Market Scorecard

Index	2018 Total Return*
Treasury Bills	2.02%
Barclays Aggregate Bond	0.01%
S&P 500	-4.38%
EAFE (Foreign Stocks)	-13.79%
Nasdaq	-3.88%

*Includes price appreciation and reinvestment of dividends.

Uncharted Waters

Never before has a central bank raised interest rates and implemented quantitative tightening at the same time. But of course, never before had a central bank maintained zero interest rates for eight years and created cash equal to nearly 25% of the country's GDP. Inconclusive debate has continued for years as to the positive impact that quantitative easing had on the economy and markets (creation of $3.6 Trillion Dollars). More elusive still is the affect from shredding parts of the $3.6 Trillion. All we know is that the easing policy had some positive effect on GDP and asset prices. It is only natural that tightening policies will have some negative effect. As we noted last summer "The last ten years of monetary ease and rising stock market valuations are behind us. Looking ahead, the market will need to adjust to gradually normalizing interest rates. We expect higher volatility during the transition".

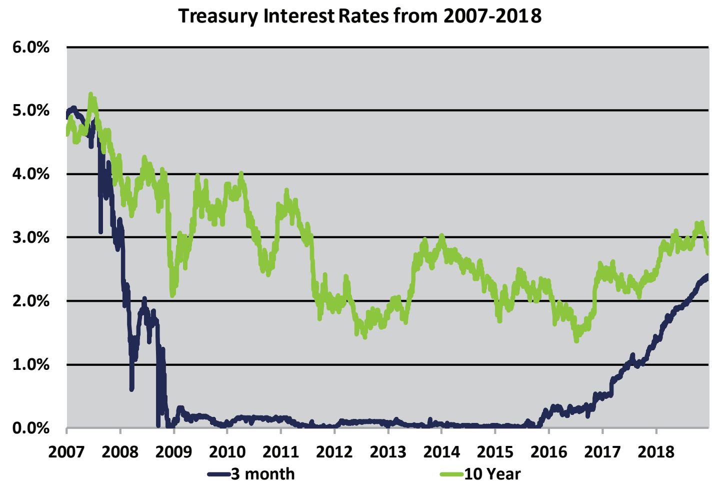
The severity of the stock market correction that started in October was a surprise to many given the 26% increase in corporate earnings, unemployment numbers at five-decade lows, and relatively low interest rates. One year ago (pre tax-cut) the S&P 500 price/earnings ratio was above 82% of historical readings. The tax-cut boost to earnings tempered valuations leaving the market valuation at the highs in September above 66% of its history. Today, the S&P 500 p/e ratio is near the lower third of its historical readings and indicates stocks have quickly gone from over-valued to under-valued based on the last 12 months of earnings. This basic measurement of stock valuations is backward looking…like driving a car while looking in the rearview mirror. It does, however, give us a general flavor of how the market has changed over the last year.

The stock market is a great predictor of future economic trends. It does a much better job than most economists and definitely better than the Federal Reserve. What are the markets telling us?....

Interest rates

Over the last 2 1/2 years 3-month Treasury Bills have moved from 0.25% yield to 2.36%. Ten-year Treasuries have essentially doubled from 1.40% to 2.70%. Ten-year bonds recently traded as high as 3.24%. Clearly, the trend is toward higher rates. Short term rates are controlled by the Federal Reserve and have yet to reach the "neutral rate" that is considered neither restrictive nor stimulative. At least T-bills yield a positive return after reported inflation of 2.20%. Long term bond yields are more sensitive to future expectations. The Treasury bond market seems comfortable with the notions that inflation is not set to soar and the market can absorb $1.5 Trillion of supply over the next 12 months. The bond market is telling us that the economy may be set to slow from its recent 3.2% growth over the last year.

Higher interest rates also support our cautious approach to credit quality. Over the last three months high-yield bond rates have increased from 6.2% to 8.0% and the popular leveraged loan market is showing weakness with a -3.45% total return for the quarter. Ten years of low interest rates have supported many marginal corporate borrowers and prompted investors to 'reach for yield' in lower quality credits. Higher interest rates will result in higher default rates and the markets are starting to anticipate with lower prices for bonds and loans issued by lower quality borrowers.



Corporate profits

Corporate profits will post a tax-cut-fueled growth of 26% for 2018. Estimates for 2019 profit growth stood at 12.2% just a couple of months ago. The stock price correction last quarter is challenging future expectations and 2019 estimates have already fallen to 9.6% over the last two months. Stock prices will continue to be highly sensitive to earnings expectations over the next several months.

Stock prices

The stock market is also indicating a slowing economy in 2019. The stock price correction took a larger toll on growth companies, although growth did outperform value for the year across all capitalization ranges. Growth companies are typically more volatile and 2018 was no exception. However, the recent relative weakness of growth confirms the market's building skepticism of expected growth estimates for 2019.

Total Return	Large Growth	Large Value	Mid Growth	Mid Value	Small Growth	Small Value
4TH Quarter	-15.89%	-11.72%	-15.99%	-14.95%	-21.65%	-18.67%
2018	-1.51%	-8.27%	-4.75%	-12.29%	-9.31%	-12.86%

Clearly stocks have started to adjust to higher interest rates and seem to be looking for the appropriate balance between continued, yet moderating growth and modestly higher interest rates.

Assuming that global trade negotiations do not devolve into an adverse and protracted tariff war, a large portion of the adjustment in stock prices seems to be behind us. At the same time, we need to keep in mind the path the Federal Reserve is following is uncharted. And because we live in a global economy (for now), we need to be mindful that the rest of the worlds' central banks have also announced plans to follow along with reversals of their respective easing programs over the next 9 months.

We appreciate the opportunity to assist you in meeting your goals and investment objectives.

Our best wishes for a healthy and prosperous 2019,
Your AAMA Team

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