December 2018

Monthly U.S. and Global Market Outlook

I. Market Performance

The month of December marked a very uncharacteristic month for the markets which was filled with heightened volatility and severe market uncertainties. All three major U.S. indices wiped their gains and plunged into the negative for the year. The S&P 500 Total Return, NASDAQ and Dow Jones fell -9.03%, -9.48% and -8.66% for the month of December closing the year down -4.38%, -3.88% and -5.63% respectively. The primary concerns for 2019 include yield inversion, trade war discussions, timing and size of interest rate hikes, and lower corporate earnings. These uncertainties continue to pressure both domestic and global markets.

For Q4 2018, the estimated earnings growth rate stands at 12.4%. The forward 12-month P/E ratio was further revised to 14.2, trending below the 5-year and 10-year average. Analysts forecast all 11 sectors to report continued year-over-year earnings growth. Analysts cut the S&P 500 earnings estimate by 3.8%, marking the largest cut since Q3 of 2017. The earnings cuts are primarily led by the following sectors: Materials, Utilities and Energy.

Forward-looking, the CY 2019 estimated earnings growth rate is 7.9%. The estimated earnings and revenue growth rates are below 2017 and 2018 forecasts. There is concern regarding the higher international exposure and potential lower earnings and revenue growth for 2019. Additional factors that could significantly impact corporate earnings and revenue growth include: rising costs, rising interest rates, oil price fluctuations, escalating tariffs and the potential for slower international economic activity and growth due to tariffs.[1]

II. Economic Indicators

For the month of December, the U.S. labor force participation expanded rapidly. The U.S. economy created 312,000 jobs. Annual wage gain increased 3.2% and the unemployment rate increased to 3.9%. The surge in job creation was due to expansion in the health care, manufacturing and retail sectors. The 2018 employment data set was the second strongest data set since early 2000.

The Consumer Price Index for November was reported unchanged for the month, +2.2% year-over-year and the Producer Price Index increased +0.1% for November, a +2.5% year-over-year change. The Consumer Sentiment Index declined further for the month of November. The Consumer Confidence Index continued to decline in December. The Global Manufacturing Index (PMI) continued to retreat, plunging even lower to 51.5. The U.S. Consumer Spending and U.S. Personal Consumption Expenditures reported both lower than previous months at +0.4% and +1.8% respectively.

According to the Bureau of Economic Analysis, Gross Domestic Product for Q3 2018 advanced at an annual rate of +3.4%. The next GDP release is expected on January 30th. Housing data continues to weaken. Both housing starts and new home sales fell 4% and 12% respectively year-over-year. As of January 4th, the 3-month U.S. treasury yield increased to 2.42%, while the 1-year yield declined to 2.57% and 10-year yield at 2.67%. Gold increased to $1,284.83 per ounce, oil retreated to $47.96 per barrel and natural gas closed at 3.04 MMBtu as of January 4th .[2]

III. Monetary Policy

During the December FOMC meeting, the Fed increased interest rates to the 2.25% - 2.50% target range. The Fed increased interest rates four times during 2018 and provided guidance on up to two rate hikes in 2019. Based off Fed Chairman Jerome Powell's latest speech on 01/05, the Fed will remain flexible in 2019. The next monetary policy meeting will be held on January 29th - 30th. We do not anticipate any change to the federal interest rates in January. Per Fed Fund Futures data as of 01/06, the market is heavily pricing against additional rate hikes in 2019 with a 96.1% probability that the Fed Funds rate would be higher than the current rate through the December 2019 meeting.

IV. Global Outlook

While there is a temporary 90-day suspension to the negotiations between US and China. the two countries will be holding vice-ministerial level trade talks in Beijing on January 7th – 8th. GDP growth is forecasted to slow down in 2019 and 2020 primarily due to the repercussions of 2017 tax cuts and tariff impacts. In addition to this, according to Factset, as a result of the 2017 tax cuts, the federal budget deficit is forecasted to expand to 5.0% of GDP by 2020, the biggest deficit since 2012. The investment committee remains conservative and is planning on reducing market exposure across all strategies by 50% – 70% and invest in short-term treasuries to better defend against market volatility.

Portfolios Recap

Tactical Long/Short Strategy: -4.25% YTD 2018

The Tactical Long/Short Strategy declined -8.29% net of fees for the month of December, bringing the annual net return down to -4.25%. The S&P 500 Total Return declined -9.03% for the month and closed the year down -4.38%. The Tactical Long Short Strategy outperformed on the downside for the month and year. The investment committee maintains the long market positions as we anticipate strong Q4 earnings, however, we plan to reduce exposure over the next quarter and increase cash levels in order to best position for the year.

Core Strategy: -7.90% YTD 2018
Equity Opportunity Strategy: -7.20% YTD 2018

Global Strategy: -8.64% YTD 2018

For the month of December, the Core Strategy, Equity Opportunity Strategy and Global Strategy declined -8.49%, -7.99% and -7.03% respectively net of fees. The S&P 500 Total Return declined -9.03% for the month, pushing into the negative for the year. The equity strategies faced additional pressure due to the heavy technology allocation. The technology sector significantly underperformed during the month of December. The Global Strategy outperformed on the downside for the month and year in relation to the MSCI ACWI Global Benchmark. The MSCI ACWI Global Index declined -7.17% for the month of December and -11.18% for the year.

For the equity strategies, the investment committee is planning on reducing single-equity exposure over the course of Q4 and increase exposure in short-term US treasuries. The investment committee will continue to focus closely on market valuations, market movements and macroeconomic indicators during the first quarter. The Core Strategy, Equity Opportunity Strategy and Global Strategy invest excess cash into short-term 3-month U.S. treasuries which currently have an annualized yield of approximately 2.4%.

Dynamic ETF Option Strategy (DEOS): +1.44% YTD 2018

For the month of December, DEOS declined -1.75% net of fees bringing the year-to-date net performance to +1.44%. The strategy outperformed its benchmark, the PUT index, along with the S&P 500 index which had YTD performances of -5.93% and -4.38% respectively. This was primarily due to the risk-off stance we have been setting throughout Q4 which enabled the strategy to have a much lower beta than the broad market. As the market continued to sell off, we proactively credit rolled the closer strike positions further out of the money and out in time. Despite the rebound we've seen in the short term, we anticipate volatility to remain elevated throughout 2019 due to several macro headwinds. In light of this, we'll be rolling out hedged options spreads as exposure continues to reduce in Q1 and Q2 of 2019. We'll be continuing to keep the strategy in a very defensive stance as we monitor the market and macro conditions.

As always, we welcome you to reach out to us any time to discuss your portfolio and any questions.

Fariba Ronnasi, *Principal*

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References

1. Factset Earnings Insight December 21st, 2018
2. Bloomberg
3. Bureau of Economic Analysis, International Monetary Fund