Blankinship & Foster
Family Wealth Advisors

QUARTERLY INVESTMENT REVIEW
Fourth Quarter 2018

B&F Perspectives

GLOBAL STOCKS TUMBLE
Stocks broadly sold off throughout the quarter as investors refocused on risks and decelerating growth.

YIELD CURVE FLATTENS
1-year Treasury ended 2018 higher than 2-, 3-, 5- and 7-year bonds, though still lower than the 10-year.

OIL LOWEST IN THREE YEARS
Driven by a global crude oil glut and slowing growth, oil prices dropped below $43 in December.

ECONOMY STILL GROWING
GDP growth is estimated at 3% for the year, though likely to slow to around 2% in 2019 as stimulus fades.

Quarter In Review

After logging strong returns in 2017, global equity markets turned negative in 2018. Investors had a lot to digest as headlines throughout 2018 included conflicting reports on slowing global economic growth, record U.S. corporate earnings, record low unemployment in the U.S., trade tensions with China, interest rate uncertainties, and the implementation of Brexit.

Global equity markets declined in the fourth quarter. Large U.S. company stocks fell 13.5% in the fourth quarter while stocks outside the U.S. were down 12.8%. As a result, the S&P 500 shed 4.4% for the year and the MSCI All Country World Index dropped 9.4% for the year.

At the same time, the return on the U.S. fixed income market was relatively flat; the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.0%. The 'benchmark' 10-year Treasury bond yield rose from 2.46% to a high of about 3.25% before falling back to 2.69% by year-end. Credit spreads, which are the difference between yields on lower quality and higher quality fixed income securities, broadly widened during the year. This means that investors were demanding higher yields to take on the higher risk of default for lower quality bonds.

Outlook

With the yield curve signaling higher risk at the end of the quarter, there were basically four themes that were bothering investors, three of which have since been mitigated.

The first concern was that global economic cooling could impact the U.S. economy. The economy is still growing, and the first statistics received in

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January confirmed the U.S. is still in pretty good shape. The strong jobs report, with improved wage growth, combined with other statistics, were very reassuring.

Generally speaking, recessions typically begin as a result of one of three things: massive external shocks, some kind of systemic financial breakdown or overdevelopment in a particular part of the economy. We can't predict when or how external shocks will happen, but that's always a possibility. The financial system is in much better shape than it was 10 years ago, with significantly less leverage on bank and personal balance sheets. Looking at the parts of the economy that have been responsible for recessions in the past (autos, residential investment, business investment and inventories), none are particularly overbuilt at this time.

The second thing bothering investors at year-end was the Federal Reserve's ("Fed") apparent intent to keep raising interest rates despite slowing growth. In the U.S., the yield curve flattened during the quarter as interest rates increased more on the short end of the yield curve than the long end. The yield on the 3-month U.S. Treasury bill increased 1.06% to end the year at 2.45% while the yield on the 10-year U.S. Treasury note increased just 0.29% during the year to end at 2.69%. At the end of the year, the yield on the 2, 3, 5, and 7-year Treasury bonds were all lower than the yield on the 1-year bond, suggesting the markets anticipate slower growth ahead. It also implies a higher risk of recession in the next few years, but that's not guaranteed.

ASSET CLASS	INDEX	QUARTER	YTD	LAST 12 MOS	3 YRS	5 YRS
STOCKS						
U.S. Large Cap Stocks	S&P 500 Index	-13.5%	-4.4%	-4.4%	9.3%	8.5%
U.S. Mid Cap Stocks	Russell Midcap Index	-15.4%	-9.1%	-9.1%	7.0%	6.3%
U.S. Small Cap Stocks	Russell 2000 Index	-20.2%	-11.0%	-11.0%	7.4%	4.4%
Global Stocks	MSCI All Country World Index	-12.8%	-9.4%	-9.4%	6.6%	4.3%
International Stocks	MSCI EAFE Index	-12.5%	-13.8%	-13.8%	2.9%	0.5%
Emerging Markets Stocks	MSCI Emerging Markets	-7.5%	-14.6%	-14.6%	9.2%	1.6%
BONDS						
Core U.S. Bonds	Bloomberg Barclay's Aggregate Bnd	1.6%	0.0%	0.0%	2.1%	2.5%
Interm. Treasury Bonds	Bbg. Barclay's Intermediate Treas.	2.2%	1.4%	1.4%	1.2%	1.5%
Short-term Bonds	Bloomberg Barcap 1-5 Yr Gvt/Credit	1.5%	1.4%	1.4%	1.4%	1.3%
Money Market/Cash	US 3 Month T-Bill	0.6%	2.0%	2.0%	1.1%	0.7%
OTHER						
Real Estate	Dow Jones US REIT Index	-6.0%	-4.0%	-4.0%	4.3%	8.1%
Commodities	Goldman Sachs Commodity Index	-22.9%	-13.8%	-13.8%	0.5%	-14.5%

Source: Morningstar

With the yield curve signaling caution, investors were relieved when Jay Powell, the Fed Chairman, recently made it clear that the Fed would be careful about looking at the data first. Investors interpreted this as a pause in the steady path upward in interest rates, reliving their third concern.

The third concern for investors at year-end was a combination of weakness in the Chinese economy and little progress on cooling the trade tensions between the U.S. and China. It is not helpful for either country to have trade tensions ramping up while both economies are slowing. As we go to press, there have been some encouraging developments, though we'll have to see where discussions go in the coming months.

Finally, investors have largely ignored the government shutdown, but the longer it goes on, the more it will bother Wall Street.

One quick side note about declines like the one we saw in the fourth quarter. Equity market declines of 10% have occurred numerous times in the past. After declines of 10% or more, equity returns over the subsequent 12 months have been positive 71% of the time in U.S. markets and 72% of the time in other developed markets. If this pattern holds true, it would be good news for investors.

Our Portfolios

2018 was not a good year for balanced portfolios. Bonds outperformed stocks, but only because they didn't lose money. Some alternative asset classes did okay, but just about anything exposed to international trade or emerging markets suffered. Looking ahead, our portfolios are well positioned to benefit from a recovery in stock prices as investors regain confidence. We are also prepared for slowing growth (which suggests interest rates may either stabilize or come down a bit) and the possibility of recession.

With global economic growth slowing and the U.S. economy expected to decelerate, investors should not expect the kinds of high gains we saw in 2017. In fact, 2017 was an anomaly: the lowest stock market volatility in the past 50 years combined with one of the highest annual returns. 2018 was much more 'normal' in that regard. We expect higher volatility to continue as investors try to gauge the trajectory of growth, inflation, interest rates and trade policy in the coming months.

Looking overseas, equity valuations are extremely compelling. Thus we maintain our allocation to international investments to take advantage of the opportunity the attractive valuations present.

In short, we view the current environment with cautious optimism, at least for this year. Our portfolios are positioned somewhat conservatively, preparing for difficult times ahead. Since nobody can reliably predict when a recession might begin (or when the stock market might sell off ahead of that event), we balance our risks and opportunities to make the best of the conditions present today.

As always, if you have any specific questions about your investments or your portfolio, we'd love the opportunity to discuss them with you.

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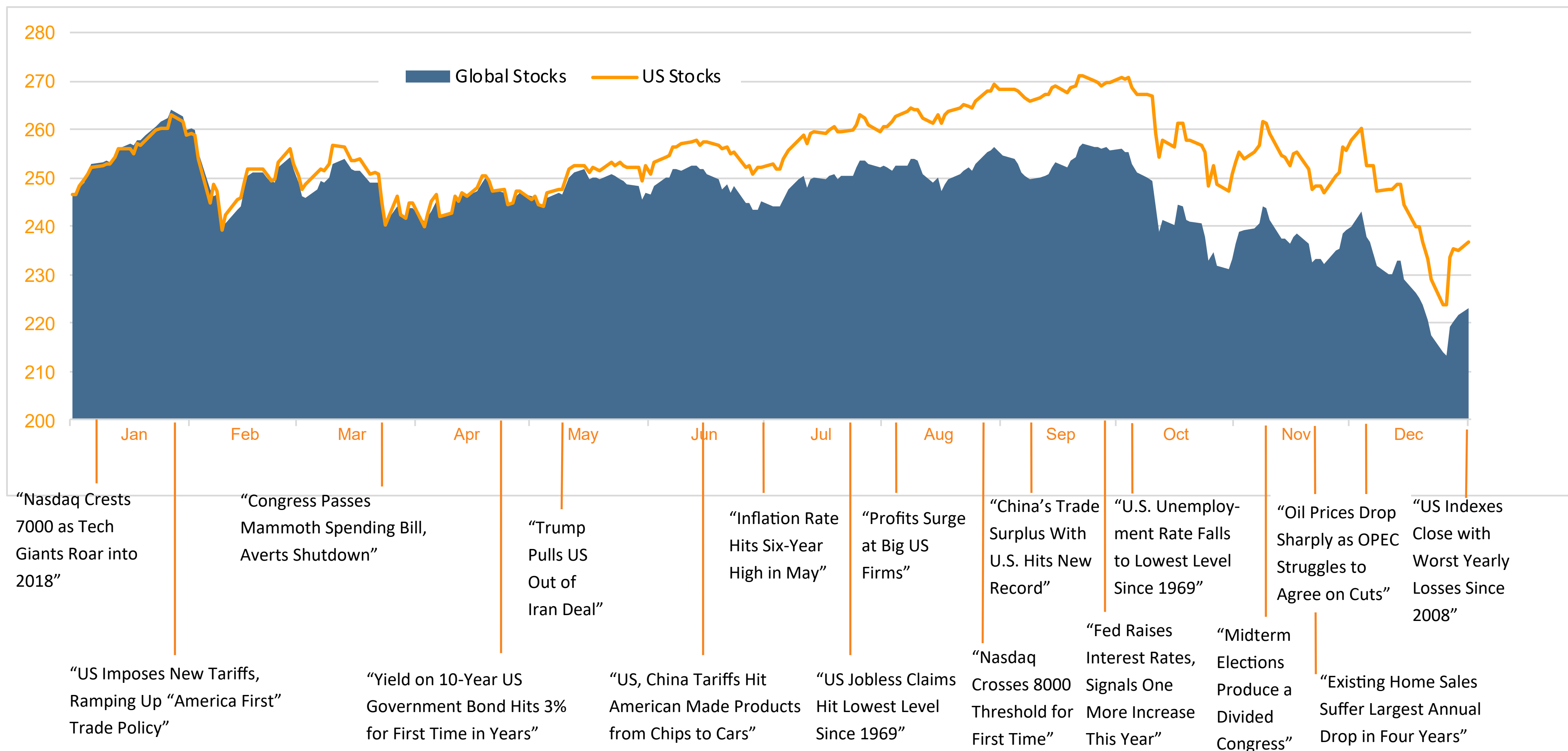
Global Stock Market Performance

The chart below shows the change in global equity markets throughout the year. Juxtaposed over the market performance are some of the key events that occurred during the period. Sometimes as we get to the end of a volatile period, it's difficult to look back and remember everything that happened along the way.



Returns in US dollars. Graph Source: Dimensional Fund Advisors, Morningstar. It is not possible to invest directly in an index. Performance shown does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results. Selected headlines are not necessarily indicative of any impact they may or may not have had on the market. Global Stocks are the MSCI All Country World Index. US Stocks are the S&P 500 Total Return Index.