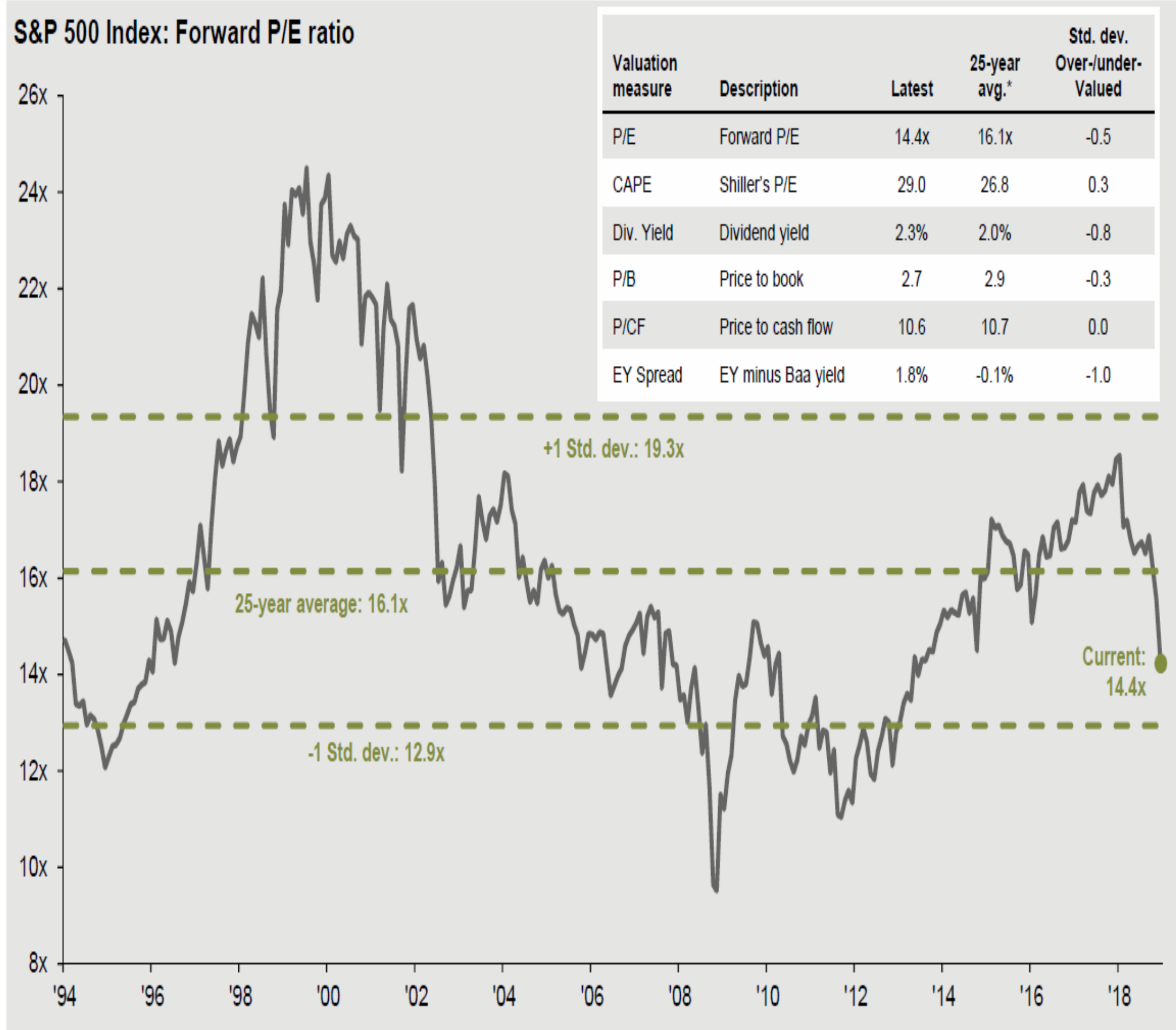
Q1 2019 Market Commentary
Year-end Review

U.S. stocks closed the year with their worst performance since the Financial Crisis, with the S&P 500 Index down -6.35% in 2018. Other indices were also weak. William O'Neil + Company reports that the Vanguard Emerging Market index closed down -17.01%, the Vanguard Real Estate index closed down -10.13%, while the IShares Core Aggregate U.S. Bond index closed down under -3%. The sell-off was even worse for smaller companies. Barron's magazine reports that the Russell 3000 index (an index of the 3000 largest U.S. equities representing 98% of all U.S. stocks) had 74.7% of its members stocks down 20% or more last year.

In this market commentary, we will highlight the factors that we believe caused the market to sell off, including the Federal Reserve hiking interest rates too fast, the government's rising debt load, political uncertainty, and tariffs. We will also talk about valuation, economic growth rates, as well as about what we see for the year ahead.

Traditionally, the stock market sells off because valuations have become too high, as was in the case of the internet bubble in 1999, or because a recession is imminent, as was the case in the Financial Crisis in 2008. However, as of January 1, 2019 the historical P/E ratio of the market was trading at 14.4 times forward earnings, a substantial discount to the 25 year average of 16.1 times earnings. So, valuations are not high right now and do not need to go lower to

restore value to the market.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

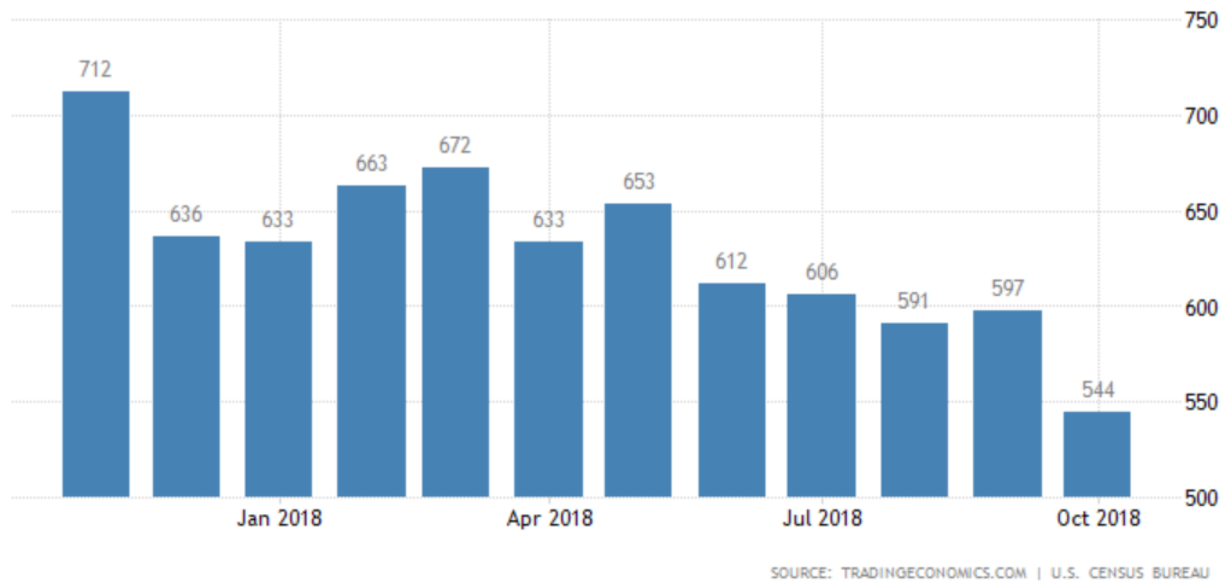
Likewise, the economy has slowed in the last three quarters, but it is still strong. Indeed, unemployment rates are near 50 year lows, corporate profits are at all-time highs, and the American Railroad Association and the American Trucking Association both reported record freight traffic and strong growth. Freight traffic is usually a good indicator of current growth.

Wal-Mart and Target, two of America's biggest retailers both announced same store sales growth of 4.5% last quarter (up from 1-2% growth in previous years), and the best numbers in a decade, suggesting the U.S. consumer is still strong. So, the current economy is actually doing well, and expectations are for more growth in 2019; however, we are starting to see some cracks in the economy that showed up last quarter.

The weakness we are starting to see in the economy includes lower auto sales and home sales, both on a quarter over quarter and year over year comparison. These two industries are among the largest in the economy, and have large multiplier effects on other industries. These industries are very reliant on credit, and thus very vulnerable to higher financing cost. The weakness in these two industries accelerated as the year progressed and as interest rates increased. Mortgage rates have increased from a low of 3.5% a few years ago to 5% last November, over a 40% jump in financing costs. The same has happened in auto loans. So even

though earnings are up for the average worker, they are not up enough to compensate for the higher financing costs. This is what is causing fear for investors. Investors fear that the Federal Reserve, while raising interest rates to prevent inflation from getting out of control, will instead hurt the economy inadvertently.

New Housing Sales (thousands):



Starting in October, the new Fed Chairman took the markets on a steep correction. The Federal Reserve chairperson is one of the most powerful people in the financial markets. The Federal Reserve determines the level of the risk free rate (the starting point of all interest rates), and it is the starting point of any risk/reward investment decision. As a result, every word that comes out of Fed Chair's mouth is carefully analyzed by Wall Street analysts. What scared the market analysts was the new Chairman's hawkish tone, especially considering how the U.S. ten year bond rate (over 3% in the U.S. in October vs only 0.4% in Germany and 0.1% in Japan) was already much higher than other advanced economies. Here are some important dates during last year's sell off:

October 3, 2018 - Chairman Powell said that "rates are a long way from neutral" implying more interest rate hikes and higher interest cost on everything from autos to housing. That day was the top of the market with the financial markets selling off immediately after the chairman's comments.

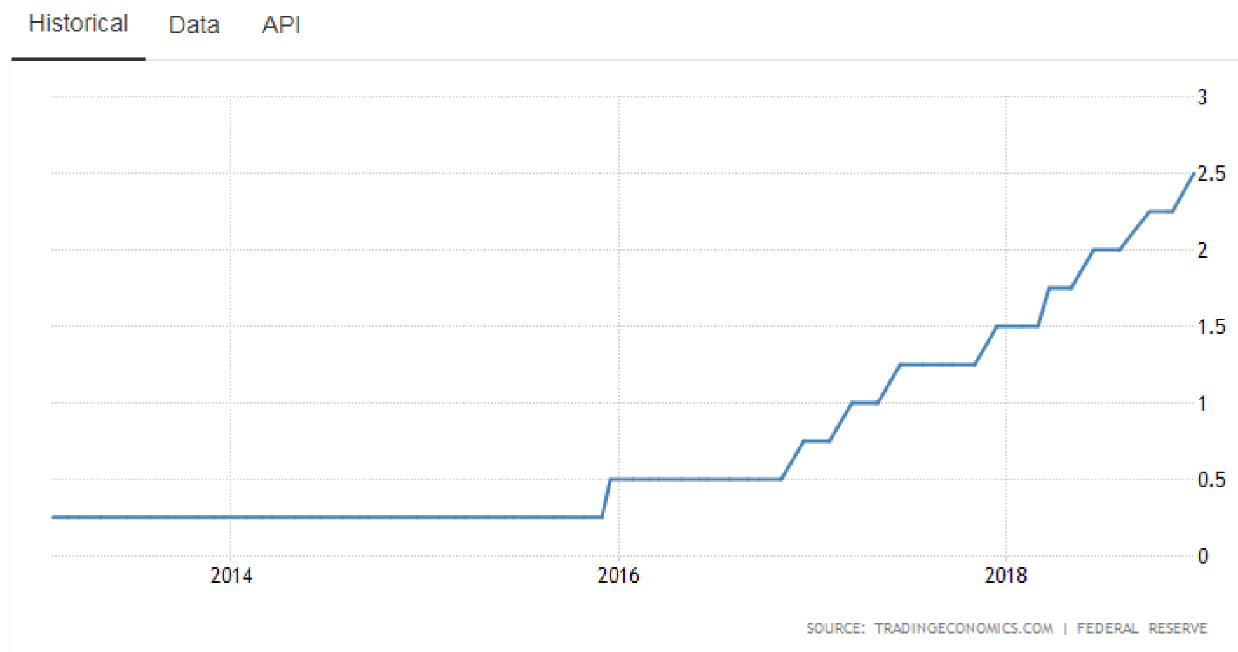
November 28, 2018 - After the market sold off over -10%, Chairman Powell stated that the economy is now near neutral (meaning no new interest rate hikes). The markets immediately began to rally on this news, rallying over 2,000 points on the Dow Jones Industrials and getting close to the October highs.

December 4, 2018 - The interest rate yield curve inverted between the short term two year interest rate, and the longer term five year interest rate. This means that you could get higher interest on a two year note than a five year note. Rates invert when market participants believe that the Federal Reserve has raised short term rates too high, and that the Federal Reserve will have to undo their policy because the economy will be in a recession due to the high short term rates. From this day the market began another steep slide.

December 19, 2018 - the Federal Reserve raises the discount rate (the discount rate is the interest charged to commercial banks and other depository institutions on loans they receive from the Federal Reserve Banks lending facility) another 25 basis points to 2.5%, the fourth rate hike in 2018 and the ninth rate hike in a row. During the Fed's press conference, chairman Powell states that the Fed will be "data dependent" going forward on future rate hikes. While that was a positive statement, unfortunately the Fed chairman then stated that the Fed's balance

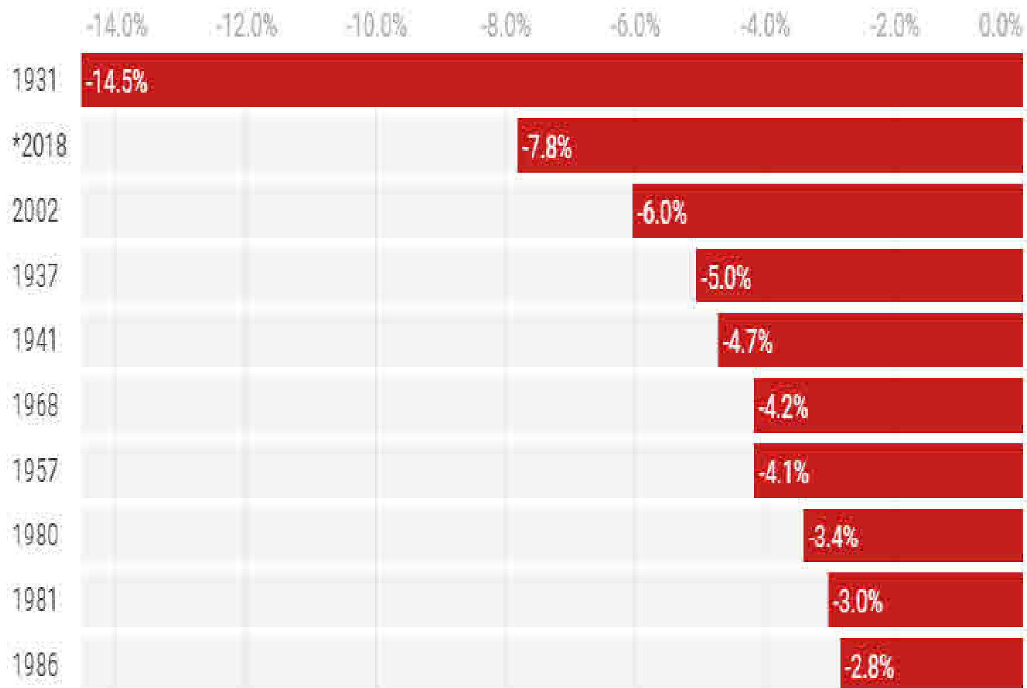
sheet reduction program would remain on "auto pilot." This "auto pilot" comment implies that the Fed is not being data dependent because their balance sheet program is taking $50 billion per month off the Feds balance sheet ($600 billion per year) which will put further upward pressure on interest rates and slow the U.S. economy. The market once again immediately sold off after the Chairman's press conference, and continued to sell off the rest of the month of December. By the end of December the market had dropped -14% and had finished its worst monthly performance since 1931.

U. S. Federal Funds Interest Rates:



January 4, 2019 – After the pounding the markets took in December, Chairman Powell chose his words much more carefully and said that mild inflation would give the central bank greater flexibility to set policy and that there was "not a pre-set" path to push the benchmark rates higher. This, in combination with a strong jobs report caused the market to rally after its worst new-year opening since the year 2000.

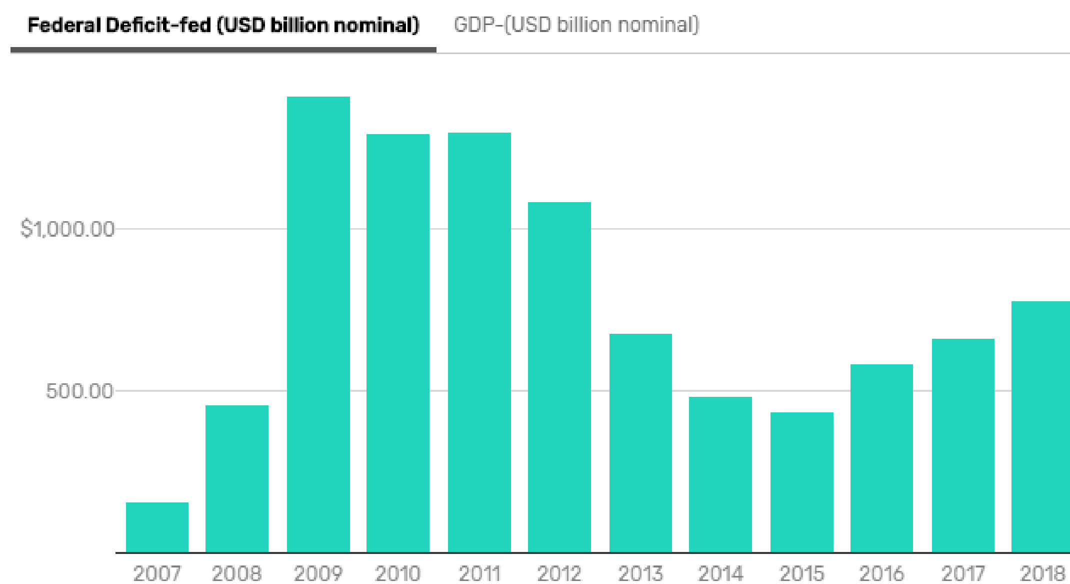
The chart below shows how December 2018 compared to other market declines historically.[1]



In addition to rising interest rates, we believe that rising debt levels contributed to the market to decline, as well. While the economy itself is and has been operating at a high level, our observation is that it took a lot of debt to get there.

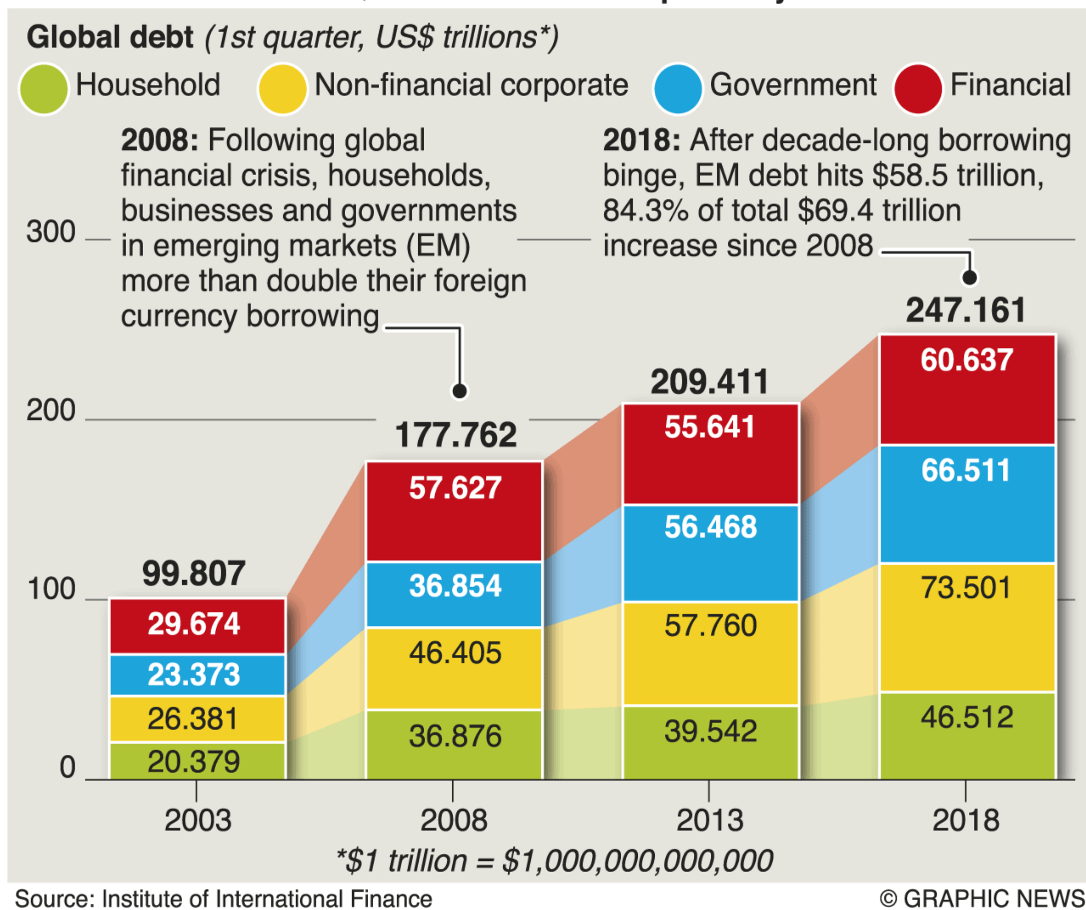
The federal budget for 2018 ended up $700 billion in the red. The federal budget for 2019 is projected to be negative again, with some observers predicting a $1 trillion deficit.

[1] Recall that bond price movement is inverse to interest rates.



Our national debt now listed at over $21 trillion, more than double the level from 2010. While Congress has not agreed to a final budget for 2019, it's fair to say that the sheer size of our deficit threatens our financial markets. Moreover, with over $21 trillion in debt, each 1% rise of interest rates increases the incremental cost of financing the national debt by additional $210 billion annually. The average duration of this debt is five years. Over the last two years, the five year note has risen from 1% to 2.53%, due to interest rate hikes. At current rates, this 130 basis point rise (100 basis points is equal to 1%) in interest will eventually cost an additional $242 billion in annual interest cost. Most of the U.S. budget is already spent before Congress arrives in Washington on just a handful of programs – defense, Medicare, and social security. Therefore, most of the additional debt service cost will end up increasing the size of the U.S. budget deficit next year which we believe will cause deficits not seen since the Financial Crisis.

Making matters worse, global debt has also increased to record levels. Debt, in our view, was the single biggest contributor to the Financial Crises. Unfortunately, debt loads, continue to get worse. All else being equal, this will put enormous pressure on central banks around the world.



Adding to market uncertainty is a tense political environment, and there is open talk in the media and some Representatives of the House, of a possible impeachment of President

Trump. Given current information, this seems unlikely because Republicans control the Senate (2/3 thirds of the Senate would need to ratify an impeachment). However, the new Democratic controlled House continues to speculate about launching numerous new inquiries into Trump, and everyone is still waiting to see the findings of the Mueller investigations. When President Nixon resigned and when President Clinton was impeached by the House, the stock market had similar sell-offs, falling between -20 and -24%. This presents a risk going forward to stock prices and likely contributed to the sell off last year as well.

In addition, Wall Street is almost universal in the condemnation of tariffs and the negative effects tariffs have on markets. Higher tariffs mean factories must move from low cost locations to higher cost locations. This hurts profits, which in turn causes stock prices to drop. Moreover, American businesses use imported components in their own products and raising tariffs increases the cost for our own companies.

Some market observers think tariffs were a primary reason for the stock market sell off. We disagree with this view. In a perfect world, tariffs are bad. However, we do not live in a perfect world and the U.S. has been routinely taken advantage of on trade and intellectual property for the last thirty years. In 2018, the U.S. trade deficit in goods, without services was $810 billion (the deficit with both goods and services was $566 billion). Making matters worse is the U.S. military is the primary protector of the international sea, land, and air trading lanes that other countries are using to take advantage of us on trade. This is a situation that cannot go on forever. The framework for much of the global trade was put in place after WWII when Europe and Japan had been heavily damaged, and during the cold war to stop Soviet expansion. The goal at that time was to build up our allies. This is no longer the case. We believe that the

hollowing out of the U.S. manufacturing base from the trade deficit is one of the primary causes of the shrinking U.S. middle class. Our hope would be a comprehensive trade bill that creates a fair trading environment for American businesses and protects intellectual property. In our opinion, if we can get a stronger middle class in the future, this will create a more balanced and healthy economy in the future and more than compensate for the higher imported cost we are now experiencing on some items. Unfortunately, the new trade bills with Mexico, Canada, and Europe, while better than their predecessors, still puts the U.S. at a disadvantage.

In conclusion, we believe the sell off last month was due primarily to rising interest rates as well as rising debt levels. On the positive side, the financial markets are now selling at valuations below their historical averages and the Federal Reserve has backed off their more hawkish tones from October and are now signally that they will be more data dependent on any future interest rate hikes. Moreover, any positive news on trade could act as a catalyst for the market. Thus, we think the market will continue to claw back some of its losses from last October's highs. However, plenty of risk still exist. As a result, we plan to continue to focus on diversified, income producing portfolios, and investing in companies who are returning cash back to investors as well as providing goods and services that people need to use on a daily basis.

We thank you for your continued support.

Sincerely,

William H. Schnieders	James F. Schnieders, CFA	John C. Schnieders, CFA, CFP®
Principal	Principal	Principal