

Introduction

2018 started with such promise, on the heels of one of largest tax cuts in US history, and markets hit new highs in the euphoric first few weeks of the year. However, as the year progressed, investors became increasingly pessimistic about prospects for global growth amidst a backdrop of Federal Reserve interest rate increases and trade tensions. By the time the year ended in a barrage of superlatives (worst year, month, and quarter since the financial crisis, biggest point increase in a single day, worst-ever Christmas Eve, biggest single day rebound), the S&P 500 was down 4.4% and investors were feeling less than festive.

The S&P 500 drop of 13.5% for the quarter erased all earlier gains for the year and more, flirting with bear-market territory after a nearly 20% decline from the high level reached in September. During this period, the only sector that had a positive return was the defensive utility group. For the year, only healthcare and consumer discretionary stocks joined utilities to end 2018 in positive territory. Energy stocks were particularly hard-hit as oil officially entered a bear market, dropping 38% after hitting a 4-year high just in October. While international stocks lagged those in the US for much of the year, impacted by US dollar strength and trade disputes, they actually outperformed during the 4th quarter. The MSCI EAFE Index of developed international stocks declined 12.5% while emerging markets declined only 7.4%.

Although not as volatile an asset class as stocks, bonds offered little respite. The Bloomberg Barclays US Aggregate Bond Index ending the year flat; in response to market volatility and global growth concerns, the bellwether 10-year US Treasury yield was unable to hold above the 3% threshold and ended the year at 2.7%. Bond yields drop as prices rise. The flattening of the yield curve, with 2-year yields and 10-year yields converging, continues to receive a great deal of attention as a potential signal of an impending recession.

For the upcoming year, the question remains as to whether recent market declines merely are a correction or whether the market is correctly anticipating a recession and, with it, the end to the longest bull market on record. Given still-low unemployment and inflation, wage growth, strong consumer spending and so forth,

we are not necessarily conflating an expected slowdown in economic growth with a recession and do not foresee one in 2019. Despite this view, we see enough risks in the economy to share the view that growth will slow, and we fully expect the result will be market volatility that is more apt to be the norm (2018) than the exception (2017).

4th Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 12/31/18

	4Q 2018	YTD Return	Price / Value
Dow Jones Industrial Average	-11.3%	-3.5%	23,327
S&P 500 Index	-13.5	-4.4	2,507
Russell 2000 Index	-20.2	-11.0	1,349
MSCI EAFE Index	-12.5	-13.4	7,048
MSCI EM (Emerging Markets)	-7.4	-14.2	2,163
Barclay's Capital US Aggregate	1.6	0.0	100
Barclay's Capital Municipal Bond	1.7	1.3	107
Gold – Continuous Contract	7.1	-2.1	\$1,281
Light Crude Oil – Continuous Contract	-38.0	-24.8	\$45

Source: Factset

Economy

Despite the healthiest employment picture in five decades, economic growth seemed to buckle heading into 2019. After peaking at a 4% annual rate of growth over the summer, the uncertain impact of the trade war and future tariffs dented business confidence and derailed corporate investment. As a result, annualized GDP growth downshifted closer to its long-term trend of 2.5% by year-end. We are encouraged that the economy continues to create jobs well in excess of what is needed to absorb new entrants into the workforce, and the unemployment rate resides at 3.7%, the lowest level since 1969. However, the trade conflict in particular seems to be hindering the manufacturing sector. According to Bloomberg, all six regional manufacturing surveys were weaker in December, with shrinking orders increasingly blamed on tariffs related to aluminum and steel. Meanwhile, the broad, double-digit percentage drop in the equity markets took its toll on confidence measures, albeit from elevated levels. Consumer confidence fell to the lowest level in five months in December, with most of the damage residing in the “expectations” component. Of concern, the deterioration occurred before the government shutdown which in past experience has a negative impact. Given the unique nature of this shutdown and the uncertainty regarding its duration, sentiment has the potential to fall further heading into 2019.

Despite the recent manufacturing weakness, consumer spending, which accounts for nearly 70% of domestic economic activity, remains on solid ground. The sharp drop in gasoline and energy prices in the run-up to the holidays was a boon for retailers. According to MasterCard, retail sales in the November/December period were up 5.1% versus last year’s pace, the biggest increase in six years, while online sales surged 19% over the period. Overall, we expect consumer spending to remain healthy in the coming year, which should help keep the economy growing as uncertainties related to US trade policy are resolved. In addition to lower fuel costs, the orderly rise in wages over the past two years and low level of aggregate layoffs (notwithstanding the high-profile GM plant closures) also are supportive of robust consumer behavior. The full benefits of the tax cut likewise provide a boost to confidence and make recent activity seem more durable. Spending this late in an economic cycle often is driven by leverage and a surge in borrowing. However, recent consumption coincides with a sharp increase in personal savings rates, fostering optimism that consumer balance sheets are not stretched and can support further outlays.

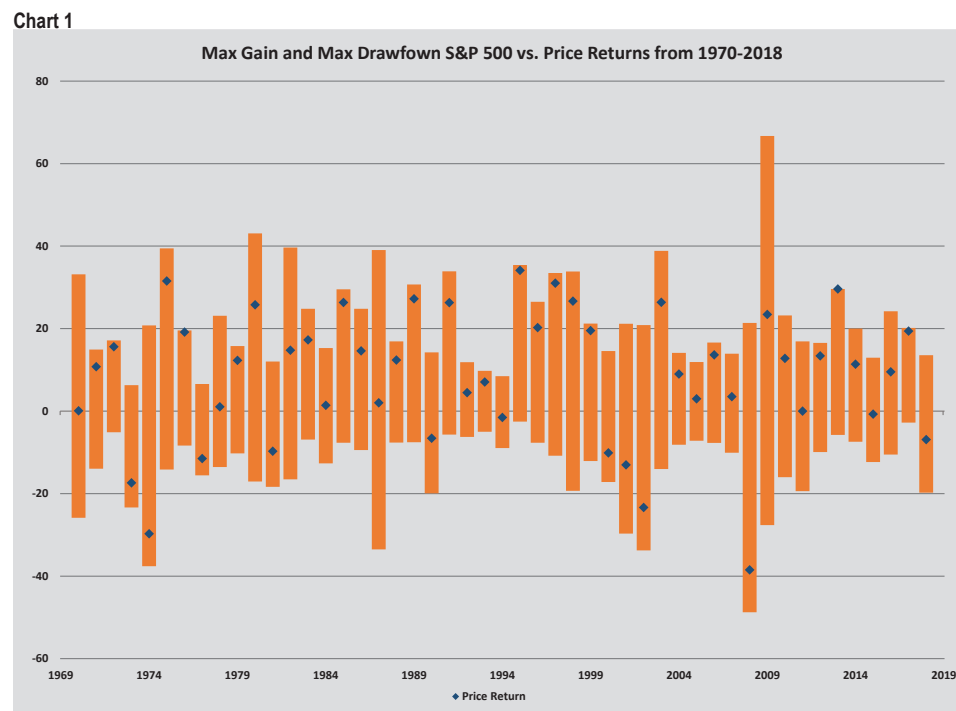
Perhaps the greatest risk outside the political arena is the Fed’s persistent interest rate increases, which serve as a preemptive tool to cool wage growth before it becomes problematic to the overall inflation picture. The Fed’s actions already have had an adverse effect on the housing market via higher mortgage rates. While we believe tighter monetary policy was appropriate in the middle innings of the recovery, volatility in the financial markets seems to be communicating the need to slow the pace in 2019. Given that measures of consumer confidence, industrial activity, housing and business leader sentiment are rolling over at the same time the government has shut down and the trade impact of tariffs is ambiguous, we would agree. The fact that monetary policy impacts the economy with a lag of up to a year is further reason to err on the side of caution. Therefore, we expect the Fed will not make a policy error that will result in a recession this coming year, and will pause its rate increases to assess the efficacy of its actions. That being said, we do not expect last year’s peak rate of economic growth to return and instead anticipate the more sustainable, low-2% pace of growth to prevail. While a Fed pause combined with a bipartisan infrastructure bill could generate a somewhat stronger pace of growth heading into 2020, we would expect any such deal, while likely to some degree, will be modest in regards to fiscal policy.

Equities

After an extended period of looking the other way, investors stopped shrugging off geopolitical rhetoric and unproductive discord in the fourth quarter. Following a very calm 2017, global markets ended the year much like they began with increased volatility and discomfort about the future. The S&P 500 finished down 13.5% for quarter and 4.4% for the year. By the end of September, US equities reached a high-water mark, up 10% for the year, but then declined sharply by just less than 20%, culminating in a Christmas Eve swoon. Markets rallied into year-end but recorded the weakest December since WWII, down 9% for the month. The US equity market still outperformed both international developed and emerging markets for the year.

Concerns over slowing global growth were exacerbated by fears of a trade or monetary policy mistake. Despite generally robust current conditions of full employment, growing wages, and a confident consumer, the constellation of

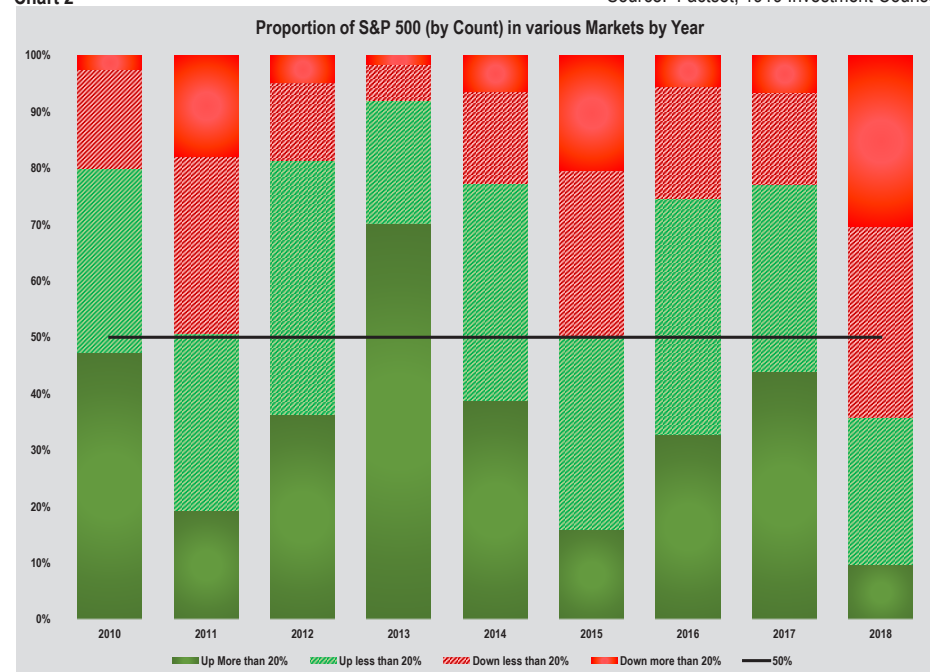
concerns drove many to take profits. As the selling pressure grew, volatility was likely exaggerated by the growing role of quantitative investment strategies and the proliferation of trading venues over the last 10 years. While the volatility during the year was significantly higher than in 2017, it was not an outlier when compared to a longer sample as illustrated in chart 1.



Source: Factset, 1919 Investment Counsel

The year-end selloff was broad, leaving more than 60% of the S&P 500 stocks down for the year, a condition that has not occurred post the financial crisis (see chart 2). Valuations for stocks became more reasonable as earnings per share (EPS), helped by corporate tax cuts, rose sharply in 2018 while prices dropped. The S&P 500 ended the year with a price-to-forward earnings estimate (forward P/E) of 14.4x. This level compares favorably with the 25-year average valuation of 16.1x, but it is still not nearly as cheap as the low levels reached in 2009 (10.4x) and 2011 (10.3x). Other valuation measures using book value, sales and EBITDA show the market still above the long-term averages and well above the lows of 2009 and 2011.

Chart 2 Source: Factset, 1919 Investment Counsel



Robust returns were not to be found in equities or other asset classes as markets lost the support of an accommodative central bank. Across the major asset and sub-asset classes, not one returned 5% or more for the year. This has not occurred since at least 1972.

As shown in the chart below, across equity sectors, leadership shifted from technology and communication services to the more defensive consumer staples and utilities. For the year, health care was the big winner, up 6.5%, outperforming in both strong and weak quarters. Utilities came in second at 4.1% due to the sector's limited sensitivity to an economic slowdown and to trade policy.

	Q1	Q2	Q3	Q4	2018
Comm Svcs	-7.5%	-0.9%	9.9%	-13.2%	-12.5%
Cons Disc	3.1%	8.2%	8.2%	-16.4%	0.8%
Cons Staples	-7.1%	-1.5%	5.7%	-5.2%	-8.4%
Energy	-5.9%	13.5%	0.6%	-23.8%	-18.1%
Financials	-1.0%	-3.2%	4.4%	-12.3%	-14.7%
Health Care	-1.2%	3.1%	14.5%	-8.7%	6.5%
Industrials	-1.6%	-3.2%	10.0%	-17.3%	-13.3%
Info Tech	3.5%	7.1%	8.8%	-17.3%	-0.3%
Materials	-5.5%	2.6%	0.4%	-12.3%	-14.7%
Real Estate	-5.0%	6.1%	0.9%	-3.8%	-2.2%
Utilities	-3.3%	3.7%	2.4%	1.4%	4.1%
S&P 500	-0.8%	3.4%	7.7%	-13.5%	-4.4%

Source: Factset

Looking forward, we are optimistic that the US and Chinese governments will agree on a trade deal. Each side is strongly incentivized to calm investors, business owners, and consumers (voters) and move forward. This will remove a significant concern for all parties. We believe the Fed will act responsibly and avoid inverting the yield curve and triggering the associated recession warning. If continued rate increases are warranted, they would be driven by a healthy and growing economy supportive of growing corporate profits and share prices. In our base case, we expect S&P 500 earnings to grow 5% in 2019. Global growth clearly is slowing, and it is unlikely the US will be immune.

We continue to believe strong corporate cash flows, associated share repurchases, and dividend increases will continue to support equity markets. Companies that deliver revenue and earnings growth, maintain healthy margins and balance sheets will garner attention and capital. We will continue to seek out these businesses for inclusion in our clients' portfolios. We expect that a higher level of volatility will continue, and investor confidence will be challenged again in the coming year. Given the recent equity price declines, low interest rates, favorable regulatory environment and motivated administration, we believe that equity investments will outperform fixed income and cash in 2019. A return to the September 2018 peak would require price appreciation of 17%. While this would be a welcome outcome, we do not believe the full recovery period will occur in the near term and is more likely to extend beyond 2019.

Economic and Market Drivers

Tailwinds	Headwinds
Low US unemployment	Political Policy Uncertainty
US & Chinese Leaders Motivated to Resolve Trade	Protectionist Trade Policies
US Improving Real Household Income	Global Growth Moderation
Low Long-term Interest Rates	Fed Policy – Rising Rates & Balance Sheet Runoff
US Healthy Consumer	Recession Concerns Rising
Lack of Investor Euphoria – Better Valuations	China Slowdown / Deleveraging
Low Inflation	Tight US Labor Market – Rising Labor Costs
Lower Energy Prices Help Consumers	Expanding Debt Service on US Federal Debt
US Household Formation Increasing	Aging Demographics in Developed Markets

Bonds

Focusing on the quarter, the Bloomberg Barclays Aggregate Index posted a positive 1.6%, led by a rally in Treasuries, as a flight-to-safety took hold amid growing political uncertainty, both domestically and globally. For the full year, the benchmark ended effectively flat (up 0.01%). The Treasury curve has sustained its bear flattening in 2018 with yields for every maturity moving significantly higher, while the ultra-short end led the curve shift upward with the heftiest boost in yields. However, it was the rate ascent in the long end that kept the lid on returns. With the increase in Treasury yields and widening of corporate credit spreads, the miniscule gain posted by the index for the year is actually quite respectable. Our forecast for higher Treasury yields and a flatter curve throughout 2019 means that we will maintain our shorter duration stance as there is little incentive to take on longer duration risk.

The other notable occurrence mentioned above has been the widening of credit spreads. As a reminder, when Treasury rates rise, assuming fundamentals have not faltered, the spread between them and investment grade corporate bonds should narrow. However, decreased demand from overseas investors and the risk-averse trend that was on again mid-quarter meant that corporate bonds would be one of the worst performing asset classes for 2018, losing 2.5% for the year, even though supply dropped by about 12%. After reaching new issuance records year after year, the investment-grade corporate bond market appears to have reached its peak in 2017. Tax reform, decreased M&A activity and increasing rates should suppress the need for additional debt going forward.

With rating agency downgrades outnumbering upgrades and the majority of new corporate issuers entering the market with BBB-rated bond offerings, BBB-rated debt has grown to about half of all investment grade debt. General Electric's epic slide into this rating category prompted many investors to become concerned about the health of the corporate bond market more broadly. While some companies have taken on too much debt during this prolonged period of low interest rates, we are comfortable with our current overweight to the sector, on an issuer-specific basis. However, we will continue to look for opportunities to lessen the overweight throughout 2019, well ahead of the prospects for a recession, which we are not anticipating over the next 12 months. Despite the expectation for solid GDP growth, our outlook for corporate bonds in 2019 is somewhat muted, as waning demand for the paper may persist.

Municipal Bonds

Municipal bonds provided sanctuary from the late-year market chaos for beleaguered investors. Despite outflows from municipal bond mutual funds in every week of the quarter, the strong Treasury rally pulled yields on high-quality tax-free bonds lower during the period as well. The result was a sturdy 1.7% quarterly return for the Bloomberg Barclays Municipal Bond Index, a proxy for the entire investment grade municipal market. The flight-to-quality rally pushed the index into the black for the year, rising 1.3%. While this is subdued compared to recent experience, tax-free bonds handily outperformed all other fixed income alternatives, most of which suffered losses as risk aversion prevailed. We expect this trend to continue into 2019 as uncertainty related to the trade dispute's impact on the economy, the government shutdown, and heightened volatility within the equity markets should favor safer options like high-quality local government debt.

Treasury yields usually set the course for other investment-grade fixed income securities, municipal bonds included. Therefore, it was not unexpected that municipal yields moved higher in 2018 despite the strong rally late in the year. The Fed, now chaired by Trump-appointed Jerome Powell, maintained the strategy of previous Chair, Janet Yellen, of raising overnight interest rates once a quarter, which pressured short maturity yields higher. Concurrently, the Fed remained committed to reducing the amount of longer-maturity Treasury bonds the Fed had on its balance sheet. These bonds were bought during the credit crisis in an attempt to keep borrowing costs low and stimulate the economy. Not surprisingly, the Fed's reduced demand for these securities forced longer-maturity yields higher as well.

Additionally, despite passage of a tax cut that on the surface should reduce the value of a tax-free income stream, demand for tax-free income remained resilient for most of the year. We believe the limitation of the deductibility of state and local taxes (i.e. SALT) for high-income residents played a role in this demand dynamic, creating the possibility of a higher tax bill despite lower marginal tax rates.

Dependable tax havens such as municipal bonds were beneficiaries as wealthy taxpayers await the result of this April's tax season before deciding how to navigate the current ambiguity of the law. We expect investors' worries will prove valid, particularly within wealthy, high-tax states such as New York, California, New Jersey, Connecticut, Maryland and Massachusetts, where the new \$10,000 limit on SALT deductions in most cases will be reached quickly. Tax-free bonds should continue to benefit accordingly, particularly within the aforementioned states.

While it is possible that yields move higher from here, it seems the Fed's previous tightening moves successfully cooled the prospects for an overheating in the economy and, more importantly, inflation expectations. The resulting volatility within other risk-based assets, primarily equities, should likewise buoy the prospects of conservative, high-quality assets such as tax-free bonds. While we forecast the economy to slow from the pace of mid-2018, we do not forecast a recession this year, so credit trends within the municipal space should remain healthy.

Conclusion

2019 marks the 100th anniversary of the founding of our firm. Throughout that period, our sole focus has been on investment management and counsel for our clients, whether in periods of war, political upheaval, terrorism, depression, recession or, of course, bull markets that one wishes would go on forever. As investors ourselves, we understand how unsettling it can be when markets are volatile. Yet the legacy of being in this business for so long is that we constantly are reminded of the importance of a long-term investment strategy, one that should not be derailed by short-term market moves. The market had a pretty good year in 1919; our hope is that it does in this anniversary year too!