STERLING
CAPITAL

Investment Review and Outlook
December 31, 2018

***"This is the part of our journey that is the most harsh and difficult. It is where you find out who you are supposed to be when you arrive."* - Mariwether Lewis, American Explorer (1774 – 1809).**

It is now official; the U.S. bull market has finally ended. Despite economic turmoil, political upheaval, and global unrest U.S. stocks plowed higher for 112 consecutive months without experiencing a 20% decline, making it the longest bull market in history. Although trailing two previous bull markets in total return, the S&P 500 rose an impressive 340% from its low on March 9, 2009 to its peak on September 20, 2018. Skepticism loomed over this bull market throughout its run as investors and strategists continuously forecasted its demise as it moved higher.

The collapse into bear market territory came abruptly, and with a vengeance. Throughout the third quarter investors were being treated to a steady stream of positive economic news. Employment gains were the strongest in decades, corporate profits were surging, and consumer confidence was soaring. These economic tailwinds pushed equity prices to record highs in the final weeks of September. Entering the fourth quarter the market was solidly in positive territory with the broad-based Russell 3000 Index up over 10% for the year.

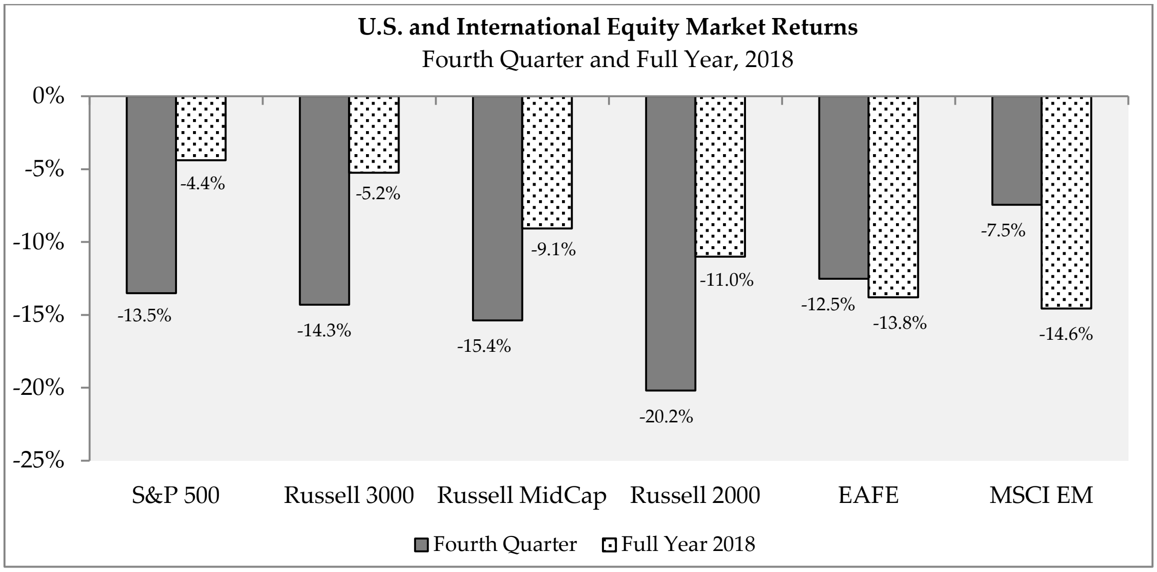
Markets began to crumble when investors shifted their attention away from the rosy economic reports of late summer to the uncertainties that loomed on the horizon. As the quarter progressed economic visibility grew murky. An initial equity pullback in early October quickly accelerated into a full scale downward spiral, resulting in the sharpest quarterly decline since 2008. The S&P 500 dropped 13.5%, the Russell Mid Cap Index 15.4%, and the Russell 2000 Small Cap Index 20.2%.

Investor sentiment quickly turned negative as several troubling issues surfaced. Fear escalated over concerns that the Fed was moving too aggressively in raising short term interest rates. The shift in congressional power following mid-term elections threatened to undermine recently enacted pro-business policies. A tariff standoff with China threatened global growth, and concerns escalated over economic protests in France, a possible Italian debt crisis, and the politically clumsy execution of Brexit by Britain's Prime Minister Theresa May.

Although investors were comforted by a rally in the final trading days of the year, it was far too little to rescue full year results. The broad-based Russell 3000 Index dropped 5.2%, marking the index's first calendar year decline since 2008, and only it's third in the past 25 years. Despite the S&P 500's positive gains through the third quarter the index declined 4.4% for the full year, marking the first time in history that the market entered the fourth quarter in positive territory only to end the year negative.

International stocks marginally outperformed U.S. markets for the quarter with the EAFE Index declining 12.5% and the MSCI Emerging Markets Index sliding 7.5%. However, for the full year international equities trailed U.S. stocks by a wide margin, with major European markets ending the year deep in the red. France's CAC 40 Index finished the year down 11.3% and Britain's FTSE 100 lost 13.6%. Germany's DAX ended the year in bear market territory down 22.8% from its January high, and 18.2% from the start of the year.

The chart below shows the market's sharp fourth quarter decline and its impact on full year results.



Source: Factset, S&P, MSCI

Fixed income markets fared much better as investors fled risk assets and crowded into high quality bonds. Treasury yields declined in the quarter with the 10-year Treasury rate dropping 35 basis points from 3.06% to 2.71%. The market's move to reduce risk pushed the spread between corporate bonds and Treasuries from 129 basis points in September to 188 at the close of the year. The closely watched yield curve remained essentially flat for the quarter as the 10-year versus 2-year Treasury spread finished at a razor thin 20 basis points, after dropping to a low of 13 basis points in mid-October. Overall, bond prices rose in the quarter, which helped push most bond indices into positive territory for the year.

After several quarters of attracting little investor attention commodities moved back into the spotlight. Oil prices collapsed in the quarter as supply/demand forces drove the price of this key commodity lower. Middle East turmoil and Russian production increases, accompanied by a slowing global economy, drove crude oil prices down over 40% in the final months of the year, pushing the full year decline to nearly 30%.

After a grueling fourth quarter investors have reached the *"most harsh and difficult"* part of the economic journey. Market actions have been unsettling, and the path forward remains uncertain.

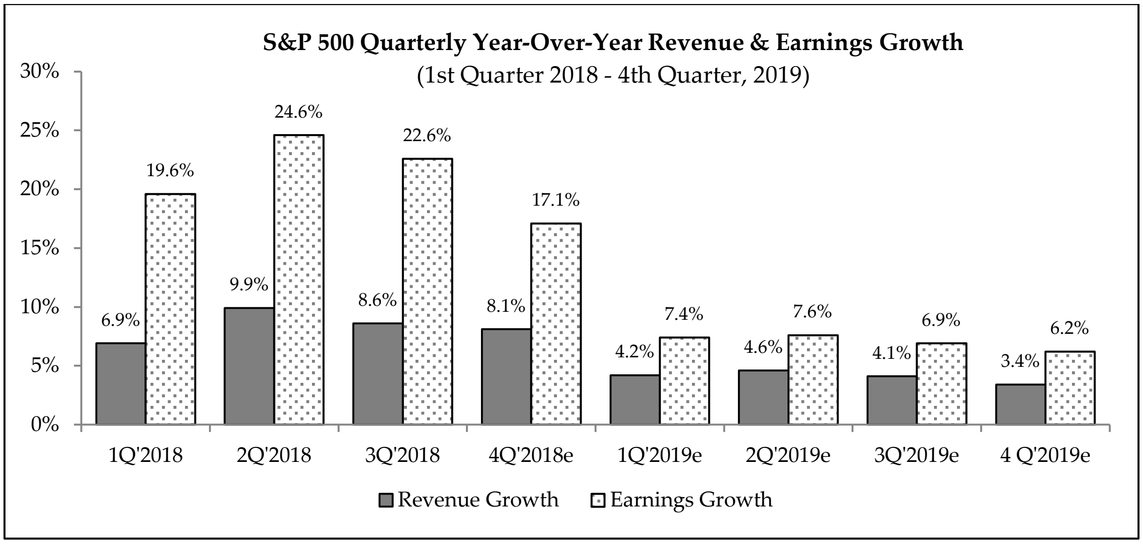
The Economy: Don't Confuse a Slowdown with a Recession

"What appears to be the end of the journey may simply be a bend in the road". **John Denver, Grammy Award winning singer-songwriter (1943 – 1997).**

Although the U.S. economy is slowing, we do not expect the current economic slowdown to spiral into recession. Growth peaked in mid-2018 with second quarter GDP expanding 4.2% and third quarter growth topping 3.5%. Similarly, corporate revenue and earnings growth reached their peak during the same period. The surge in economic growth was driven by a wave of tax cuts, regulatory rollbacks, and expanded fiscal spending.

The "sugar high" spike in economic activity is dissipating, and a more normalized pace of expansion is anticipated in 2019. The economic journey that began in the first quarter of 2009 is not over, we have simply reached a "bend in the road" that occurs when growth slows, but remains positive.

As a result, corporate earnings and revenue growth are expected to slow in the new year. The chart below shows the path of corporate revenue and earnings in 2018 and growth expectations for the new year.



Source: Factset, S&P, MSCI

Top line growth is expected to shift from over 8% last year to marginally greater than 4% in 2019. Profit growth will be dragged lower by slowing revenue growth and profit margin pressures brought about by higher interest costs and rising wages. Despite these pressures on fundamentals we expect both top line and bottom line growth to remain positive.

Although U.S. GDP will slow in the new year, growth should remain solidly in positive territory. Unsustainable economic growth in the 3.5% - 4.5% range experienced in 2018 is expected to subside to a more reasonable range of 1.75% - 2.25%. The positive influences of continued consumer and capital equipment spending, infrastructure expansion, and positive global growth should provide ample demand to buoy the U.S. economy.

This economic course correction to slower growth is not unique to the U.S. The major economies of the world are well into this "downshift" in economic growth. The divergence between the U.S. and the rest of the world became increasingly pronounced in 2018 as U.S. growth moved higher against slowing international markets. The "synchronized global growth" theorem from early last year quickly unraveled with dislocations brought about by the tariff standoff, geopolitical hostilities, and renewed uncertainty over the economic future of the Eurozone.

As the path of economic growth bends current Federal Reserve policy has landed directly in the crosshairs of investor psychology. Since December, 2015 the Fed has raised the fed funds rate nine times. Most often these rate hikes were viewed as confirmation that the economy was trending higher. However, current Fed actions are being met with hostility as investors now view tightening monetary policy as a risk to an already slowing economy. Fed Chair Powell has a difficult economic needle to thread in 2019. In his remarks following the December Federal Open Markets Committee (FOMC) meeting he expressed confidence in the U.S. economy when he stated:

"The U.S. economy continues to perform well. The economy is adding jobs at a pace that will continue to bring the unemployment rate down. Wages have moved up for workers across a wide range of occupations, and inflation remains low and stable."

This positive assessment should provide confidence that the Fed is taking measured steps to prevent economic overheating. However, his follow-up statements raised significant concerns and uncertainty when he said:

"However, some crosscurrents have emerged. Despite this robust economic backdrop and our expectation for healthy growth, we have seen developments that signal some economic softening. Growth in economies around the world has moderated, albeit to still-solid levels. At the same time, financial market volatility has increased over the past couple of months, and overall financial conditions have tightened--that is, they have become less supportive of growth."

To help balance these two statements, and reduce uncertainty, the Fed suggested that future actions by the FOMC will be "data dependent". As with most attempts to straddle the policy fence investors have found little comfort in the Fed's response. Prior guidance by the Fed indicated 3-4 rate increases in 2019. However, after the December meeting Chair Powell revised this estimate lower to only two increases in the new year. Perhaps recent events have tempered their gusto to raise rates too aggressively. We are hopeful this is what Mr. Powell is referring to when he says the Fed is "data dependent".

The Fed's rhetoric, a prolonged trade standoff, and global growth concerns are eroding investor enthusiasm for the new year. Despite the twirling chaos of the current environment we believe the economy will avoid recession, corporate profits will grow modestly, and the Fed has seen the *bend* in the economic road ahead, and will adjust policy accordingly.

The Equity Market: Perspective is Everything

"The only thing you have control over is perspective. You might not have control over your situation, but you always have control over how you choose to deal with it." **Steve Jobs, inventor, philanthropist, co-founder and former CEO of Apple, Inc. (1955 – 2011).**

Maintaining the proper perspective is difficult, especially during turbulent times. The temptation to chase the latest "shiny object" often overwhelms rational behavior. Dramatic volatility, economic crosscurrents, and political brawling is too much for most investors to ignore. Combine this intoxicating environment with the opportunity to make money and the stage is set for investors to over-think, over-react, and underperform.

With the benefit of hindsight we know there are certain aspects of investing that hold true through the most trying of market conditions. We know the actions investors take to align security prices with underlying economic fundamentals can be an ugly process. Volatility is most pronounced when macro-economic forces shift. History tells us that investors overshoot valuations to the upside when expectations turn positive, and indiscriminately punish equity prices when the economy begins to soften.

Economic inflection points are brutal to those investors caught up in the mania of the moment. We are not minimizing the pain experienced from the recent erosion in stock prices. However, we do not believe 'panic' is a viable long-term investment strategy. In fact, our preference is to stay above the market fracas and adopt a perspective that keeps us focused on how portfolios are allocated, and maintain a long term perspective. We gain comfort in knowing that markets are functioning in an orderly fashion, without structural impediments, and we accept that the new slow growth environment will deliver lower equity returns and higher volatility than experienced over the past several years.

Perspective tells us that abandoning equity markets after they fall into bear market territory is a costly strategy. As jarring as the market's recent drop has been we know that following every bear market decline since 1950 the S&P has traded higher than its previous peak within five years. These bear market recoveries have rewarded patient investors with significant returns. In addition, during difficult market times it is important to stay focused on the portfolio's overall asset allocation. Diversification not only drives market returns, but also determines the portfolio's volatility risk. Understanding the importance of maintaining a long-term perspective helps investors weather the periodic market downturns that come in the equity markets.

The investment landscape is filled with investors who have found themselves on the wrong side of a market move that has left them unable to achieve their long term investment objectives. The most destructive influence on investment results occurs when investors attempt to time the movements in the market. Effectively anticipating when to enter and exit the equity markets is an exercise in futility at best, and financial suicide at worst. The most important investment perspective history offers us is that maintaining the appropriate asset allocation through market turbulence will reward investors by allowing them to achieve their long term investment objectives.

Market Outlook & Investment Strategy

"Where the road bends abruptly, use caution and take short steps." Ernest Bramah, English author and educator (1868 – 1942)

Market Outlook:

As we enter 2019, the economic "juice" that excited the markets is running low, causing the journey ahead to be more challenging than in previous years. Our investment strategy remains focused on building portfolios to withstand turbulent markets through broad diversification and an emphasis on the long term. However, in the near term we believe there are three key challenges confronting investors that will need resolution before markets can move meaningfully higher.

First, the Fed is continuing its monetary tightening by signaling two additional rate hikes in 2019, after four increases last year. Restrictive monetary policy, with a flat yield curve, at a time when global growth is decelerating could choke off an already slowing economic expansion. We share the market's concern that there is a risk the Fed moves too aggressively and overshoots its objective to slow the economy.

For now, we believe Fed Chair Powell is focused on the right economic metrics to help guide the FOMC's actions, and he has demonstrated the ability to be flexible and adjust policy as needed. Until there is more clarity investors will assume the worst outcome.

The second challenge facing investors centers on resolving the trade impasse with China. Several critical issues have developed that make a mutually beneficial trade agreement essential for continued economic growth for both the U.S. and China. China is the second largest economy in the world, and is expected to grow at 6%-8% annually for the next several years. Our trade with China has become more complicated with high-valued goods such as technology and telecommunications equipment now accounting for the majority of traded goods versus low-valued products such as textiles, furniture, and tobacco that dominated our trading relationship less than a decade ago. Striking a trade deal, even if only marginally effective, would alleviate a significant concern investors are currently feeling.

Finally, the political battles that raged during the first two years of the Trump administration were just an opening act to what is likely to be the main event. The shift in power within Congress after the mid-terms has already set off a political brawl over economic and national security issues. Normally, we would not be concerned with political infighting. However, the depth of divide, and the lengths elected officials are willing to go to achieve their objectives, has us paying closer attention to what is happening in Washington. Although we believe politics will have less influence on the markets relative to the larger issues of monetary policy and global trade, we will be watching closely so as not to be blindsided by a political battle that spills over into the financial markets.

Swift and positive resolution to all three of these challenges is not expected. Our expectations are that markets will deliver muted returns and violent volatility as they plow through these messy issues. Investors that adhere to an investment discipline of diversification and maintaining a long term perspective will be best positioned to withstand the slow grind that lies ahead.

Investment Strategy:

Given the market's sharp fourth quarter decline and the high-pitched rhetoric streaming through the financial media, investors may feel the urge to shift their investment strategy in reaction to recent events. Our belief is that the market's shift to a slowing economy is not sufficient to trigger a major reallocation of assets within well-established portfolios. For that reason we are maintaining our existing exposure to the U.S. and international equity markets. Our belief is that current conditions will create additional volatility to an already unstable market; but we do not see a protracted decline in U.S. equity markets from current levels. Our strategy continues to emphasize diversification across capitalization, investment style, and discipline – to include both active and passive approaches.

International markets present their own set of challenges. After trailing U.S. markets for over a year, it is difficult to predict when a shift in global equity leadership will occur. However, we are certain that international markets offer unique growth opportunities that will eventually be recognized by investors. In addition, history demonstrates that relative performance in international markets comes quickly, and without notable indication before it occurs. Given this dynamic we are maintaining our exposure to international equities in both developed and emerging markets. We currently favor developed markets over export-oriented emerging markets due to a higher level of certainty regarding near-term growth prospects.

Our interest rate outlook continues to call for rates to rise across the maturity spectrum, with short rates leading long rates higher as the Fed continues its restrictive monetary policy. This environment makes portfolio decisions regarding duration, credit selection, and yield curve positioning extremely important when considering the total return potential of bond portfolios. Our view is that the best approach is to emphasize corporate securities over Treasuries and agency bonds in taxable portfolios. In addition, we remain positive on high quality municipal bonds, and believe current yields relative to corporate bonds are attractive.

We are positioning portfolios short of their benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. On a more optimistic note, higher yields will result in increased income generation, something investors have not experienced in many years. We believe our current fixed income strategy is positioned well to effectively navigate through the crosscurrents of the current interest rate environment.

It is difficult to launch into a new year in the aftermath of a decisively negative quarter. We believe that 2019 will require investors to temper their expectations and brace for wild market swings. As the year unfolds it is most important that investors understand the importance of holding a diversified portfolio that is built to achieve long term objectives.

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