



DICKMEYER BOYCE

FINANCIAL MANAGEMENT, INC.

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2018 Year End Review

It has been suggested that we keep the year-end review short and sweet. This will be tough for those of us who are so numbers driven. But, we will endeavor to be summary focused, but some detail where needed.

Raise your hand if you feel cheated by the disconnect between the strength of the U.S. economy and the tremendous decline in the stock market in the fourth quarter. It is unanimous.

January was a great month, February and March – not so much, but then steady through September. By 3rd quarter end: A 100% stock portfolio without dividends reinvested was up 6.1%, assuming 20% International; the Barclay's Intermediate Term Investment Grade Bond Index was down 1.67%. This was reasonable given great corporate results, rising interest rates, and weakness overseas. By year end, 100% stock index was down 6.24% and bonds were up 0.01%. Corporate earnings gained nearly 25% for three quarters and it looks like around 11% to 14% in the final quarter.

The Federal Reserve raised rates four times in order to keep the economy from over-heating. Yet, high quality bonds rallied hard (prices rose) in Q4. Yes, there was plenty to be nervous about with storms brewing to the east. To name the key concerns: trade war with China escalating, partial government shutdown, slow-down in Europe, and a possible no deal Brexit (U.K. leaves the European Union on March 29, 2019 without a formal deal with regard to moving product and people across borders).

This quote from the January 4, 2019 Wall Street Journal sums it up. Overall, the data “clearly show that some of the uncertainties on the outlook are beginning to weigh on actual business activity,” Mark Cabana, Band of America Merrill Lynch. ISM Manufacturing index dropped from a very heady number (63.9) in September to a decent number (54.1) in December. The ISM Service index also declined in this period, but remained at high levels, 61.6 to 57.6.

Along with the strong recovery in the stock market this January, ISM Manufacturing jumped back up to 60.5. The ISM Service number is scheduled to report later this week.

The big questions on everybody's minds these days: 1. Is the Bull Market run over? 2. Are we heading for a recession?

Question #1 was answered emphatically in January. A 100% stock portfolio is up about 8%. The Federal Reserve has clearly signaled a pause in interest rate increases this year as they point to the storms building to the east. This position by the FED may prove to be premature, but probably necessary more for Europe and Asia than the USA. The trouble to the east was beginning to have an impact in front office decisions with regard to business investment. If you don't know what the rules are going to be, you stand still. Also, the slow-down in China's economy was impacting manufacturing for U.S. based multi-national corporations and European manufacturing stalwarts.



Question #2 is addressed in the entirety of his page. It is playing daily in financial news. Institutional investment companies are trotting out a lot of data in an effort to try to answer the question. The data is quite contradictory at this point. Leading Economic Indicators are still at peak levels in the U.S. In contrast, the yield curve has flattened (the spread between short and long term treasury interest rates are declining). With regard to the latter: An inverted yield curve (long term rates are lower than short term rates) has predicted 8 of the last 7 recessions. That is not a typo. Sometimes, it gives a false reading. It is likely giving a false reading now. Pensions are desperate for interest and are buying long bonds aggressively. This is driving prices up and reducing long term yields. The Federal Reserve has been raising short term interest rates. The result is a flattened yield curve. As discussed above, the Federal Reserve is now pausing on rate increases.

The U.S. economy remains on strong footing for now. Has the U.S. economy peaked? Probably, the leading economic indicators look to be topped out. Corporate earnings gains will now have tough comparisons to tax code change aided earnings in 2018. But, the consumer is in great shape. Debt is down, hiring is gaining strength, pay increases are solid, and there is strong evidence that people are returning to the workforce (U6 unemployment and under-employment rate has jumped from a low last year of 7.4% to 8.1% in January, and the participation rate rose from 62.7% a year ago to 63.2% now).

Automotive sales and the housing market have very likely peaked. Both are interest rate sensitive. Automotive sales have been running in the 17 to 17.5 million range for the last three years and are likely to stay there.

Existing home sales declined 6.4% from November and 10.3% from the previous year's level. The decline comes from a confluence of factors. Tight supply, rising prices, and higher interest rates has impacted the affordability for first time buyers. The 30 year mortgage rate rose to just below 5% in November. Home prices increased 2.9% nationally in December. This rate of increase has been declining for a few months now. The share of listings with a price drop increased from 12.5% to 15% in the last quarter. These are signs that market prices are adjusting and could decline; this could inject some positive momentum. The 30 year mortgage rate adjusted back down in December to 4.45%. Purchase mortgage applications grew 9% for the week ending January 11th. Stay tuned, the final verdict on housing has not been reached. But, affordability appears to be a big issue. Therefore, success in the housing market will be tied to interest rates.

IMF global growth forecast has been reduced to 3.5% to 3.7%. Europe GDP growth forecast for 2019 has been lowered to 1.5% from 1.8%. China's GDP growth rate was reported as 6.4% in December, their lowest rate in 30 years. Corporate debt, over-capacity, and the trade war are weighing heavily on their economy. They are making progress on adjusting down dependence upon exporting and increasing consumption.

The U.S. GDP growth rate was likely 3% for 2018. Projections for 2019 and 2020 from the Federal Reserve are 2.3% and 2%, respectively, and economists polled by Wall Street Journal are 2.2% and 1.7% respectively.

Recession predictions are all over the map from late this year to 2022. China trade negotiations and Brexit are two wild cards. Throughout this nearly ten year economic growth period, we have moved back up the economic curve multiple times. We are clearly past the peak now, but the quality of the trade negotiations with China will have a significant impact on where we go from here. A successful result will likely push a recession out to 2022. A tariff laden result will accelerate the path to recession, as early as this year end. We do not believe that the USA, nor China, want the latter outcome.



We would be remiss not to mention that just as China has a corporate debt problem, the U.S., some European countries, and Japan each have a growing national debt issue. At best, if not addressed, it will lead to a “crowding out” issue where government debt crowds out economic growth.

Value stocks trailed growth stocks (and therefore all stocks) by 12.62% (6.31%) by 3rd quarter end last year. After the 4th quarter stock market swoon, Value stocks made up almost half of the spread and trailed all stocks by 3.28% at year-end.

At year-end, the price to book value for growth stocks declined to 6.29. This is still 30.2% above the long term average of 4.83, but much improved from 61% over the long term average at the 3rd quarter end.

At year-end, the price to book value for value stocks declined to 1.90. This is now 6.4% below the long term average of 2.03. At 3rd quarter end value was 7% above the long term average.

We conclude this year-end review with a quote from the January 5, 2019 Wall Street Journal regarding market timing. *“It is almost always true that very good days come in the midst of very bad ones. Missing just a handful of them is surprisingly costly. For example, an investment in the S&P 500 over the past 15 years would have grown \$10,000 into a little over \$30,000, according to Putnam Investments. But missing just the 10 best days would have cut that sum in half; sitting out the best 20 would have erased all the returns. In other words, just one half of 1% of trading days over that stretch made up all of the profit to be had from owning stocks. Many of those days were in the heart of the 2008 financial crisis when individual investors were far more spooked than they are now. The only clear message of that era, and one that can be applied today, is that to navigate market upheaval, investors have to stick to their plan rather than react to wild gyrations and scary headlines.”*

We intend to do just that.

Reports: We are including your Portfolio Analysis, Position Performance Summary, and Portfolio Statement. Instead of writing on each report as we have in the past, you are receiving a spreadsheet with the hand notes summarized.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

Dave Dickmeyer, M.B.A.
Wealth Advisor
Principal Owner

Ian D. Boyce, CFP®
Certified Financial Planner™
Principal Owner