

A December *Not* to Remember

What just happened?

A CONFLUENCE of disruptive market forces, many of which have been looming on the horizon for some time, led to the recent sharp and widespread retrenchment in global markets. Slowing global growth, tightening monetary policies, valuations, and geopolitical uncertainty had made markets vulnerable. After markets made new highs in the third quarter of 2018, those forces converged in the fourth quarter in rapid succession. Earnings guidance was cut, trade policy with China reached an inflection point, Brexit negotiations fell

apart, the Federal Reserve continued its path of increasing interest rates, and a U.S. government shutdown occurred over funding for a border wall.

As we know, markets abhor uncertainty, and in an instant, uncertainty seemed to be all around us. After the Christmas Eve rout, the S&P 500 index virtually suffered its first bear market (declining 19.8% from its September 20 high) since its recovery from the global financial crisis that began in March 2009. Declines from recent peaks for the Russell 2000 index of small-cap stocks, the

NASDAQ Composite index, and emerging markets index exceeded the 20% bear market threshold. Developed markets outside the United States, on average, fell 17%.

In dramatic fashion, complacency was shaken out of the market. Although markets have rebounded strongly since Christmas, the underlying concerns troubling investors remain. The question now is whether this sentiment-driven correction is creating an opportunity for investors, or are the markets telling us we are headed toward recession, which could lead to new lows.

WHERE do we go from here?

AFTER NEARLY 10 YEARS of global economic expansion, investors are naturally worried that we are nearing the end of this bull market—a valid concern given the current shifts in sentiment across the global landscape. Our view is that we have now passed “peak growth” in economic and earnings terms and the next few quarters will see a fade from recent highs. While naturally uncomfortable for investors, this fade is somewhat inevitable given the intense period of stimulus that is now rolling off.

Even so, the global economic framework has not changed significantly. We have long maintained a belief that we are living in an era defined by low GDP growth, excess debt, excess oil, and low inflation driven by technology and automation. But a world of relatively low growth and inflation does not imply a world absent of positive change, progress, or opportunity. If anything, it implies a broad dispersion of stock returns and a need to position portfolios actively on the right side of change, as it evolves.

As we look out, we are focused on three policy responses that will shape the path and

slope of growth into 2019–2020. These are:

- China’s domestic economic stimulus response
- The U.S. Federal Reserve slowing the pace of interest rate rises, especially if oil prices continue to weaken as we expect
- Some resolution of the U.S.-China trade dispute

We believe enough policy response tools exist to shepherd the global economy back toward the “new normal” environment (i.e., a low-growth, low-return world) being reestablished, although the highly unusual political environment is certainly adding to the complexity underlying this opinion. However, our base case remains that politicians will avoid the worst scenarios of economic self-harm when rhetoric ultimately meets reality and defines policy.

While overall global growth is expected to slow in 2019, we do not anticipate a recession in the United States and expect some rebound in global growth. Most of the Fed tightening is behind us and should become less of a challenge as we work through 2019. The U.S.

auto sector is late in the cycle and housing has slowed, but there are not the distortions that are typically apparent at the end of a market cycle, e.g., a misallocation of capital and euphoria in certain sectors, such as telecom infrastructure in 1999 and housing in the mid 2000s. In other words, it is hard to have a bust when we really haven’t had a boom.

In Europe, fiscal policy should be slightly stimulative in 2019, and the European Central Bank has not even started to raise interest rates. The Italian government seems to have reached a truce with the EU. Europe is an oil importer, so the significant decline in oil prices should be supportive, and auto production in Germany, which accounts for 20% of German exports, should improve.

Japan continues to benefit from a strong combination of fiscal and monetary policy initiatives, including government spending and an accommodative monetary policy stance from the Bank of Japan. Yet structural reforms have proved elusive and another increase in the value-added tax (VAT) is on tap for October. As a result, the economic growth trajectory for Japan may peak by midyear, though

more stimulus could be extended as spending ramps up ahead of the 2020 Olympics.

EM economies continue to perform relatively well, despite concerns around trade, currency weakness amid dollar strength, and moderating demand from Europe and China. As the world's second-largest economy, what is most crucial is the extent to which China restimulates. China has the scope to make additional selective tax cuts and to further

reduce bank reserve requirements. We believe it is probable that China announces further stimulus measures post-Chinese New Year in February 2019, though not of the "shock and awe" variety experienced post-2008.

All in all, we remain sanguine on the prospects for an equity market recovery, citing more appealing valuations, slower but still healthy corporate earnings growth, relative strength in the global economy, a fading

headwind from U.S. monetary policy, and possibly reduced tensions on trade and other geopolitical concerns. We would be remiss not to acknowledge the risk that the current lack of confidence in global equity markets persists, creating a negative feedback loop that could ultimately cause a recession. However, we are in no way on the precipice of a credit crisis akin to 2008, despite what recent market action might have you believe.

WHAT does this mean for your portfolio?

WITH THIS ECONOMIC FRAMEWORK, our outlook is that the world is now moving out of a stimulus-driven complacency period and into a new phase with higher risks but the potential for still strong returns. Since many of the risks that have unsettled global markets remain, we are likely to be in for a choppy ride until we have more visibility. Yet we are cautiously optimistic that investors will adapt to a less buoyant but still supportive market environment, and that many of the risks may be overstated.

Ultimately, we think President Trump makes a deal with China, which will steady global growth; the Fed begins to pause; the U.S. economy decelerates in the first half but stabilizes and gets better in the second half; inflationary pressures from oil, steel, and interest rates have already peaked; and the market valuation at 15x to 16x earnings is reasonable in an environment of 2% to 2.5% economic growth and interest rates below 3%.

While economic growth is fading, this remains an environment of change, progress, and opportunity. Investors must make the distinction that, while the rate of growth in profits may have peaked, absolute profits are at record levels and expected to rise. Also, a look back at the past 10 profit cycles reveals that following a peak in the year-over-year profit growth rates, it has taken about four years before the economy slipped into recession. Perhaps even more important, equity prices climbed by an average of more than 50% during that intermediate period. Clearly, peak profit growth does not usually indicate a recession is at hand.

As such, we believe equity market alloca-

tions should remain in line with the target benchmarks we set with you. We further emphasize our approach of balancing low-cost index investments with funds managed by active, fundamental stock-pickers, as now more than ever we want to further intensify a focus on higher-quality investments with stable and improving corporate fundamentals over the next 12–24 months. We do this in part to defend our portfolio against growth and profit deceleration, as we firmly believe that stock-specific insights can be defensive.

And while a focused portfolio is important in times of volatility, any concentration of risk factors is equally important to manage. Therefore, we maintain that diversification into broad global equity markets and across stocks, bonds, and alternatives should remain a key portfolio construction discipline.

During such periods of market turbulence, we encourage you to review your asset allocation but also try to maintain a long-term perspective. There is a long history of investors selling near the bottom. It can be difficult to fight that urge, but know that we have been taking steps to reduce risk along the way by employing disciplined rebalancing and tilting away from more volatile or overvalued market segments. The 24-hour news cycle is aimed at creating an emotional response that will keep the audience tuning in, but try to block out that noise. Your mix of stocks and bonds was set to reflect your financial goals, time horizon, liquidity constraints, and risk tolerance; changes to that plan should typically only come from changes in your circumstances, not due to changes in market conditions.

What is new at Ropes Wealth Advisors?

As of January 1, 2019, we are delighted to formally welcome to the Ropes Wealth family the 14 client service professionals who have been working with you on the administration of your accounts and implementation of your wealth management plan. These colleagues had been a part of the Ropes & Gray Private Client Group, and are joining us in recognition of their key and integrated role in our service delivery to you.

Please explore our updated team website here, and note that the email addresses for these colleagues now reflect a [ropeswealth.com](https://www.ropeswealthadvisors.com/en/overview/who-to-contact) extension: <https://www.ropeswealthadvisors.com/en/overview/who-to-contact>

Thank you for the confidence you have placed in us as your investment and financial planning advisor, and we look forward to working with you in 2019.

Best wishes for a happy, healthy, and prosperous new year.

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P 1-617-235-4260

F 1-617-235-4261

[ropeswealthadvisors.com](https://www.ropeswealthadvisors.com)