To Our Clients and Friends:

We are pleased to bring you our report for the fourth quarter of 2018.

How many of you on Christmas Eve would have expected to read the following in today’s financial headlines? “U.S. stocks are on their swiftest rebound in more than a decade, fueled by reinvigorated confidence in the domestic economy and signals the Federal Reserve will take a cautious path on future interest rate increases.” Not many we bet. And, while the amazing recovery in equities, longer term bond yields and even oil prices does not necessarily mean we are out of the woods, it does give us all an opportunity to pause and instead give some thought and consideration to those things that couldn’t seem to rise above the din of media negativity over the last three months. Call it balance, perspective or whatever you want; it’s something we make a point of trying to provide in this age of 24/7 news and media sensationalism.

If one needs a catalyst for self-assessment, particularly one’s sensitivity to and ability to tolerate breathtaking market swings, they need look no further than Q4 2018. It was an ugly quarter, which turned a promising year into a disappointing one. Almost cruelly, it came on the heels of the S&P 500 Index’s best quarter since 2013, which left that index up almost 10.5% for the year through September. Almost exactly 10 years since the depths of 2008, which many have forgotten (and some never really knew) the equity markets could no longer contain the pressure that had slowly been building for a long time. Things we preach about regularly are far more difficult to experience than they are to read about in our missives when times are good and markets seem to go nowhere but up. But sometimes an actual punch to the gut is what human nature requires us to experience in order to learn the lessons and see how well we really know ourselves, our emotions and levels of self-discipline. Those with short time horizons and/or an inability to withstand inevitable periodic market corrections should not have a disproportionate amount of their investment assets in equities. A corollary to this is that those who have forgotten (or never really knew) what periods of normalized interest rates are like should not blindly assume that bonds are a guaranteed antidote to difficult equity markets. Of all the quarters in the last 10 years, perhaps this is the one where perspective is most needed.

But enough about 2018 – there’s no point in dwelling on it further except as it may impact and compare to what may lie ahead for 2019. We are not in the business of making predictions, but we do have

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1 The S&P 500 dropped 2% that day, its nadir for the quarter, capping a miserable December for the equity markets. Hopefully most of you had better things to do that day than follow the financial markets.
3 This is an encouraging sign, especially since all three were headed in the other direction for most of the quarter.
4 For the quarter the S&P 500 Index lost 13.5% (-4.4% for the year) and the MSCI World ex-USA Index lost 12.7% (-13.6% for the year). The Bloomberg Barclays U.S. Aggregate Bond Index rose 1.6% for the quarter but was essentially flat for the year. Data source: Dimensional Fund Advisors. 2018 was the first year in a long time – at least 10 years - that cash (1.8% return for 2018, per Western Asset Management) was the top performing asset class.
some thoughts on the factors that will dictate the direction of the markets’ moves going forward.

**Interest Rates.** While the Fed’s communications are always nuanced and hedged (making interpretation difficult), it has, in our opinion, signaled that although it may not be done raising rates, that time may be close. Inflation, one of the primary macroeconomic objectives that the Fed is charged with managing, has, in the recent words of Fed Chair Powell, been “muted”, and, in fact, is very close to the Fed’s targeted rate of 2%\(^5\). This means a key objective of raising rates has essentially been met for the time being. And, while buoying the stock market is not one of the Fed’s mandates, it presumably did not anticipate (or like being “blamed for”) the violent reaction to the December rate hike and won’t want to be blamed for what the market saw as an unnecessary rate hike. Whatever the reason, 2019 is likely to see a more dovish Fed than seemed likely even as recently as September\(^6\).

**Recession.** The sources we find credible and informed generally believe that any economic slowdown is not likely to rise to the level of a recession. The consumer sector looks strong, particularly the labor market\(^7\). An end to increasing rates will allow companies’ interest rate expenses to moderate, which will help their bottom lines and their ability to stay in business. It will also help consumers who have loans that are tied to the Fed Funds Rate and could keep them from otherwise cutting back on their purchases. And, since the Fed has now built up the Fed Funds rate from essentially 0% just three short years ago to 2.5% now, it finally has some ammunition (in the form of actually lowering rates for example) to use if the economy does falter too much.

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\(^5\) “...Instead, the outlook is consistent with...inflation expectations anchored near 2 percent.” Fed Chair Jerome Powell, October 2, 2018.

\(^6\) In September, the Fed was forecasting three rate hikes in 2019 and one last hike in 2020, which would have brought the Fed Funds rate to 3.5%, well above its target long-term “equilibrium” rate of 3.00%. In December they not only reduced the target rate to 2.8%, they also “officially” removed one of their projected 2019 rate hikes. Source: J.P. Morgan Asset Management.

\(^7\) December’s jobs report was excellent, with payrolls rising a far-better-than expected 312,000 for the month, 128,000 above consensus.

\(^8\) Source: Financial Times.

\(^9\) Source: Mauldin Economics.
not-so-good news: Earnings growth is slowing. The better news: Most analysts believe that the markets have already priced in these somewhat wobbly 2019 earnings estimates.

Valuations. Related to earnings is valuation. At the end of September, the S&P 500 was selling at 16.8 times forward operating earnings, about 4% above its 25-year average of 16.1 times. On the last trading day of 2018, the S&P 500 was selling at only 14.3 times, about 11% below its 25-year average. So, even with modest (or declining) earnings growth, current valuations mean that buyers are not having to “pay up” for equities.

Uncertainty. To the markets, elevated levels of uncertainty are worse than bad news. While of course nothing is certain, excessive levels of uncertainty rob investors of their confidence in the markets and CEOs of their confidence in longer-term business plans, particularly capital spending. This is one of the most “uncertain” environments we have seen in a long time. While the Fed has become a little less uncertain, lack of clear and consistent policy from the White House (including not heeding advice and/or changing advisors with regularity) has more than made up for it. And, while it might not explain the reason for the market drops of late, might it have impacted the severity of the market pullbacks? We think so, to a significant extent, which might help us better understand what it will take to reverse the current trends.

Volatility. While not necessarily indicative of market returns (as fundamentals, like earnings and valuation, tend to be), volatility nevertheless plays a big role in investors’ comfort with investing and staying in the market. Like everything else that affects the market, no one knows the extent of volatility that lies ahead. What we do know, however, is that volatility is not a problem unless one is compelled by circumstances or emotion to react to it. A good financial and investment plan should keep you from having to react to it for either reason. If you are seriously troubled by the market’s behavior in the last few months you probably have too much exposure to it. Volatility is likely going to continue to be an unpleasant and unwelcome visitor to the equity markets going forward and those who seek to harvest gains from the equity markets must have the discipline and intestinal fortitude to “hold their nose” and ride it out. As First Trust Advisors’ chief economist Brian Wesbury says: “Volatility is the price we pay emotionally to make money over the long run.” Our advice: Focus on the things you can control, such as having a plan that is designed with your needs in mind to harness market returns as well as keep you from overreacting to short-term market volatility to the point of abandoning it.

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