TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

The S&P 500 Index lost 4.4% for the year 2018. Not one asset class generated a profit of more than 5%, not large or small-cap equities in the U.S., not international or emerging equities, not Treasuries, investment-grade bonds, commodities or real estate. 2018 started with hopes of strong and coordinated global growth. Indications of a different picture in 2019 are mounting. Expansion in major advanced economies is set to slow, with a marked divergence between the U.S. and the rest. Some emerging markets face a recession. Key uncertainties include the trajectory for Fed tightening and its impact on markets, in particular emerging markets, the intensity and economic downturn from the U.S. and China trade dispute, and the economies and politics of tighter financial conditions in the euro zone. 2019 is not likely to end the economic cycle, but risks are growing and new sources of incentives are needed.

Fixed-Income Market Developments

Investment grade debt (Bloomberg Barclay U.S. Agg. Total Return Bond Index) was essentially flat for the year (0.0112%) while the Bloomberg Barclay Long Term U.S. Treasury Total Return Index recovered from a low of -6.4% to finish the year -1.84%, as the flight to safety increased in December. The year-end volatility also stoked speculation of an impending inversion of the yield-curve leading to a premature recession. Interest rates will continue to rise in 2019 at a slower pace as the economy is likely to slow. U.S. Treasuries tend to be the most sensitive to rising interest rates. The bond market is, however, exceedingly diverse. Each sector and asset class responds differently, some of which seem to do well in a rising interest rate environment. Investment grade bonds, high yield bonds and mortgage backed bonds (MBS) are examples. We recommend to latter maturities in investment grade corporate bonds and reinvest in higher yields over time which will increase the bond portfolio's return potential and offset the initial negative price impact of rising rates.

The Economy

U.S. economic growth should remain above trend in 2019, but the trajectory is likely to slow amid failing tailwinds from fiscal stimulus. GDP growth is set to decelerate from 3.1% to 2.4% in 2019 and to 2.1% in 2020. We expect employment growth to moderate in 2019, but still continue to exceed a level that is consistent with stable unemployment over time. Headline inflation is set to drop sharply over the next several months reflecting a slowing economy and the recent plunge in oil prices. Meanwhile core inflation of 2% is expected to trend sideways as expectations of wage inflation remain low.

Federal Reserve Policy

The Federal Reserve Bank is committed to gradually tighten monetary policy, given that they met their employment goal and inflation target. They will carefully weigh every move in 2019 as they want to retain flexibility and avoid expectations that they are on a preset "measured" course of rate increases. Furthermore, their interest rate schedule will be vulnerable to global risks and a stronger dollar, as well as intensification of the trade conflict. Interest rates remain accommodative despite Fed rate increases. The cost of financing relative to the pace of growth is a critical determinant of future growth. When real interest rates exceed GDP growth this typically leads to a recession. We are a long way away from this scenario. Despite a benign inflation outlook, wage inflation in the U.S. has reached 3% for the first time during this expansion. It is possible that wages start to accelerate more in response to declining unemployment. However, rising productivity growth, as well as increasing competition due to the Amazon effect is, in our opinion, likely to keep consumer price inflation in check. We expect a pause in rate hikes in the first half of 2019 and one to two increases in the second half of 2019.

Outlook

While the economic expansion may continue beyond its 10th year, the growth gap between the U.S. and the rest of the developed world is likely to narrow. In 2018 the U.S. was ahead in many ways. It had a large fiscal tax boost that propelled the economy ahead, while the rest of the world was slowing, a central bank that confidently raised rates every quarter, a stock market that outperformed most others and an appreciating dollar which attracted assets. Looking ahead, we see a slowing growth rate in the U.S. as tighter financial conditions begin to leave its mark, fiscal stimulus is fading, and the recent plunge in oil prices benefits oil importing countries more than the U.S. which has become a net exporter. Despite a narrowing of the growth differential with the world, we expect U.S. equities to do better as companies are more profitable and cyclical sectors weigh less in the stock markets. The favorable interest rate differential argues for a steady dollar.

Equity markets are likely to remain volatile, favoring cautious positioning overall and focus on a mix of least cyclical high-quality growth and defensive equities with attractive dividends. Although nearly half the stocks in the S&P 500 index are down 20% from their highs, valuations are likely to adjust even more to Q4 earnings reports and guidance. Apple was one example. Corporate earnings grew 25% in 2018. 15% could be contributed to the tax cuts and 10% to organic growth. We expect the organic growth rate to slow to 6%-8% in 2019. There are still too many headline risks and uncertainties in the market. Most important for the markets, however, will be corporate earnings and guidance. Therefore, while we wait for select investment opportunities to present themselves during and after earnings season, we prefer high quality large-cap equities with solid dividends trading at a discount. In all, we have a positive outlook on the market. Our finance system is sound and the economy continues to

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perform well. There is ample evidence that this cycle can continue well into the future.

Your Terra Nova Team!

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