TFC FINANCIAL
The Financial Counselors

COMMENTARY | 4Q 2018
January 2019

OUR VIEW

Sentiment turned sharply negative in the 4th quarter, setting the stage for 2018 to conclude with near double-digit losses for global equities.

The latter part of the year created economic and policy concerns that overcame the positive economic news from the first three quarters of the year.

2018 Market Performance

Sentiment turned sharply negative in the 4th quarter, setting the stage for 2018 to conclude with near double-digit losses for global equities. The market downturn was in sharp contrast to U.S. economic momentum that remained strong for much of the year. Second and third quarter U.S. GDP growth represented the strongest back to back quarters since 2014. Jobs continued to be plentiful, as the unemployment rate declined and the workforce participation rate rose. Wages showed signs of positive momentum, while inflation remained close to the levels targeted by the Federal Reserve. Corporate tax cuts boosted results for U.S. companies already benefiting from robust growth. The U.S. was the clear economic leader, as challenges faced by China and Europe made last year's synchronized global growth environment a distant memory. In response to strong economic growth, U.S. interest rates rose for much of the year. The U.S. dollar rose relative to the Euro and emerging markets currencies.

The latter part of the year created economic and policy concerns that overcame the positive economic news from the first three quarters of the year. Global manufacturing indicators weakened, in part because of slowing economic growth in China and worries about trade tensions. Steps by the Federal Reserve to raise interest rates and decrease the size of its balance sheet created fears that the Fed would trigger a recession by raising rates too much. The resignation of James Mattis as Secretary of Defense, rumors that President Donald Trump would fire Federal Reserve Chair Jerome Powell and the shutdown of the U.S. Government were unwanted gifts for investors hoping for a restful holiday season.

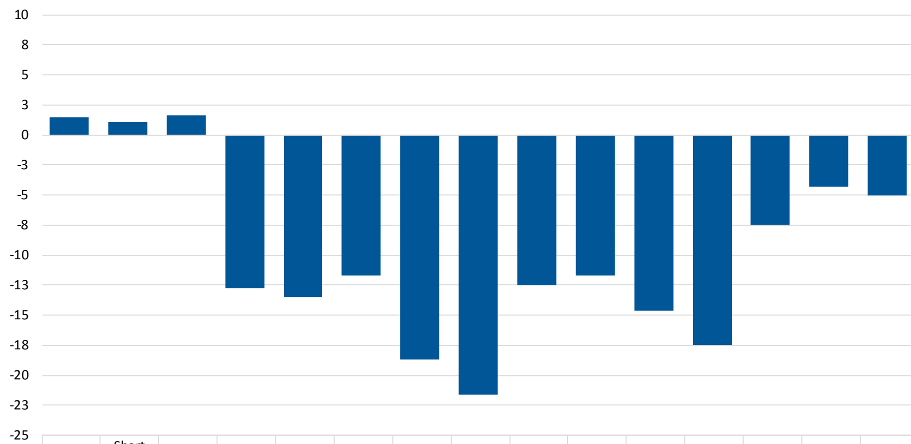
Global equities, as represented by the MSCI All Country World Index, declined by 9.4% for the year. U.S. large company stocks were relative outperformers, with the S&P 500 falling 4.4%. 2017's best performers -- international, emerging markets and international small company stocks -- were among 2018's worst performers. International and emerging markets stocks declined by approximately 14%. Value stocks trailed growth stocks in much of the world, and small company stocks trailed large company stocks. Short-term bonds provided slightly positive returns during the quarter, a welcome source of capital preservation in a difficult year.

The energy sector followed crude oil prices downward, falling by 18% for the year. Defensive sectors, including healthcare and utilities, held up best during the end of year selloff. The technology sector, which led the market advance during the first three quarters of the year, fell back sharply to end the year.

Despite brief periods of value outperformance in the last few years, the overall outperformance of U.S. growth stocks relative to value stocks approached "dot com" era levels. Growth stocks, as measured by the Russell 1000 Growth Index, have beaten value stocks, as measured by the Russell 1000 Value Index, by nearly 4% per year over the past three years. However, we may be at the beginning of a long overdue reversal.

Quarter To Date Index Returns

12/31/2018



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	US Large Value	US Small Value	US Small Growth	Intl. Large Core	Intl. Large Value	Intl. Small Value	Intl. Small Growth	EM	Frontier Markets	Global Real Estate
QTD	1.5	1.1	1.6	-12.8	-13.5	-11.7	-18.7	-21.7	-12.5	-11.7	-14.6	-17.4	-7.5	-4.3	-5.1
YTD	1.4	1.8	0.0	-9.4	-4.4	-8.3	-12.9	-9.3	-13.8	-14.8	-18.2	-17.6	-14.6	-16.4	-7.0
Full Cycle*	2.5	2.3	3.7	2.8	6.8	5.1	5.3	6.8	0.0	-1.0	2.4	2.6	-0.5	-2.4	2.1

* Full Cycle is the annualized return from October 2007 peak to present.

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TFC client portfolios generally declined for the year, and lagged client benchmarks slightly. Gains from TFC's bond holdings in mostly high-quality, shorter-term fixed income investments did not offset negative returns throughout equity asset classes. TFC's tilt to small company and value stocks was the major reason for that lag.

TFC's asset allocation approach is designed to provide clients with diversified equity investments across regions, economic sectors and investment styles. We are wary of "all or nothing" investment approaches, consequently TFC portfolios are "tilted" toward value but have a reasonable allocation to growth stocks. Although recent performance is behind TFC client benchmarks, the gap between TFC and benchmark performance was considerably narrower than the gap between value and growth referenced above.

Looking forward, we remain confident that value stocks will return to favor. Value underperformance has been notable in recent years, however, over longer periods of time value stocks have outperformed relative to growth stocks. The valuation disparity between growth and value is at high levels today, leading us to be confident that value will ultimately return to favor. In our view, the time-tested value investment approaches of Benjamin Graham and Warren Buffett will pay off in the long run.

Market Outlook

As we discussed in our letter earlier this month, we think that economic growth has peaked but that a recession is not imminent.

As we discussed in our letter earlier this month, we think that economic growth has peaked but that a recession is not imminent. The American consumer remains a strong engine for economic growth. Consumers are benefiting from a tight job market, long-overdue wage increases and healthy personal balance sheets. Solid retail sales this holiday season offsets much of the negative news elsewhere in the economy.

Overall, although U.S. economic growth will slow from the rapid pace of the first three quarters of the year, fourth quarter GDP growth is projected to remain above-trend for this economic expansion.

Second-guessing the Fed is a popular pastime, but we disagree with President Trump's assertion that the Fed is to blame for the economic slowdown and market downturn. The Fed's actions to date have been consistent with the mandate to promote maximum employment, stable prices, and moderate long term interest rates. We expect slowing growth and the flattening yield curve to cause the Fed to hit the "pause button" on rate hikes in early 2019.

China's growth is slowing but likely to rebound as the government slows the pace of financial sector deleveraging, encouraging more small/medium business lending and infrastructure spending. Trump might "prefer" to escalate trade disputes with China for the remainder of his first-term as President, but he ultimately will be "constrained" by the negative impact of a protracted trade war on U.S. unemployment and economic growth. Although there is likely to be a "grand bargain" with China on trade before the 2020 election, the next year may be filled with periods of hope and despair much like that experienced in the days following the Trump/Xi dinner at the G20 Summit in December.

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Portfolio Positioning

From a positioning perspective, TFC is positioned roughly in line with long-term strategic targets for stocks, though we will be thoughtful in maintaining enough portfolio liquidity to address known cash needs over the next six to twelve months. Global growth and increasingly attractive valuations supports a neutral weight to equities. Policy uncertainty and the longevity of the economic cycle makes heightened volatility an unfortunate reality for 2018. Bonds remain a necessary counterweight to equities. TFC continues to favor shorter-term/investment grade credits, but supplements with intermediate-term bonds that provide desirable diversification and additional income.

The U.S. remains the fastest growing developed market, but still is relatively expensive compared to other developed markets. Economic momentum is slowing in the Euro Area amid worries about trade, Brexit, and Italian political conditions. Europe could rebound if headline risks fade.

We have made changes to the emerging/frontier markets segment of TFC portfolios. We sold the Harding Loevner Frontier Emerging Markets Fund in order to purchase the Harding Loevner Emerging Markets Fund. We respect Harding Loverner's emerging markets investment capabilities, and determined that their Emerging Markets fund was an attractive complement to TFC's other emerging/frontier markets holdings and a solid long-term long-term holding for TFC client portfolios. The Harding Loevner Emerging Markets Fund has an investment universe that incorporates both emerging and frontier markets, and has the latitude to do so in an opportunistic matter. We think the more flexible investment mandate will be a more appropriate investment choice for the years ahead than the fund we sold, which was more focused on frontier and smaller emerging markets countries.

Please join me for the quarterly TFC webinar, scheduled for January 22nd at 11:30 am. An invitation will follow, and we'll post the webinar on our website for those unable to attend live.

We monitor the market environment and will incrementally adjust the portfolio based on new information. As always, we welcome your comments and questions.

Sincerely,

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