Q4 2018 MARKET RECAP

JANUARY 10, 2019

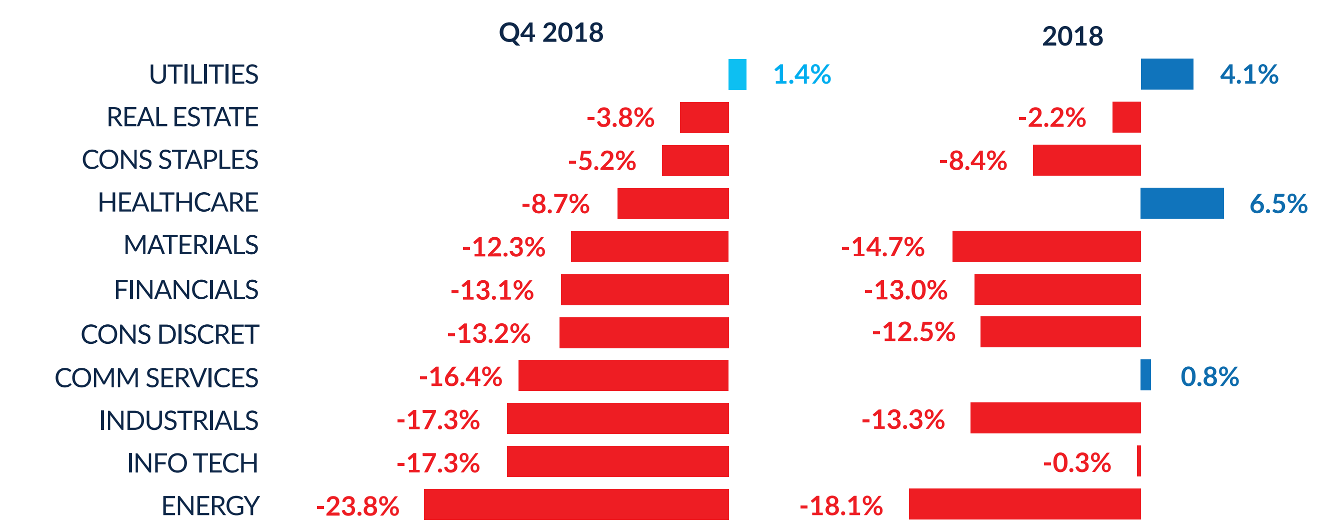
VOLATILITY, MIXED WITH SOME POSITIVES

The fourth quarter of 2018 saw the re-introduction of volatility into the markets as the S&P 500 plunged over 20% from peak to trough, taking global indices with it, wiping out 2 good years of price returns. December was particularly difficult as the Dow Jones Industrial Average and S&P 500 had their worst December month since 1931. However, as uncertain as things might seem coming in the wake of a negative year, the good news is that back-to-back negative years do not occur very often. Based on data since 1928, there's only a 25% chance of a second consecutive negative year. Perhaps it feels a bit more worrisome as we've had 9 straight years of positive total returns for the S&P 500 (prior to 2018).

Domestically, while the U.S. economy is in the late stages of the recovery, GDP growth continued to be ebullient, with the Q3 reading for the U.S. coming at 3.4%. GDP is on track for 3% growth for the full year of 2018 and the first full year above 3% in 10 years. Estimates call for the economy to grow at 2.4% in 2019, above potential, which is estimated to be around 2.0%. We believe it will exceed expectations and we don't see a recession until 2020 at the earliest. Contributing to that outlook is the domestic labor market, which remains very tight, with unemployment falling to 3.7% in November and wage growth rising to above 3% for the first time since 2009. Inflation (as measured by Core Personal Consumption Expenditures) remains subdued, sitting just below the Fed's target of 2.0%. It was against this data that the Federal Open Market Committee opted in December to raise rates for a fourth time in 2018. The statement also indicated that the FOMC is now forecasting 2 rate hikes in 2019, down from 3 back in September. Despite the increased dovish tone of the statement, markets responded very negatively to Chairman Powell's actions, which followed. The Fed has since walked back their forward guidance as inflation remains subdued and markets have forced their hand.

However, there are several positives which remain solidly in place. Domestically, U.S. retail sales were very robust in the fourth quarter. Auto sales are strong and while falling oil is bad for oil companies, lower oil prices should benefit the consumer at the gas pump and provide cash to spend elsewhere. It's important to remember that spending makes up more than 2/3 of the U.S. economy. The forward P/E on the S&P 500 is now at 14.4x (source: JP Morgan), down from 18.5x a year ago, and a 11% discount to the 25-year average of 16.1x. This contraction is the 3rd greatest in 40 years. Furthermore, the S&P 500 price/earnings to growth ratio (PEG ratio) hit 0.85 in December, matching levels last seen at the bottom of the financial crisis. The market sell-off and corresponding multiple contraction seemed to ignore the strong fundamentals we've discussed above. On a fundamental basis, the strategies here at Main Management appear as strong or stronger than they were a year ago and are selling at lower valuations, which, for long term investors like ourselves, suggests that the underperformance in 2018 should set up outperformance in 2019. Across the strategies we continue to be cost aware and tax aware and we achieved that again in 2018.

Sector Returns As of 12/31/18



MAIN
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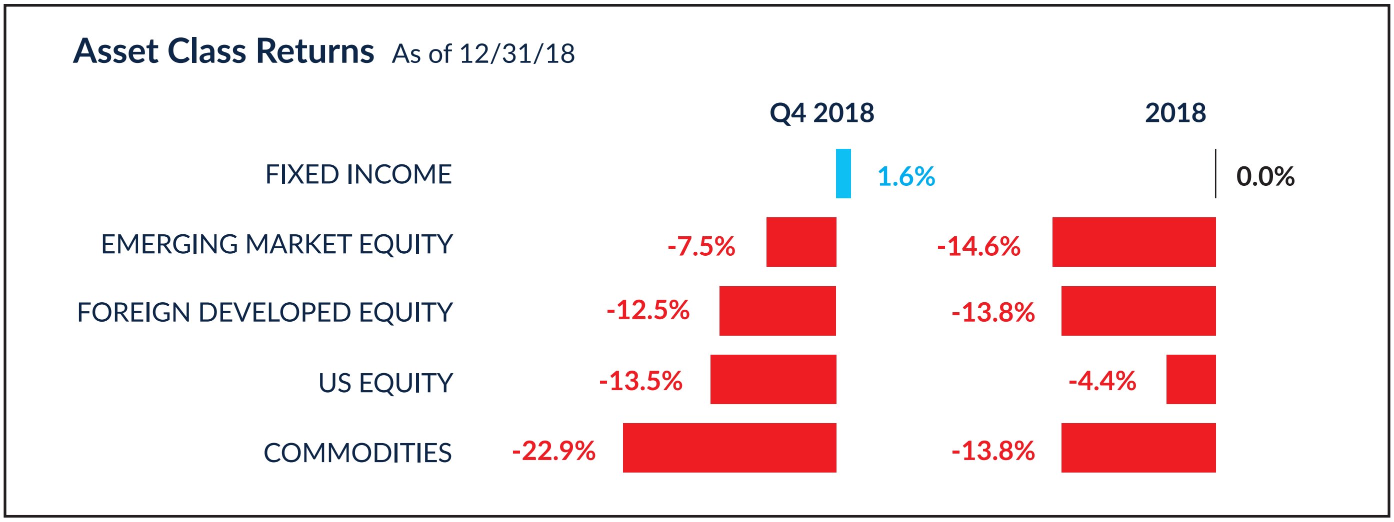

GLOBAL CONTEXT

Internationally, China, the world's second largest economy, just experienced GDP growth of 6.6% and is forecasted to hit just above 6% in 2019 coupled with 2+% inflation. China has also devalued its currency, cut interest rates, cut taxes, and begun to stimulate fiscally, all of which seem likely to benefit its economy in 2019 and help shore up global growth, especially in Emerging Markets. A stronger China economy and a dovish outlook by the Fed would help cap the US Dollar. Since China and Asian currencies make up more than 50% of the trade-weighted dollar, any strength there should result in a weaker dollar, which may benefit international equities. In Developed Markets, things appear murkier. Brexit is proving to be rather messy and concerns around Italy remain in the picture and even the outlook for France is in question. European Manufacturing PMI numbers, which were so strong a year ago, have weakened considerably but remain in expansion territory (although barely). The ECB remains on its path to exit from quantitative easing over the coming quarters and will likely not raise rates until mid-2019 at the earliest.

WE REMAIN VIGILANT

As we move into the New Year, we remain vigilant in an uncertain market environment. A year ago, we were constructive on the world economy, wary of heightened valuations and strong positive sentiment, and believed that any pullback would be short-lived. Today, we still feel that fundamentals remain sound while valuations across the globe have been reset by the recent drawdown and sentiment has soured. The decline we had in December was certainly unpleasant, but it was not unprecedented, and it is good to remember that in the short term, the market trades on emotion but eventually fundamentals prevail. At 14.4x, much has been discounted in the U.S. and international equites, making valuations more attractive. There has been talk of a bear market, which can accompany a recession. On average, bear markets are down 30% over 13 months and it takes stocks 21 months to recover. However, as we do not see an imminent recession, the market may well have approached a bottom with its 20% decline. In 2019, the FOMC remains the focus of investors as markets are clearly concerned over possible further rate hikes and their possible effects on the U.S. economy. China, too, will remain a major focus, with the possible trade war and growth concerns ongoing. We continue to see dispersion among sectors and countries, highlighting the need for vigilance and the ability to move when opportunities arise. Recession dashboards are signaling growth, not warnings, and we are largely constructive heading into 2019.

Sincerely,

Kim David Arthur
CEO and Portfolio Manager