The dichotomy between the first three quarters of the year and the last one, was stark, to say the least. Through September, the S&P had gained 10.6%; at year end, it reversed to -4.4%. The Nasdaq Composite Index, whose components fueled much of the run-up earlier in the year, entered official bear market territory on December 22nd, dropping 22% from peak-to-trough. The correction in market prices was not necessarily unexpected, it was the magnitude of the decline and ferociousness of the volatility, that caught most off guard.

For the past several years and most notably the second and third quarters of 2018, we saw complacency take hold in the markets, characterized by historically low volatility and “up days” in the market solidly outpacing down ones. This behavior came on the back of the longest bull market in history, stretching back to March of 2009, in which investors enjoyed outsized returns amid the recovery from the 2008 financial crisis. Recently, several factors have contributed to not only a of reversal this complacency, but to a stoking of anxiety and panic, which, in our minds, seems overblown and not totally grounded in reality.

The lead-up to Q4 saw a confluence of factors that contributed to record returns. Mainly, accommodative Federal Reserve policy made credit cheap, allowing businesses to borrow, refinance debt, spend on capital projects and fill their cash coffers. Similarly, mortgage rates sat at, or near all-time lows for nearly eight years, fueling a boom in real estate transactions and the construction business. Coupled with record low unemployment, an ongoing structural shift towards technological-based productivity improvements, tax cuts and a generally favorable global economic and geopolitical backdrop, investors were happy to continue rolling forward their expectations for a rosy outlook and thus, pump up prices.

Cracks have begun to form in this picture though, roiling markets and spooking investors. The ongoing trade war with China, and the overall political atmosphere of gridlock, obstinacy and incompetence in Washington have injected uncertainty for businesses. Similarly, the current government shutdown is estimated to reduce quarterly GDP by 0.13 percentage points, for every week it continues.

Generally solid economic conditions have allowed the Fed to raise benchmark interest rates, which has also served to unnerve markets. Mortgage rates have increased, as have short-term US Treasury yields, making them more attractive vis-à-vis, stocks. Amidst this, the yield curve remains unusually flat, signaling that bond investors lack confidence in the direction of the long-term economy. In response to the markets’ violent reaction to their statements, the Fed has increasingly adopted a less hawkish tone, however and appear ready to concede a more flexible approach in their evaluation of economic conditions and potential rate increases; this has served to stabilize markets.

Lastly, in addition to and perhaps because of these factors, the earnings outlook for 2019 is tempering. With the effects of the tax cuts moderating, the levels of growth seen in 2018 were unsustainable, but initial estimates were for 10% growth in the new year; this has now moderated to around 4%, as investors lower their assumptions. In reality, this re-rating of risk and expectations is quite healthy. The volatility that was experienced in Q4 was actually right in line with historical averages, yet it felt much more severe given the backdrop of such sustained low volatility in the preceding period. Likewise, expecting interest rates to remain at 0% forever, or earnings to grow at 20% in perpetuity is wildly unrealistic, yet for a time, these were the factors on which investors were pricing the markets.

Despite some pockets of valid concern, we do not anticipate a recession or a financial crisis ahead; slowing growth is part of the market cycle. Fundamentals remain sound and companies are positioned quite effectively to manage balance sheets and employ capital when needed. If anything, stocks are much more attractively priced now than they were three months ago, affording us an opportunity to prudently deploy cash and invest in those stocks which we have always favored: quality companies with strong financials and stable growth prospects. We anticipate undertaking a minor sector rotation, allocating away slightly from technology and increasing our stakes in healthcare, financials and some consumer names.

Likewise, the recent uptick in bond yields and sell-off in credit has made fixed income attractive, especially in the short term and we are actively looking at opportunities across the credit and sector spectrums. We see bonds with shorter maturities, at the lower end of the investment grade range, as offering the best risk-reward proposition and expect to re-enter the individual securities space, diversifying away from the mutual fund-only strategy that we've employed for the past several years.

As always, we advocate for a long-term outlook; a strategy that requires some patience and confidence in the reversion of events to the mean. Price corrections, volatility and investor overreaction are not new phenomenon, though they feel as such when one is experiencing them. We must and will, look past the short term and maintain a disciplined approach to investing for the achievement of long-term goals.

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