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Fourth Quarter 2018

Down, But Not Out

The markets in 2018 were a far cry from 2017, which had historically low volatility and double digit returns. Instead, last year was a bit of a rollercoaster that ended with a decline for the ages as the markets experienced their worst December since 1931 and worst annual returns since 2008. Despite spending much of the year in the black and hitting multiple new highs in 2018, nearly all major indexes ended the year in negative territory. The one major index that ended the year on a positive note, albeit just barely at 0.01%, happened to be the one index that spent the entire year in the red – the Barclays US Aggregate Bond Index. The S&P 500 and Dow Jones Industrial Average came within striking distance of officially crossing into bear market territory as they were down 19.78% and 18.77% peak to trough, respectively – and on Christmas Eve of all days! The NASDAQ officially slid into a bear market in late December, falling 23.64% from its peak.

A combination of aggressive Fed talk, more trade worries, and fears of peaking earnings growth spooked the markets at the most inopportune time as the end of the year drew nearer and no money managers wanted to buy into the dip so close to year end, creating a sort of "buyers strike." Couple that with opportunities for tax loss harvesting and we saw an oversold market leading into Christmas Day. Investors pulled $75.5 billion out of mutual funds and ETFs in December alone according to Lipper, which was the biggest monthly outflow from equity funds since 1992 when the company began collecting the data. Despite a strong recovery the day after Christmas that carried us through the end of the year, the S&P, Dow and NASDAQ posted their lowest annual returns since 2008 closing -6.24%, -5.63% and -3.88% lower for the year, respectively.

Small caps and international markets fared much worse last year. After seeing large gains in late 2017/early 2018 due to being a beneficiary of tax cuts and somewhat immune to tariffs, the Russell 2000 Small Cap index ended the year down -12.18%. Rising interest rates have been a cause for concern as they relate to increasing debt burdens in small companies who tend to rely on debt financing more than equity financing like their large cap counter-parts. The MSCI EAFE declined by more than -16% last year with foreign markets being on the losing end of a strong dollar and heightened trade tensions. Countries like Mexico, Korea, China and Taiwan whose exports make up a large relative percentage of GDP are much more vulnerable to trade disputes and weakening local currencies, which makes trade agreements a critical issue with respect to the potential for a global slowdown.

Much of the pullback during the last three months of the year wasn't driven by a change in fundamentals as much as it was driven by the trio of what we referenced above; the fear of a peak in earnings growth, trade tensions, and what some consider overly-aggressive Fed policy. Instead, these factors which drove market movements were in turn responsible for the changes we saw in fundamentals. The S&P 500 forward price-to-earnings (P/E) ratio fell from 18.2x at the beginning of 2018 to its current level of 14.4x, below its 25-year average of 16.1x. The markets now look slightly cheap relative to historical averages. It's important to remember that both fear and greed play a pivotal role in driving the markets which leads to them being oversold in times of turmoil – like we saw in Q4 – and overbought in times

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when it seems as if the markets will never go down and greed takes over. Most indicators of US economic growth, albeit exhibiting a loss of momentum, remain positive which means the economy is still growing, just at a slightly slower pace. Fourth quarter 2018 GDP growth is expected to be in the ballpark of 2.5 – 2.8%, which would put 2018 annual GDP growth in the neighborhood of 3%. Analysts are estimating the economy to grow at an annual rate of around 2% in 2019 and while several factors are pointing to *slower* growth that doesn't necessarily mean *negative* growth (i.e. a recession).

We experienced this type of volatility in both 2011 and 2015, both of which proved to be long-term buying opportunities. The saying goes that when life gives you lemons, make lemonade. As we were reviewing client portfolios in preparation for the annual rebalance, we saw numerous opportunities for tax-loss harvesting. Tax-loss harvesting entails taking losses in positions by selling out of an investment and buying a similar investment (i.e. selling an S&P 500 ETF at a loss and buying a Russell 1000 ETF) in order to "realize" those losses and either offset some of the gains that have long needed to be realized or enable clients to take an investment loss on their taxes, both of which lower their overall tax burden.

REMINDER — 2018 tax information (Form 1099) will be provided by your custodians (Schwab/Fidelity/TD) mid-quarter. Any information provided by FAS is not official tax advice and should not be used for tax calculations.

2019 IRS Changes to Retirement Plan Contribution Limits

IRA/Roth IRA — $6,000 ($7,000 Age 50+)
401(k)/403(b)/457 — $19,000 ($25k Age 50+)
SEP IRA/Solo 401(k)— $56,000
SIMPLE IRA— $13,000 ($16,000 Age 50+)
Health Savings Plan (HSA) — $3,500/$7,000 Indiv/Family ($4,500/$8,000 Age 55+)

Over the last few weeks of the year you may have noticed increased trading activity in your account, which was FAS making lemonade out of the lemons the market handed us in 2018 by swapping out of securities with losses into similar securities. This allowed us to capture those losses for tax purposes all without pulling assets completely out of the market, which is quite possibly the worst decision one could make during times like these. A perfect example of this was December 24 when the markets experienced their worst Christmas Eve in trading history only to rebound by nearly 5% the very next trading day after Christmas.

Past performance is not indicative of future results, but history has shown that a long-term approach combined with a well-designed and well-executed investment strategy can overcome periods of heightened volatility, market corrections, and even bear markets. We understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility like we experienced in the fourth quarter is unlikely to alter a diversified approach set up to meet your long-term investment goals. Therefore, it's critical for you to stay invested, remain patient, and stick to the plan. We've worked with you to establish a personal allocation target based on your financial position, risk tolerance, and investment timeline. Therefore, we aim to take a diversified and disciplined approach with a clear focus on longer-term goals. We understand that volatile markets are both unnerving and stressful, and we thank you for your ongoing confidence and trust. Rest assured that our entire team will remain dedicated to helping you successfully navigate this difficult market environment.

2018 Performance Figures

	Q4	2018
DJIA (Dow)	(11.83%)	(5.63%)
S&P 500	(13.97%)	(6.24%)
NASDAQ COMP	(17.54%)	(3.88%)
MSCI EAFE	(12.86%)	(16.14%)
Russell 2000 Small Cap	(20.51%)	(12.18%)
Barclays US Aggregate	1.64%	0.01%
MSCI World All Cap	(13.74%)	(10.44%)