SLOAN

INVESTMENT MANAGEMENT, LLC

2018 Year End Letter

## 2018: The Imperfect Storm

Market volatility abruptly began in early October after a Fed speech stoked fears a hawkish Federal Reserve might make a policy mistake by raising interest rates too fast, resulting in a recession. The pessimism continued to build as a concrete resolution on trade with China had yet to materialize. Selling pressure grew as the market struggled to cope with massive year-end tax loss selling. December saw a record amount of mutual fund liquidations by investors spooked by a volatile market which brought us to our 2018 market lows.

The only thing missing from what would have been a perfect storm: the economy tanking. We continued to see positive signs from the 'real' economy. GDP forecasts and corporate outlooks remained positive for the most part, albeit slowing gradually from an elevated pace driven by the positive effects of the 2017 tax reform.

## Volatility and Modern-Day Markets

In last year's letter (which can be found at sloanim.com), we wrote:

**"We expect volatility to increase and the likelihood of a correction is heightened going into 2018".**

Fortunately for our clients, we increased their cash balances earlier in the year. As volatility peaked in the 4th quarter, stock valuations traded down to significant discounts to historical averages creating an opportunity to reinvest the remaining dry powder we had previously raised. Volatility creates investment opportunities; and it is during these periods, that our clients most need a disciplined investment approach which is the key component of our proprietary investment methodology, Post Modern Portfolio Management (PMPM).

The level of volatility that we experienced in 2018 was extreme, especially considering the strength of the US economy. While most individual investors are confused by the new trading dynamics, our team understands the new paradigm of modern-day markets where daily trading volume is now dominated by:

- Computerized / Algorithmic traders
- High frequency traders
- Global hedge fund traders
- Program traders / Day traders

These traders are not interested in the long-term fundamentals of the economy and stocks. They thrive on the day to day volatility to the detriment of market psychology and in particular, individual investors. The good news is that once the volatility subsides, the market will ultimately return to trading on fundamentals, creating opportunities across asset classes.

The media is another participant of the modern-day markets that not only contributes to but thrives on sharp day to day pricing moves of public securities. The goal of the media is to draw as many daily viewers as possible. So alarming headlines, flashing red 'Alerts' and populating the tv screen with as many market experts (talking pundits) as space allows should always be taken with a grain of salt. It's interesting to note that in 2017 when volatility was at an all-time low, CNBC's ratings sunk to a 22-year low.

## Recession Projections are Getting a Lot of Press

Is the market really a good predictor of recessions? We have seen several pullbacks in recent years of similar magnitude to what we experienced in the 4th quarter, yet the economy continued to do well. For example, in 2016 the market had its worst start to the year in history but ended the year up double digits. Recessions are typically caused by either systematic financial problems or excess buildup in the economy; neither of which are present at this time, but we continue to monitor closely.

Banks are much better capitalized (and regulated) since the financial crisis and global central banks have shown they are ready and willing to step in to provide price stability. Inflation is stable around 2% as commodity prices have dropped including a 44% drop in oil prices during the 4th quarter. This translates into cheaper energy prices for consumers and businesses, which will ultimately benefit the global economy.

## **<u>We Approach 2019 with Optimism</u>**

The median forecast by Fed economists for U.S. GDP growth in 2019 is 2.3%. This is slower than in recent years, but the key word remains *growth*. More broadly, the International Monetary Fund is projecting a 3.5% global growth rate for 2019.

The dollar strengthened approximately 4% in 2018, creating a headwind for U.S. multinational corporations. With the Fed lowering the number of expected rate hikes in 2019, the dollar should stabilize and come off its highs, making U.S. exports more attractive to foreign buyers.

While the concerns surrounding the trade dispute with China have contributed to recent market volatility, we do think there will be meaningful progress towards a resolution at some point this year as both sides have a very strong vested interest in making a deal. The U.S. has been at a disadvantage for many years due to unfair trade practices and intellectual property theft by the Chinese. A deal moving forward to address these issues will benefit the U.S. in the long run.

The market reacted negatively when the 10-year treasury yield swiftly rose to 3.2% earlier in 2018 before retreating to 2.7% by year end. This has flowed through to the mortgage market, where rates on 30-year mortgages are down considerably from the 5% level reached in November. This pullback in rates, along with a shortage in housing inventory, should provide a lift to the closely watched housing component of GDP

The Fed has made it clear in recent commentary they will be both data dependent and flexible moving forward with regards to further interest rate increases. A fundamental driver of inflation is wage growth which continues to be offset by workers coming back into the work force and increased productivity. We believe the Fed will be careful not to surprise the market with multiple rate hikes in 2019.

The benefits of tax reform are still working their way through the system. 2018 tax refund checks to individuals and families are expected to increase by over $42 billion from last year. There are still billions of dollars in cash on corporate balance sheets that is held overseas and will likely be repatriated back to the U.S. There is a multiplier effect in which consumers and businesses continue to spend and invest the additional cash on hand from the tax reform. We would not be surprised to see sustained consumer spending, corporate share repurchase programs and dividend increases. Also, it appears there could finally be some progress made on the infrastructure plan as both sides of the aisle seem to be interested in advancing the discussion.

Volatility has subsided from late 2018 levels but will remain part of the modern-day investment landscape. It underscores the importance of having a disciplined global tactical methodology such as PMPM that has successfully navigated portfolios through multiple market cycles.

**As we close the books on 2018, we wish you and your family peace and happiness in 2019**

**The Sloan Investment Management Portfolio Management Team**

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