What Investors Need to Know to Start 2019

Markets

- Virtually every major stock market recorded negative performance for 2018.
- An equity market sell-off through much of the fourth quarter erased gains made earlier in the year.
- After more than nine years of growth for the markets, investors have come to expect stocks to keep delivering positive returns.
- The negative returns were all in the last quarter of the year, making the impact seem larger (from the highs of September 2018) and more immediate.
- The intraday and day-to-day volatility played up in the media magnified the fear factor.

Counsel and Private Wealth Portfolios

- As markets were down in 2018, so are the Portfolios to various degrees.
- Allocations to our trend-following strategies designed to mitigate risk provided an element of downside protection as they shifted out of riskier assets and moved into short-term bonds or cash throughout the fourth quarter.
- The fixed income component in the Portfolios is dampening equity volatility as per design.
- Our overweight to International equities detracted somewhat as International equities trailed U.S. equities over the year.
- By definition, diversification means that some areas of your portfolio will be down while others are doing well. Maintaining that balance is crucial to successful long-term investing.
- As volatility increases, it is more important than ever to stay disciplined and focused on your long-term goals.

Outlook

- We believe that there’s reason for cautious optimism in 2019. Equity markets will likely endure more volatility before edging higher. Fundamentals remain positive and valuations are not excessive.
- On the economic front, while U.S. data suggests the pace of growth will slow in 2019, the good news is that the U.S. economy remains strong, as unemployment is holding at record lows and job growth continues.
- It’s reasonable to expect that corporate earnings, after growing significantly this year, will also slow. However, we don’t see a recession lurking around the corner as both consumer and business sentiment have edged lower but are still well above historical norms.
- With stock markets having gone through this dramatic pullback that has made valuations more attractive, barring a ‘black swan’ event, or some other entirely unexpected market shock, the worst of the drawdowns seen by equities could well be behind us although we can’t forecast investor sentiment precisely.

When markets are volatile, we know it can be challenging to keep your emotions at bay. We’re here to be your guide and help you stay focused on your goals. If you have any concerns, please give us a call.

We spoke with some of our investment specialists about what they were doing to preserve capital during the fourth quarter, what their outlook is for 2019 and what is one important thing that investors should remember as we start this new year. Here are their responses.

Wasatch Advisors, International Small Cap

Coming into Q4, we were sensitive to high valuations and cautious on our positioning in cyclical areas like semiconductors and automotive. We were trimming and selling expensive names in the first three quarters of 2018, particularly in the industries mentioned. We also saw opportunity in high quality emerging markets like India that were relatively better-valued and we added to great businesses that had sold off earlier in the year.

Continued volatility and choppy markets will be with us through at least the first half of 2019. Through our interactions with management teams, uncertainty has definitely increased but by no means have their businesses fallen off a cliff. The U.K. remains uncertain until the country can reach a resolution with Brexit. In Europe, valuations are becoming compelling but that is being offset by incrementally weaker but still positive economic data. Japan will also see volatility from a macro headline point of view, but we believe the small-cap companies that we focus on have ample headroom and flexibility to adapt and continue to grow their businesses and we have been increasing our allocation to Japanese small caps. Emerging market small caps have good relative valuations and we are seeing great opportunities in countries like India.

It is important to keep a long-term perspective. While we cannot predict the short-term gyrations of the market, we can say with confidence that the high-quality companies with great management teams that we invest in will adapt and continue to execute and grow their market share and earnings through the cycle.

Putnam Investments, North American High Yield Bonds

The overall headwinds in the marketplace seem to be persistent with no clear catalyst to shift sentiment over the short-term. This has caused us to become more defensively minded (we typically have a conservative tilt regardless). We have increased our cash balance in the portfolios from the usual 1-2% range to 5-6%.

Our overall view of the high yield asset class remains generally constructive. The fundamental landscape of high yield issuers in the U.S. is positive, buoyed by favourable corporate earnings and economic data. Overall default levels have significantly fallen over the last 12 months and are at levels last seen in 2014 (1.87%, including distressed exchanges). From a valuation standpoint, spreads now look attractive given the recent back-up during December. Meanwhile, the technical environment has been generally positive due to moderate net new issuance volumes coupled with a search for yield but tempered by outflows in the asset class in 2018. With that said, the risks to our constructive outlook include commodity price volatility, policy missteps from global central banks, heightened geopolitical tension and/or escalating trade rifts. Overall, we will continue to capitalize on relative value opportunities in the primary and secondary markets.

It is typical of high yield to have sharp rebounds after periods of weakness as we saw in 2015/2016. A high starting yield allows for solid returns should the market stay stagnant, and very strong returns if we get a change in tone throughout the year.

Mackenize Investments, Canadian Small Caps

With the ongoing market volatility, we have done the following:

- Trimmed Energy holdings starting in late Q3 and began raising cash
- Raised more cash in Q4 of 2018
- Maintained our weight in gold stocks which have been doing well in this environment

As we enter the new year we have cash of over 3%. We will be watching various macro events but plan to use the cash to selectively acquire existing names as valuations have become much more attractive.

The current outlook is cautious for 2019 and will depend on positive resolutions to the US - China trade dispute and Brexit. Investors also have been concerned that the U.S. economy may be slowing down due to higher interest rates, the trade war, and slowing growth in Europe, although some recent reports suggest that the U.S. economy continues to create jobs and will keep growing, even if its at a slower pace than previous.

Markets probably ran up too far, too fast over the past two years and the recent weakness is a healthy correction rather than the beginning of a long bear market. Valuations are far more attractive now compared to three months ago and we have the liquidity to take advantage of this situation.

Marsico Capital, U.S. Growth

Starting in late Q3, we began changing the composition of the portfolio with the addition of more defensive, high quality, capital-return oriented core-growth franchises such as McDonalds, Monster Beverage Corp., and Eli-Lilly. Simultaneously, we decreased our overweight positioning in certain growth/Tech names such as Apple and Alibaba, Inc. and eliminated Nvidia, Tencent and Activision Blizzard completely. We have an elevated cash position, averaging nearly of 9% during Q4, compared to the usual 1-3%.

If the first few days of 2019 are a sign, we continue to expect the market will remain volatile as it grapples with de-synchronized global growth and fiscal/trade/monetary regimes around the world. In the U.S., we currently anticipate 1st half 2019 GDP will moderate from 2018 levels (lapsing of 2018 tax cuts and tighter financial conditions) and, as signaled by Chairman Powell, the Federal Reserve will likely take a “wait and see” approach to interest rates given the apparent disconnect between economic data and financial markets. While this will not alleviate all concerns over U.S. growth prospects, it should provide for a more supportive market for asset prices. Across Asia and China more specifically, we continue to expect governments will attempt to stimulate the economy across various channels. We expect the combination of activities across 2H18/1H19 will stabilize and improve growth prospects as 2019 progresses given the typical lags to fiscal/monetary policy that exists. Given the various puts and takes to the current environment, we continue to believe a more balanced approach is prudent, and high-quality factors (ie: balance sheet strength, revenue sustainability) will remain key attributes.

Don’t overreact! While the environment has proven to be more difficult than anticipated, investors can rest assured that the growth franchises in the portfolio are of the highest quality and should outperform the market over time. The companies (and the U.S. Growth portfolio in aggregate) are stress-tested across various market scenarios and as a team at Marsico we are keenly aware of the evolving opportunities and risks in the current market and will adjust our portfolio accordingly to support continued performance.

Acadian Asset Management, Global Dividend, North American Growth, North American High Income

We continue to focus on risk management and imposed risk controls for Russia, Turkey and Italy with emphasis placed on the most affected industries within these countries. At the beginning of December, we removed the Turkey constraint as risk levels moderated and are currently in the process of reviewing Italy where the Italian parliament passed the revised budget agreed upon with the EU in December.

Globally, our Macro model prefers Portugal, Denmark and Japan in developed markets and Russia and Colombia for Emerging Markets. By sectors, the model is pointing to Telecoms, Banks, and Food and is less positive on Autos and Semiconductors. From a Dynamic Factor perspective in developed markets, Momentum is most favored and Growth/Quality least favored. In Emerging Markets, Value/Momentum are most favored with a neutral stance on Quality/Growth. There is, however, considerable variation across regions and industries.

The most significant market influence is likely to be the pace of economic growth and any marked changes in expectations. Often, when this occurs, we see a change in market leadership and investment style preferences as individuals and corporations become more conscious about discretionary spending. Currently there is much attention on slowing Chinese economic expansion, trade wars, Brexit, oil prices and interest rate policy. However, one should remember that forecasting events is a complex exercise and to use an ancient Chinese proverb “Trouble never comes from the expected quarter”.

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