Review & Outlook

Fourth Quarter 2018

January 11, 2019

Executive Summary

John Augustine, CFA, Chief Investment Officer

2018 market total returns:

S&P 500	-4.39%
S&P 400	-11.09%
S&P 600	-8.52%
MSCI EAFE	-13.32%
MSCI EM	-14.49%

Barclays Intermediate Bond Inde	0.88%
Barclays High Yield Bond Index	-2.08%
Barclays TIPS Bond Index	-1.26%
Barclays Municipal Bond Index	1.28%
Gold	-2.14%

Markets End 2018 Waiting for Policy Errors in 2019

It was a tumultuous quarter for investors. Stocks on the S&P 500 saw their worst quarterly performance since 2011, while bond yields fell to levels from earlier in the year.

In the end, 2018 was the worst year for global stocks since 2008—and a year when no asset group we track in the chart above produced any meaningful return to investors. Markets ended last year waiting for trade, fiscal or monetary policy errors in 2019.

In the fourth quarter, markets disconnected from the economy. Our economist, George Mokrzan, notes in the next section that, outside of housing moving from a seller's market to one more balanced between sellers and buyers, the U.S. economy is doing fine. When the GDP numbers are tabulated in the first quarter, 2018 may have been the best performance of the U.S. economy since the Great Recession.

The stock market, though, would have none of the economic or profit-growth success. It lost confidence in global policymakers during the fourth quarter, from the U.S. to the U.K. to France, Italy and China. Now it will be up to those policymakers to instill confidence back into markets in 2019 or risk a recession in their economies.

For stocks, there was only one sector higher in the S&P 500 during the fourth quarter: Utilities. For the year, only Healthcare and Utilities saw price gains. Randy Hare, our director of equities research, discusses the stock volatility in his section.

In fixed income, it was the fourth consecutive year when the bond market defied all of us who thought the 10-year Treasury yield would be above 3% by now. While the 10-year yield did spend much of the third quarter above 3%, it gave up the gains in the fourth quarter on fears that policymakers would slow the global economy in 2019. Kirk Mentzer, our director of fixed income, discusses his observations of the fixed income markets in 2018.

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While 2018 was the first year since 1994 when no asset group provided any noticeable return, it is important to note that 1995 was a very good year for investment returns. However, we will likely have to get through a choppy first quarter in 2019 as policymakers try to gain back confidence.

The Economic Forecast

George Mokrzan, Ph.D., Senior Vice President, Director of Economics

The fourth quarter topped off one of the strongest years of growth in the U.S. economy during the current economic recovery and expansion. The U.S. economy in the fourth quarter featured high economic activity, the strongest labor markets of the economic expansion, and solid consumer spending throughout the important holiday shopping season. The ISM Manufacturing and Non-Manufacturing Composite index from the Institute for Supply Management showed the strongest three-month overall economic activity in the economy since index records began in July 1997. Benefitting from the lowest unemployment rate in a half century and the creation of 762,000 net new jobs in the fourth quarter, consumers view their present condition as nearly the best of the current economic recovery, according to the University of Michigan sentiment survey.[§] In addition to strong labor markets, consumers began to incur lower inflation as the monthly average of daily prices of West Texas Intermediate Crude Oil fell from $70.2 per barrel in September to $48.96 per barrel in December.

Despite the preponderance of strength in economic activity, not all areas of the economy were robust in the fourth quarter. While capital spending on business equipment was very strong in 2018, new orders for capital goods slowed in the fourth quarter. Much of the slowdown could be attributable to reduced energy investment resulting from the sharp energy price drop, but weakness in financial markets during the fourth quarter, as discussed in the Equity and Fixed Income sections, may have lingering effects on business confidence, should it continue. A sharp December slowdown in new manufacturing orders, according to the Institute for Supply Management, was a further sign that an economic slowdown could deepen if financial market weakness continued.

Housing market sales slowed in conjunction with reduced affordability and relatively tight inventories. Much of the affordability decline was created by very strong home price appreciation in recent years. A slowdown in housing markets is welcome in that it would reduce the risk of another boom or bust cycle. **We forecast a slower, but healthy, housing market, although one that contributes less to overall economic growth in the near term.**

The world economy outside of the U.S. showed signs of slower growth as country-specific challenges on almost all continents dominated the headlines in the second half of the year. (Please see our Fourth Quarter 2018 *Economy in Focus* publication for a more detailed discussion of the economy at the end of 2018.) Taken together, fourth quarter developments provided sufficient signals to the Federal Reserve that future interest rate increases could begin to slow the economy significantly. We turn to our forecast, in which **we presume that Federal Reserve policymakers will slow the rate of interest rate**

increases from their ambitious original projections to achieve the appropriate balance for financial markets and the economy.

Our economic forecast remains largely positive for 2019, but with a tilt toward domestic economic growth over foreign economies. **Real GDP growth is forecasted to moderate from 2.9% in 2018 to 2.5% in 2019.** This recovery has been buoyed by strong jobs and real income expansion, and consumers will likely continue to be the major drivers of economic growth. However, higher interest rates in 2019 over 2018 are projected to moderate housing and unit vehicle sales somewhat next year.

Business capital investment is expected to slow somewhat from 2018, but continue to benefit from recent business tax cuts, the need to expand productivity growth in tight labor markets, and generally rising obsolescence compounded by years of underinvestment in the U.S. Business capital investment is the most likely area of GDP that could underperform in 2019 if business confidence is reduced by volatile financial markets and/or policy uncertainties.

Inflation is expected to decline from 2.4% in 2018 to 1.9% in 2019 for the lowest inflation since 2016. Overall inflation could go down even further. Lower energy prices, slower expected growth in the international economy, lower commodity prices and tightened U.S. monetary policy are expected to contain inflationary pressures. Wages will likely continue to rise, but are not expected to create significant cost push pressures.

With inflation expected to be low, and past interest rate increases already exhibiting slowing effects on interest-rate sensitive areas of the economy**, the Federal Reserve is forecasted to raise the Fed Funds rate target only once in 2019 to 2.75%.** We view this plateau of the Fed Funds rate target as largely neutral, and consistent with our fundamental forecast of a solid but not over-heated economy. We anticipate the 10-year Treasury yield to resume an upward trend once the Federal Reserve pauses its rate-hiking cycle. The timing of the increase is less certain, but it will likely occur when policy uncertainties have eased, both in monetary and international trade areas.

Fixed Income Markets

Kirk Mentzer, Senior Vice President, Director of Fixed Income

Risk perceptions shifted dramatically in the fourth quarter of 2018 as market concerns moved towards credit rather than interest rate risk.

Many investors, including us at Huntington, began 2018 believing the 10-year Treasury note would finally crack the 3% barrier and remain there for the year. While the average was 2.91% for the year, and a formidable attempt to hold 3% was made early in the fourth quarter, the 10-year Treasury ended 2018 at 2.69%. Policy concerns, global economic growth rates, a few high-profile credit downgrades and the equity market correction all served to heighten credit risk sensitivity.

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What was shaping up to be a reasonably good year for corporate bonds at the beginning of October degenerated into one of the worst years on record. Credit spreads widened significantly, leaving excess returns the worst since 2011 and total return measures the lowest since 2008. The pain was most acute in high-risk segments of the investment grade investing space (lower BBB-rated bonds with the longest maturity). Better relative performance was generally found in shorter-maturity credits with higher ratings. Taken together, the Bloomberg Barclay's Intermediate Index produced a positive total return of 1.65% for the quarter thanks to strong performance in Treasuries.

Looking ahead, we anticipate the trends in the fourth quarter of 2018 will continue into 2019. Yields will likely remain volatile, with a general rising trend in 2019. With our expectation for supportive economic backdrop, the Federal Reserve should feel compelled to continue reducing monetary stimulus via modestly higher short-term interest rates. Likewise, the 10-year Treasury yield is expected to rise towards 3% once again.

We believe the real story for 2019 will be how to navigate a less-friendly credit environment. Cracks below the surface in the credit markets tend to reside in the riskiest parts of the bond market: leveraged loans, high yield and private credit. As a result, we will remain focused on higher quality bonds. We offer these suggestions to be best positioned in the current credit environment:

- **Buy higher quality issuers.** This means focusing on A-rated over BBB-rated names during the repricing phase.
- **Sector bias is clearly slanted towards economically stable** sectors with little to no merger and acquisition risk. We find the best risk reward in large banks, real estate investment trusts (REITs), utility and financial technology issuers.
- **Security selection should place an emphasis on companies with conservative cash flow allocation** that seek to maintain ample debt service cushions. Massive share repurchasing schemes are not on this menu.
- **Seek additional ways to improve portfolio income streams with minimal risk.** Callable agency notes offer higher yields in exchange for potentially early redemption. In a rising rate environment, this risk is low and, as a result, should provide a performance edge.

One last point of clarification: the outlook for investment grade credit is actually fairly positive. Our current positioning is designed to absorb near-term volatility as markets reprice risk. It is important to remember that earnings growth remains positive, high-yield default rates remain low, recession risks are moderate and new issuance is expected to decline 10% in 2019.

Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

The fourth quarter saw stocks give back all gains achieved through the year. The S&P 500 had its worst quarterly performance since 2011. When stocks decline that quick, volatility, as measured by the Chicago Board of Options Volatility Index (CBOE VIX), increases. After trading around a level of 15 during the summer, the VIX Index traded above 25 late in the year.

During the fourth quarter, U.S. stocks, as measured by the S&P 500, declined 13.5%. Utilities and REITs were the best performing sectors as investors sought the relative safety in these sectors. The S&P 500 Utility sector finished the fourth quarter higher by 1.4%, and the S&P 500 REIT sector finished the quarter down 3.8% on a total return basis. Energy and Technology stocks declined the most during the fourth quarter. The S&P 500 Energy sector declined 23.8% in the fourth quarter as the price of a barrel of oil declined by 38% during the same period. Stocks in the S&P 500 Technology sector declined 17.3% after technology companies began to warn investors that profit growth will begin to slow going into 2019.

With a boost from pharmaceutical stocks, Healthcare was the best performing sector (+6.5%) in the S&P 500 for the full year.

Looking ahead to 2019, **some of the factors that we are keeping our focus on include:**

- U.S. economic growth, as noted above, is forecast to slow from 2.9% in 2018 to a more moderate rate of 2.5% in 2019.
- From a market perspective, commodity prices at about 25% lower than the September peak and the relative under performance of cyclical stocks in the fourth quarter are already pricing in slower economic growth for 2019, as noted above.
- Despite the peak in S&P 500 earnings per share growth during 2018 with over 20% gains, the earnings outlook of +7% growth for 2019 should continue to provide a stable environment for stock investors, though we will review the progress quarter by quarter.
- The S&P 500 sectors with projected double-digit earnings growth in 2019 currently include Consumer Discretionary, Financials and Industrials.
- We continue to focus on consistent earnings growth where recently lowered valuations present attractive opportunities.

Weighing the headwinds and tailwinds, we see a continuation of positive earnings growth, which should be beneficial for stocks. The swirling trade, policy and political headlines will require U.S. investors to be patient, but equity valuations have already moved noticeably lower to account for these.

Stocks ended 2018 on a very negative note. The S&P 500 had its worst December performance since 1931, according to LPL Research. Looking at the year ahead, we see volatility continuing at least for the first half of the year, but we also note the much lower valuations for stocks from the market action in the fourth quarter of 2018. **This lower valuation will allow us to locate quality stocks and companies that can weather the headlines and volatility.**

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§ *Index of Consumer Sentiment provided by the University of Michigan, December 2018*