U.S. stock markets took volatility and turned it up in the final quarter of the year. The 4th Quarter was brutal across the landscape with all the major indices suffering losses—wiping out any gains from the first three quarters. Internationally, the strength of the U.S. economy and the impact of a strong U.S. dollar put strains on both developed and emerging markets. The impact of tariffs on China also contributed to an overall negative year for international markets and the Federal Reserve roiled the markets with its 4th rate hike of the year. While the Fed has hinted it will be more data dependent in its decision making in 2019, it won’t show up until the first Open Market Committee meeting on January 29-30th.

This year tested all of us in a manner last seen during the Great Recession. Our reaction to short-term market volatility (without stepping back to look at more than the last trading day or week) is the single largest hindrance to achieving our investment goals. It is vital to know ourselves when markets are calmer so that when they are riled up, we can manage our emotional response a bit and keep on track. In our experience, there is never a good time to make an emotional decision regarding your portfolio. (continued on pg. 4)
July 2019 will mark a significant milestone for the American economy barring an abrupt change from positive to negative economic growth. The current economic expansion started in June 2009 following the Great Recession and is the second longest (since at least 1857 when the National Bureau of Economic Research started maintaining records). Growth was strong in 2018, rising 4.2% in the 2nd quarter and 3.5% in the 3rd quarter on an annualized basis. The unemployment rate is 3.7%, the lowest since 1969, as the economy has added almost 20 million jobs over the last eight years.

The Federal Reserve raised interest rates four times in 2018, increasing the target range on the federal funds rate from 1.25%-1.5% to 2.25%-2.5%. There is much debate on whether the Fed will ease up on the pace of additional rate increases in 2019 as it tries to keep inflation in check without hurting economic growth. Annual inflation for 2018 is expected to be 1.9% (in part due to lower energy prices) and slightly down from 2.1% in 2016 and 2017. If current inflation trends hold, the Fed may slow the pace of future interest rate increases as it continues the move back to normalized short-term interest rates in the 3% to 4% range.

Political change is coming now that the Democrats have regained control of the House of Representatives and President Trump’s negotiating skills should be put to the test as he works to advance his agenda. Democrats may decide to be obstructionists and block Republican legislative initiatives, but they would do so at the risk of getting labeled as “do-nothings”. Republicans will need to adjust to divided government by demonstrating a willingness to compromise and work across the aisle to make legislative progress. The worst-case scenario for Republicans would be an economic slowdown going into a presidential election year.

The administration will likely take another shot at getting a $1 trillion infrastructure bill passed in 2019 after failing miserably in the first attempt (which would have required state and local governments to fund at least 80% of the costs). To get the support of Congress, especially Democratic leadership in the House, President Trump will need to include significantly more federal funding to achieve success. Infrastructure may be President Trump’s best hope for domestic success as it is unlikely Congress will partner with the administration on border security, immigration reform, additional tax cuts, or changes to health care.

Any attempt by the House to impeach President Trump would most certainly halt any prospects for legislative progress, but it is almost certain that he wouldn’t be convicted by the Senate even if impeachment were successful, as the Constitution requires a two-thirds supermajority for conviction.

At this point in the expansion it is certainly reasonable to wonder when the next recession will occur. Most economic forecasts are predicting decelerating growth in 2019 and possible recession in 2020. The Conference Board’s Leading Economic Index is not currently flashing warning signs for a recession, and it is likely President Trump will take active measures to reduce the risk of an economic slowdown in an election year.

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So, despite the underlying strength of the American economy, caution abounds and we expect 2019 to be a year of headline risk—both to the upside and downside. Most of the “breaking news” out there is just noise. Unfortunately, financial markets hate uncertainty and we have plenty of it. Just resolving any number of issues – such as the Mueller investigation, the Trade War with China and the outcome of Brexit—will help reduce our collective angst. In the meantime, markets will likely remain more volatile than they have been in recent memory. For the long-term health of your portfolio and financial plan, we encourage you to focus on those things in your life you can control and avoid worrying about those things you can’t control.
We begin the new year with a continuation of a divided and dysfunctional government in Washington, which I generally believe will be a positive brake on both parties’ worst instincts.

There are several areas to watch in 2019. First, legitimate progress in trade talks between the United States and China—this was the most significant contributor to volatility and economic uncertainty during the 4th quarter of 2018 and we will know much more by the middle of February.

Second, corporate earnings growth—we will have had a full year under the new tax act and the sustainability of growth in earnings will impact stock market sentiment significantly in the first two quarters of the year.

Last, will the Federal Reserve decide to take a “wait and see” approach on additional rate increases? Previously we had anticipated 2-3 more hikes in 2019 but Chairman Powell may adopt a more data driven approach. Their first meeting is January 29-30 and markets will parse the statement released with a telescope to rival the Hubble.

After experiencing a historically low rate of market volatility in 2017, investors saw a 2018 that was at the other end of the spectrum. For most investors, their biggest fear is a sudden stock market downturn that greatly reduces their portfolio. For those approaching retirement, this is even more of a concern. Even if we know a volatile market in the short-term will produce positive returns over the long run, a few negative years at the beginning of retirement can lead to a permanent shortfall for retirees. Although there are no signs of a deep recession, recent stock market volatility is rattling some investors. One recent survey from Allianz Life showed that 38 percent of Americans thought that if the market experienced a significant drop, there is no way they could rebuild their savings in time for retirement. (Source: 2018 Market Perceptions Study from Allianz Life Insurance Co.) This sentiment is why the asset allocation decision between equities and fixed income is the most critical decision to be made for an investment portfolio.

As we’ve written in previous newsletters, the investment grade bonds that we use are not highly correlated to the stock market. They tend to retain value and return income during periods of stock volatility. Vanguard completed a study in 2017 that looked at the period January 1988 to June 2017. Investment grade corporate and municipal bonds had positive returns even in periods where U.S. stocks averaged negative monthly returns of nearly 8%. (Source: The Vanguard Group, Fixed Income Series)

There are inherent risks with any investment. As the Federal Reserve raises interest rates over the next few years, bond investors must understand that bond prices and interest rates are inversely correlated. The way we protect clients from bond price volatility is by holding bonds to maturity. For investors with large fixed income portfolios, we use individual bond ladders to diversify their investment and control the interest rate risk. For those with smaller fixed income portfolios, it is more efficient for us to diversify using bond ETFs (and preferably ETFs that hold bonds to maturity). The key is holding to maturity so that unless there is a default (highly unlikely in investment grade bonds), the investor knows the rate of return at the time of bond purchase.

Bond mutual funds do not hold until maturity, and this is where the issue arises. When interest rates rise, bond prices fall. Trying to find bonds that will increase in value in a rising interest rate environment is a nearly impossible task for the bond fund manager. That is why Morningstar data shows that all intermediate and long-term taxable bond fund categories have negative returns for 2018. This means that even the “safe” part of investors’ portfolios is losing money (which only compounds the problem if the stock market has negative returns as well). Buying individual bonds (either individually in ladders or in ETFs) and holding to maturity is the key to weathering the storm in a volatile stock market. It is this perspective which makes individual bond holdings a cornerstone of the investment policy statement we develop with clients. 😊

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If a correction is defined as a -10% or more decline from the most recent high, we have had two this year. Unnerving, unpleasant and at the same time, normal, healthy and part of all market cycles. Since 1950, the S&P 500 has had 37 corrections of -10% or more (including 2018) and this year is the first year of a -20% change since 2008. We are nowhere near the economic state of a decade ago. The average correction lasts 196 days and more than half are less than 104 calendar days. (Source: The Motley Fool)

So… what should we expect in 2019? The Government “shutdown” is political theater and will be resolved—the economic impact on the nation will be negligible. We anticipate continued growth in corporate profits (but slower in the first half of the year due to uncertainty on trade negotiations) and a slower (but still present) deregulatory environment in Washington. Expect the overhang of tariffs on China ramping up if talks end with no deal which would cause greater volatility during February and March for the stock market.

The stabilization of oil prices around $45-50 per barrel for West Texas Intermediate (WTI) crude will help most industries and virtually all consumers. OPEC’s announced cut of 1.2 million barrels per day won’t be sufficient to soak up expanding U.S. production. Shale oil firms are now able to sustain production around $50 per barrel but it will slow expansion until 2020 and beyond.

Lastly, watch the linkage between labor force productivity, wage growth and inflation. Productivity growth was 1% or less every year since 2011, and in 2018 increased to 1.9% through the 3rd quarter. Part of this is due to increased business investment which should continue in 2019 and allow for wages to grow faster than inflation without spooking the Federal Reserve (so the Fed can slow its pace of rate hikes). That will be positive for market sentiment.

(continued from pg. 1)