CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 4th Quarter 2018

Summary

Stocks had a rough quarter worldwide. In fact, 2018's poor performance has raised the question as to whether or not the post-financial crisis bull market was over. Stocks declined during the summer of 2011 and again from late summer 2015 through mid-winter 2016, but both times they rallied sharply after the low was put in. This reinforced the strategy of "buying the dip". 2018 saw a correction in the first quarter followed again by "dip" buying which pushed the major market averages once again into record territory by the end of the third quarter. Immediately thereafter, a second sell-off began. The fourth quarter decline was deeper from top to bottom (-19.8%)[i] than the previous ones and the breadth (the percentage of stocks making 52-week lows) was greater as well. In other words, almost no stock was spared (especially not the large consumer technology stocks that made the most money for investors on the way up). The fact that the ten percent first quarter decline was followed up so soon with an even larger decline is not a good sign, but it is not conclusive. It does warrant additional defensiveness, we believe.

The S&P 500's -13.52% decline in the fourth quarter is the worst quarterly performance since the fourth quarter of 2008, and day-to-day volatility in December rivalled that of 2008.[ii] Small company stocks fell an astonishing -20.02%.[iii] Ten of the eleven industrial sectors declined, with only utilities able to claw out a small gain (1.4%).[iv] Energy plunged -25.1%,technology lost -17.5% and industrials fell -17.3%.[v] For the full year, the S&P 500 index fell -4.38% and the small cap Russell 2000 was down -11.01%.[vi]

International stocks actually provided a bit of a diversification benefit in the fourth quarter. Developed international market stocks fell -12.54%, but emerging markets lost only -7.47%.[vii] Over the full year, however, the declines were -13.79% and -14.58%, respectively.[viii] The question of whether the U.S. stock market could continue to do well when foreign markets were doing so poorly was ultimately answered in a negative fashion. That said, the fact that emerging markets only lost about half of what U.S. stocks did in the fourth quarter might mean that EM has become so cheap that the downside from here is rather limited.

High quality bonds such as treasury and agency-backed mortgages were the beneficiaries of the weakness in stocks. The Barclays Aggregate bond index rose 1.64% last quarter to end the year up 0.01%. Both high grade corporate bonds and lower grade "junk" bonds lost money in the fourth quarter and over the full year. The best place to have been last year in bonds was the safest – short term Treasuries (1.89%). Short term municipal bonds also performed relatively well (1.76%). International bonds lost over -5.17% in 2018 on the strength of the U.S. dollar.[ix]

Activity

Volatility increased dramatically during the fourth quarter, which kept us quite busy. There were plenty of things to do in order to make portfolios more conservative. First and foremost we raised cash levels by selling some of the more aggressive stock positions. We replace or reduced our weighting in certain funds that aim to outperform the market on the upside (but often lose more in down markets). Also, we trimmed our exposure to lower quality corporate bonds, putting the proceeds in cash or higher quality bonds. We also took advantage of the sharp sell-off in international stocks in 2018 to do tax loss harvesting. Taxable investors probably noticed substantial changes in December.

Outlook

I wrote last quarter that there were potential catalysts in both directions. The downside catalysts won out. The Trump Administration did not strike a deal with China (although it pretended to do so after the Argentina summit). As a matter of fact, Vice President Mike Pence's October speech was more of a "double down" on the trade war than an olive branch of any type. The government shutdown seems likely to drag on, which will reduce first quarter 2019 GDP. On the other hand, lower interest rates (the 10-year note, which a lot of consumer loans are tied to, is down to 2.72%) and lower gasoline prices are helping the consumer.

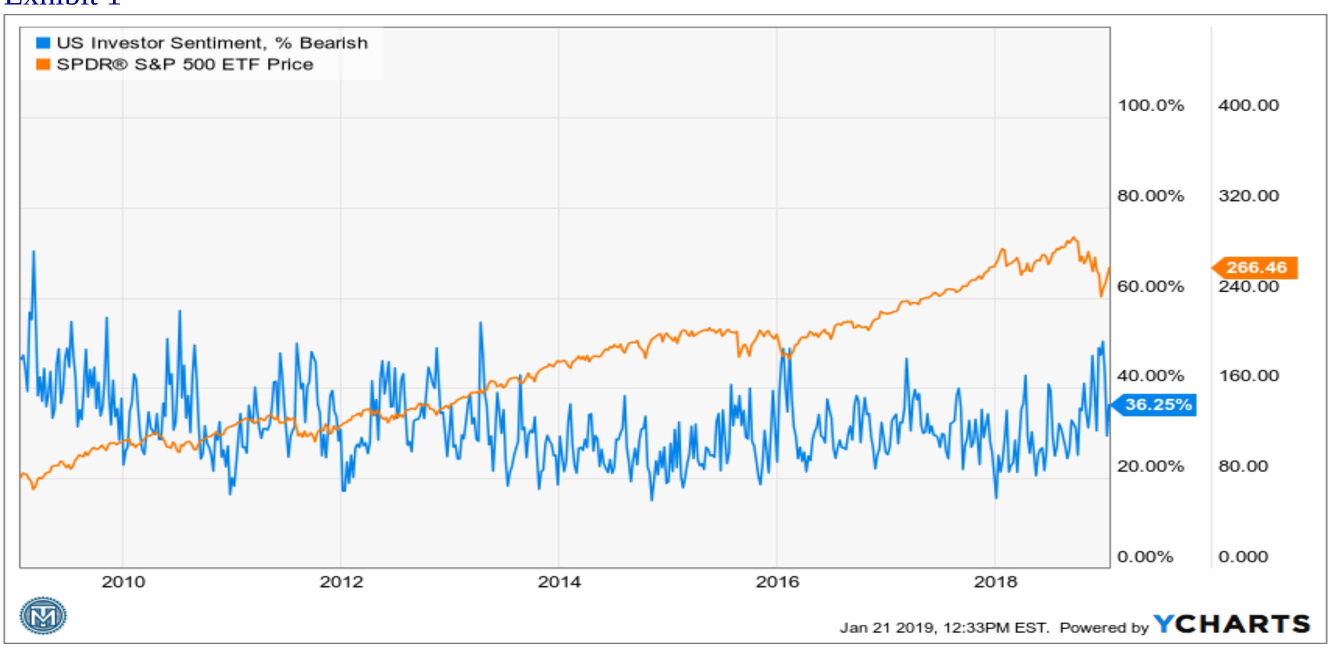
Given the above, it is difficult to foresee a strong first quarter performance from the economy. The three hopes for investors are that 1) the double-digit market decline last quarter is already more than reflected in current market prices allowing for a rebound, 2) that the relatively minor economic slowdown market pundits are calling for in 2019 doesn't turn into a full-fledged recession, and 3) that the government eventually re-opens and lawmakers again provide policy certainty, which would allow businesses to make their investing and hiring plans for the rest of the year more confidently.

Commentary – Mr. Market

At any given time and for every asset there is a tug of war between people who want to buy and people who want to sell. Prices are set, effectively, by those who change their mind and trade accordingly.[x] Buyers and sellers ("market forces") are usually slightly out of balance requiring the marginal buyer to pay a little more or the marginal seller to accept a little less than they'd like. The side that capitulates and accepts the market price depends on conviction, which can be fragile and fleeting. It can be influenced by economic data, a rumor, company specific information or oftentimes just the gut feeling of the market participant.

At the beginning of 2018, a growing global economy and corporate tax reform combined to raise the outlook for corporate profits. The demand for stocks was high relative to the supply (shares that people were willing to sell), so excess demand allowed sellers to demand increasingly higher prices. One of the interesting characteristics of investments (be they stocks, art, or bitcoins) is that a sharp rise in prices tends to increase demand as investors project even higher prices.[xi] The converse is also true, as stocks decrease in value investors project that trend into the future. Behavioral finance calls this recency bias.[xii] Exhibit 1 shows the US Investor Sentiment Index (the percentage of investors who are bearish or expecting lower prices) plotted against an ETF tracking the S&P 500. You can see that as the ETF decreases in value, the percentage of bearish investors spikes. It's a visual representation of recency bias.

Exhibit 1



Source: YCharts.com

Famous investor Warren Buffett quotes his mentor, Benjamin Graham, as saying that "Mr. Market" is like a manic-depressive business partner: "Without fail, Mr.

Market appears daily and names a price at which he will either buy your interest or sell you his. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and we can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him." Buffett concludes: "Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence." [xiii]

Every day CNBC, Fox Business News, Bloomberg, and a host of others authoritatively opine on what is driving the Market's mood. The explanations always seem to makes sense, but they are seldom of any real value to investors. If you think about it, the news has been largely the same over the last five months - the trade conflict with China, a fairly strong but modestly slowing domestic economy, the toxic political climate, among a host of other things and yet we saw stocks soar in late summer, plunge throughout the autumn and then turn sharply upward again after Christmas. It is sentiment, the tug of war between fear and greed, that moves Mr. Market.

We have been navigating the markets for more than three decades, helping investors to keep their calm no matter how Mr. Market feels. We know that money is a very emotional issue for many people, which makes what we do – helping to dampen Mr. Market's mood swings by applying both valuation and sentiment analysis – so important when markets appear to be irrational. Drawdowns (paper losses) are inevitable. As an investor you must be prepared, both intellectually and emotionally, for sentiment to occasionally turn negative and your portfolio to decline. <u>Being able to make clearheaded decisions in difficult times is what separates successful from unsuccessful investors.</u> CSFC tries to turn adversity to your advantage by investing in globally diversified portfolios of stocks and bonds that we hope dampen Mr. Market's mood swings and allow you to remain invested. We thank you for allowing us to help guide you through these difficult periods.

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[i] From the market high in the S&P 500 on September 20th to the low on December 24th.

[ii] Blackrock Returns Comparison, December 2018

[iii] As measured by the Russell 2000 Stock Index

[iv] Sector performance courtesy of S&P Dow Jones

[v] As measured by Dow Jones US Sector Indices, Blackrock Returns Comparison, December 2018

[vi] Source: Blackrock Returns Comparison, December 2018

[vii] As measured by MSCI EAFE and MSCI EM, Blackrock Returns Comparison, December 2018

[viii] As measured by MSCI EAFE and MSCI EM, Blackrock Returns Comparison, December 2018

[ix] All bond category performance data is provided by Blackrock Returns Comparison, December 2018.

[x] The person who owns Tesla and believes it is worth $500 per share doesn't move the market any more than the person who thinks it's worth $100 and doesn't own it.

[xi] This tends not to be true for objects of consumption, such as steak or peanut butter, where rising prices invite substitution. Investments are not fungible in that way. If you want to participate in a stock rally but think prices are too high, you don't go out and buy bonds. If you like Apple products and want to profit from their increased use, you don't go out and buy Home Depot or Nike stock.

[xii] Recency bias is the tendency to think that what's been happening lately will keep happening. One of a group of Behavioral Financial Biases that can cloud investors' judgment. Recency Bias can cause investors to stay in stocks or other instruments because they have been performing well, despite warning signs like historical or relative high valuation. On the other hand, this bias can also keep investors from buying when stock prices are low, as in early 2009, because for months stocks had been falling and under Recency Bias one would expect that to continue. Source: YCharts.com

[xiii] Berkshire Hathaway Annual Letter to Shareholders, 1987.