ICR® 4th Quarter Newsletter – January 2019

The fourth quarter represented an about-face in the U.S. stock market. With a loss of almost 14%, the S&P 500 posted its worst quarter since 2011 and dragged the index firmly into negative territory for the year. In one of the most volatile quarters in recent memory, 34 of 63 trading days saw swings of at least 2% in the S&P 500. By Christmas Eve, the market was down over 12% for the year, but the day after Christmas brought a belated gift of a one-day 5% rally. Still, the S&P 500 finished the year down over 6%. Small cap stocks performed even worse, losing over 11% in 2018.

Oil prices plummeted, going from $72.51 per barrel on September 28 to $45.72 by the end of the year, stoking fears of global economic slowing. The large drop in oil prices led to energy stocks posting the worst performance (-23.8%) of any sector. In fact, utilities was the only sector with a positive (1.4%) quarter. For the year, health care and consumer discretionary joined utilities as the only positive sectors.

Foreign markets didn't fare much better in the quarter, with the MSCI EAFE posting a loss of almost 13% to finish down 16.1% for the year. Emerging markets actually held up better for the quarter (-7.8%), but still finished the year with a 16.6% loss.

As fear permeated the equity markets, investors fled to the safety of Treasury bonds, sending the 10-year yield down to 2.68% from 3.06% at the beginning of the quarter. The fourth quarter rally in the bond market was enough to erase the earlier losses in the asset class, leaving the Barclays U.S. Aggregate Bond Index flat for the year.

The U.S. economy is beginning to show some signs of entering its late-cycle phase. That is, expansion has already taken place, labor markets are tightening, wages are rising, and monetary policy is contractionary. The Federal Reserve raised its policy rate another quarter-point in December for the fourth time during the year. However, Chairman Jerome Powell cited some signs of economic softening and "a moderating trajectory for growth." This view led the Fed to lower its forecast to two rate hikes for 2019 from its previously-anticipated three.

One of the big stories recently has been the federal government shutdown due to Congress and President Trump being unable to agree on an appropriations bill to fund the government's operations for the 2019 fiscal year. Just last week, President Trump agreed to a temporary restoration of federal government operations while he negotiates with Congress over funding for a physical barrier at the southern border. If nothing can be agreed upon by the middle of February, we may be looking at the shutdown commencing once again. While the shutdown caused around 800,000 federal employees to go without pay for over a month, the markets largely shrugged off its effects. In fact, during the shutdown, the S&P 500 actually climbed over 10%. That is encouraging, but if the shutdown takes effect again in February and lasts for an extended period, there would likely be harmful economic effects and markets would certainly take notice.

With so many concerning issues – both domestically and abroad – it's no surprise that we've seen a spike in volatility. Trade tensions between the U.S. and China continue to worry investors as there appears to be no end in sight. In addition to their growing rivalry with the U.S., Chinese policymakers are trying to figure out how to stimulate their economy without adding to the already-troubling issues they have with private sector debt. Meanwhile, in Europe, the ability to negotiate a smooth Brexit will also be a closely followed story in the coming months, with far-reaching effects on the rest of the world.

So, how should one invest amid volatility and uncertainty? First, it is important to remember that volatility has the potential to cause investors to do the opposite of the old adage of "buying low and selling high." It is natural to feel fear and anxiety when markets are falling and this can lead to a gut reaction to sell everything in order to stop the pain. Of course, history tells us that when fear is driving us to sell, that is probably one of the best times to buy.

But, one of our goals is to construct portfolios that don't force us or our clients to have to fight the urge to sell in falling markets or, for that matter, to get overly exuberant in a market that may be reaching its peak. That's not to say that one should wear blinders and avoid reacting at all to the market environment. Indeed, volatile markets can provide the opportunity to take advantage when fear – or greed – has caused mispricing of assets. When volatility spikes, it is not about asking, "Should I get in or out of the market now?", but rather, "Where are the opportunities now?" Those opportunities may present themselves simply as discounted prices for certain stocks or bonds. If the investor identifies a reasonable value for a security and the price drops substantially below that level, there may be the potential for gains. Opportunities can also arise in a particular segment of the market. For example, we saw the valuations of midstream energy companies get dragged down with plummeting oil prices. And, while some decrease was probably valid, the degree to which they fell alongside oil may have been overdone.

Mostly, though, it is important to remain diversified during a volatile market and stick to one's long-term investment plan. If the volatility is causing sleepless nights, then it may be time to re-evaluate that plan, but it is always important not to overreact to daily fluctuations.

If you have any questions or concerns, please don't hesitate to contact us. As always, it is a pleasure to work with you and we appreciate the trust you have placed in us.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 12/31/18)

Index	**2018 (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	-6.24	7.04	6.28
Dow Jones Industrial Average	-5.63	10.21	7.07
U.S. Aggregate Bond Index	0.01	2.06	2.52
MSCI EAFE (Foreign Index)	-16.14	0.07	-2.13

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