Northport Investment Management, LLC
A Registered Investment Adviser

Market Commentary – 4th Quarter 2018

After producing solid returns through three quarters, it turned into a tough year for U.S. stocks, with all three of the major stock indices having their worst annual performance since 2008. Fear of slowing global growth and the possibility of overly aggressive Federal Reserve interest rate hikes sparked a fourth quarter sell off, with extreme volatility, exacerbated by automated trading. The Dow lost 11.8% in Q4 2018, and lost 5.6% for the year. The S&P 500 fell 14.0% in the fourth quarter and fell 6.2% for the year (-4.4% with dividends). The tech-heavy NASDAQ Composite declined 17.5% for the fourth quarter and declined 3.9% for the year. It was the worst December for U.S. stocks since 1931. It was also the first time in many years that any of the three major stock indices finished the year in the red after rising in the first three quarters.

Diversification into other equity classes did not help equity performance in the quarter or for the year. Mid-Cap, Small-Cap, developed international and emerging market categories all performed poorly. U.S equity declines were broad-based in 2018, with nine of the eleven S&P 500 Sectors negative (six in double-digits). Energy (-20.5%), Materials (-16.4%) and Communications Services (-16.4%) were the worst. Healthcare (+4.7%) and Utilities (+0.5%) were the best. In the Dow 30, Merck (MRK) was the best 2018 performer (+35.8%) and Goldman Sachs (GS) was the worst (-34.4%).

Bonds outperformed stocks in the fourth quarter, as bond yields, which had climbed at the start of 2018, eventually retreated from their highs. Optimism over the inflation outlook, solid economic growth, and a consensus that the Federal Reserve would raise interest rates two or three times in 2019, had all played a part in keeping the benchmark ten-year Treasury yield above the psychologically significant 3% threshold. The retreat in bond yields, which reflects buying of government paper, driving yields lower, came after the 10-year Treasury yield touched a high of 3.26% on November 8. Surging stock volatility, and a more negative outlook, fueled this demand for bonds' more certain returns. The ten-year Treasury yield closed the year at 2.69%, up from the 2.41% yield where it ended in 2017.

Worries about rising interest rates, trade tensions with China, slumping oil prices, and peaking corporate earnings have slammed U.S. stocks over the past two months. Many are calling for the Federal Reserve to pause its rate increases, fearing some pockets of the U.S. economy are already buckling under the pressure of tighter monetary policy. Synchronized global growth has turned into slowing global growth. A quick, steep, drop in the stock market can contaminate sentiment and can feed on itself. Market volatility could feed back into economic weakness. How worried should we be?

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While the many risks are real, and concerning, all of the craziness makes it hard to focus on the fundamentals. Fundamentals are where our focus should be. We are a consumer economy, and the consumer is in good shape. When we look at the economy, inflation, monetary policy, equity valuation, and competition from bond yields, all bode well for the equity markets. The backdrop is favorable, albeit slower. The stock market is priced for the risk of an imminent recession, which appears unlikely. This sour investment sentiment is a contrarian indicator. In 2018, we went from an overly rosy view to recession. The reality is probably something between these two views. We are most likely witnessing a technical correction. Valuations have now decreased to levels that are supported by the fundamentals. Our economy is slowing, but still growing. Earnings growth estimates have declined for 2019, but are currently around +6%. The stock market may be overreacting to this slowing and underestimating the momentum of our economy. A massive policy mistake could trigger a recession. This could happen over a trade war, or from Fed actions. We envision progress on trade with China, because a lack of progress would be a lose-lose situation for both countries. We trust that the Fed will be flexible, using all of its tools to support our economy, and will not be on automatic pilot.

2018 was another good year for dividend increases from our individual equities. Generally speaking, our more conservative, total-return oriented, individual equities, out-performed in the downturn. Nevertheless, the past quarter was a sharp gut check. Stocks provide high rates of return over long time horizons because you have to take the temporary pain and volatility. The key is to weather the periodic storms and to stay on course. We have intentionally increased equity exposure during the current bull market, and this has paid off handsomely over the past decade. With extreme volatility here to stay, one should confirm that their current equity exposure remains a good match for their risk tolerance and current circumstances.

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