some markets, such as the Bay Area, have come back very strongly. When we look on a national or global basis, however, there are still comparative bargains and it takes experts to determine bargains from poor investments. Shifting demographics affect areas, as do shifts in the way we live and work. Some shopping malls are now nearly empty while others are thriving. Also, our ever-growing economy needs office space, but office sharing is on the rise with firms like WeWork.

These constant shifts require that we use investment managers who are well aware of how each of these shifts affect each investment. It takes intimate knowledge of each area's markets to discover them and know how to profit from them. We believe we have those managers in place and we are ever-vigilant in our reviews of their performance.

Summary

We will remember 2018 as the year that stocks finally corrected and that bonds outpaced other investments, despite the Fed's drumbeat of increasing interest rates. We will also remember it as a year of struggle for trade, Brexit, and a slowing Chinese economy.

What does this mean for 2019? As regular readers are well aware, we are loathe to predict the future and we don't pay much attention to people who claim that they can. Let's just say that our economies have a high probability of growing and our investments have a high probability of reflecting that growth over the long-term.

We hope this finds you looking forward to the challenges and rewards that 2019 will inevitably hold and we certainly look forward to working with you in the New Year.

Thank you for the trust you have placed in Vista.

Your Vista Wealth Management Team

Source of all charts and data: Morningstar Direct
Economic data is from BCA Research, Dow Jones, and The Economist Newspaper Limited.

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