



SilverOak

WEALTH MANAGEMENT LLC

Fourth Quarter 2018 Market Summary

7650 Edinborough Way
Suite 250
Edina, MN 55435

Phone: 952-896-5700

Visit us at
silveroakwealth.com

Fourth Quarter 2018 Market Summary

2018 was a unique year, a bit of a rollercoaster. The year started with a lot of market volatility and ended with even more drama. As you may recall, January saw equity markets continue their ascent, extending the strong returns from 2017. The “fear of missing out” on the next great investment trend reached a fever pitch. Then, in late January and through February, equity markets sharply pulled back by more than 10% from their highs. Volatility abated through much of April to October, which helped U.S. equities rebound and reach new all-time highs in September. Meanwhile, international equity markets struggled to regain ground, unlike in 2017 when they were up more than 25% and outperformed U.S. equities.

Then, in early October, Jerome Powell, the Chair of the Federal Reserve, spooked the markets when, during a press conference he indicated that the Fed still had a long way to go in normalizing monetary policy. Thus, their plan is to continue raising interest rates and reducing their balance sheet as long as the data supports it. Unfortunately, the markets did not react favorably to the thought of further interest rate hikes and global equities began to decline, giving up more than 10% - 20% through the end of the year. The U.S. equity markets had their worst December since 1931. The Fed has been trying to communicate that they will not cater to the financial markets and will act independently. They are attempting to underscore the message that market volatility is differentiated from financial system stability. Nonetheless, investors would like to see a pause in monetary tightening to counterbalance the U.S./China trade issues, slowing global growth, and general uncertainty.

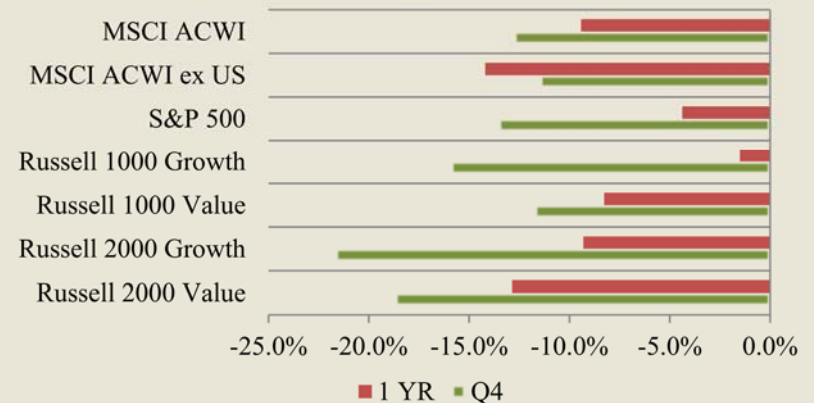
Although you may have heard the phrase “there is always a bull market somewhere”, with all the volatility during 2018, this phrase was not accurate. In fact, no major asset class even had gains of 5%, which hasn’t occurred in over 45 years. Cash and fixed income were at the head of the asset class rankings. For the year, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was up 0.01%. However, bond sectors with more credit risk like corporates, high yield and emerging market bonds had negative returns.

With the disappearance of the bull, the bear came out of hibernation during the fourth quarter. “Bear markets” are generally labeled when equities fall more than 20%. Corrections such as these are normal and healthy. Since 1950, there have been 14 instances of a drawdown of 20% or more. Half of the bear markets have coincided with a recession while half have occurred in an up trending market. During the fourth quarter of 2018, U.S. equities crossed the “bear market” threshold.

However, for the year, U.S. large company stock returns, represented by the S&P 500 Index, were down a relatively modest 4.4%, while U.S. small company stocks, represented by the Russell 2000 Index, were down 11.0%.

International stocks, represented by the MSCI ACWI ex US Index, were down 14.2% for the year. International markets started the equity market selloff earlier in the year as investors became more concerned about the impact of a stronger U.S. dollar on foreign economies. Coupled with strained Brexit discussions, Italian debt issues, populism, and trade standoff with China, there were no shortage of macro events influencing the markets. Nonetheless, emerging market currencies are attractive and international equities are near cyclical lows relative to U.S. equities.

Broad Market Index Returns Fourth Quarter 2018



With U.S. large cap stocks outperforming international stocks for most of the past six years, 2018 being no exception, some investors are beginning to ask why they should diversify their portfolios. SilverOak strongly believes in diversifying across asset classes as the future is always uncertain and the range of possible outcomes is vast. This recent quarter has been a good lesson in diversification. While equities were declining 15%-25% during the quarter, bonds were a safe haven and actually had positive returns, thus dampening overall portfolio negative returns.

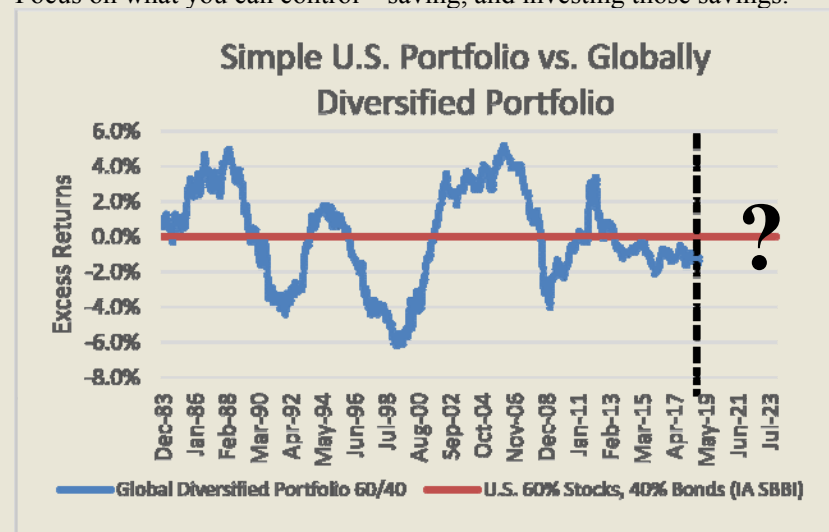
Fourth Quarter 2018 Market Summary (continued)

The fact that bonds historically have positive returns when equities have large drawdowns is a large reason why fixed income is a part of a diversified portfolio. Bonds can act as an emotional hedge when markets are volatile, keeping investors in equities which over the long-term provide the returns needed for financial independence.

The other side of the coin is, what did well in the 4th quarter, cash and bonds, will not provide the returns needed over the long run. The cost of higher returns, via equity risk premium, is volatility. Most investors must accept this risk, as equities are integral to a diversified portfolio. The key is for clients to not take on more risk than they can handle, while also not taking less risk than they need to participate in long-term appreciation.

Of course, if a portfolio's assets all had strong returns at the same time it would feel great. However, the inherent cohesiveness would signal that the portfolio isn't as diversified as thought and there would likely be unseen risks in the portfolio which could lead to poor future returns. It is important to rebalance into the asset classes that are lagging as they may become the leaders once again. Markets are cyclical – sometimes the trends may be short and other times may extend a long time. The chart below shows this cyclical relationship, comparing a simple portfolio of U.S. large company stocks and bonds vs. a globally diversified portfolio including small company stocks, international stocks, and real estate. For the past six years, U.S. assets have outperformed their global counterparts. Thus, diversification has not been additive to portfolio returns. However, the chart clearly shows times when just the opposite was true. There have been several periods of roughly 4-7 years where one type of portfolio outperformed the other. As mentioned previously, the future is uncertain; however, there are currently more tailwinds that should benefit a globally diversified portfolio going forward.

Many people think in terms of quarters, a year or even a three year time frame. Five years ago can feel like another lifetime. For markets, even five years is a short time frame. Taking action and creating change that can be seen in the short-term gives a feeling of control, which is positive reinforcement. However, it takes strength and wisdom to stick to a long-term plan. Investing is inherently uncomfortable. Sometimes the best action is no action. Time is your friend and one of your biggest allies. Focus on what you can control – saving, and investing those savings.



Another note to highlight when reviewing fourth quarter performance statements is that they are snapshots in time. Unfortunately, they don't tell the whole story. As an example, since Christmas, equities are already up 5%-15%. If those positive returns would have been added to the fourth quarter statements, many investors would feel better. Of course, investors want to continually see positive performance and forward progress in their portfolios. This is human nature. Unfortunately, investing is quite often two steps forward and a half step backwards.

HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the third estimate of third quarter 2018 real GDP, an annual rate increase of 3.4% from the preceding quarter. The fourth quarter advanced estimate release will be delayed due to the government shutdown.
- The University of Michigan Consumer Sentiment Index final reading for December was 98.3, which was a decrease from the third quarter. Consumer sentiment remains very strong.
- The ISM Manufacturing Index decreased during the quarter, finishing at 54.1 in December. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In December, the Conference Board Leading Economic Index decreased 0.1% month-over-month to 111.7. The Index has shown steady economic growth over the past few years; however, growth has slowed in recent months.
- The price of WTI Crude Oil was \$45.15 at the end of December, which is 38.3% lower than \$73.16 at the end of September. The price of Brent Crude Oil decreased 38.9% in the quarter to \$50.57. The significant decline erased gains in the price of oil over the past 18 months.
- In December, headline CPI increased 1.9% year-over-year, which is the lowest rate of change since August 2017. Core CPI, which does not include food and energy, had a 2.2% increase. Commodity prices decreased sharply in the fourth quarter, which was the cause of the headline inflation growth rate decline.

HOUSING

- The housing sector has been solid the past few years with increasing sales and rising home prices. However, the housing sector softened in 2018 as higher interest rates and home prices have caused affordability to decline.
- Preliminary existing home sales decreased in the quarter with a monthly average annualized rate of 5.18 million units from 5.27 million units in the third quarter. The December annualized rate is 10.3% lower than the 5.56 million units in December 2017. Unsold home supply remains at low levels.
- The preliminary existing home sale prices for December were 2.9% higher than the levels of one year ago. Prices have been trending up since the beginning of 2012, though the recent year-over-year gains have softened the past few months.

- New home sales were weaker during the second half of 2018.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 4.7% year-over-year in November. Of the locations in the Index, home prices in San Francisco, Seattle, Phoenix, Las Vegas, and Denver have risen the most since the 2011.

EMPLOYMENT

- The labor market has generally been healthy. The job growth rate has slowed slightly, as employers are having difficulty finding workers with the required skills. Wages have moderately risen over the past few years.
- During the quarter, nonfarm payrolls averaged 254,000 jobs added per month, which is a solid level. The December data was better than consensus expectations.
- The unemployment rate increased to 3.9% during the quarter as there were more people coming back into the workforce looking for a job.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1969, reflecting a tight labor market.

DOMESTIC CORPORATIONS

- Corporate operating earnings in the third quarter 2018 were much higher than the previous year. Estimates for 4Q and 2019 have been reduced as lower energy prices, trade tariffs and the government shutdown have pressured earnings.
- Operating profit margins have increased over the past year and remain well above historical averages. Margins have benefitted from lower taxes but have yet to be pressured by increased interest rates and modest wage inflation.
- With the recent volatility, U.S. equity forward P/E multiples have declined below historical averages while trailing P/E multiples are near historical averages.

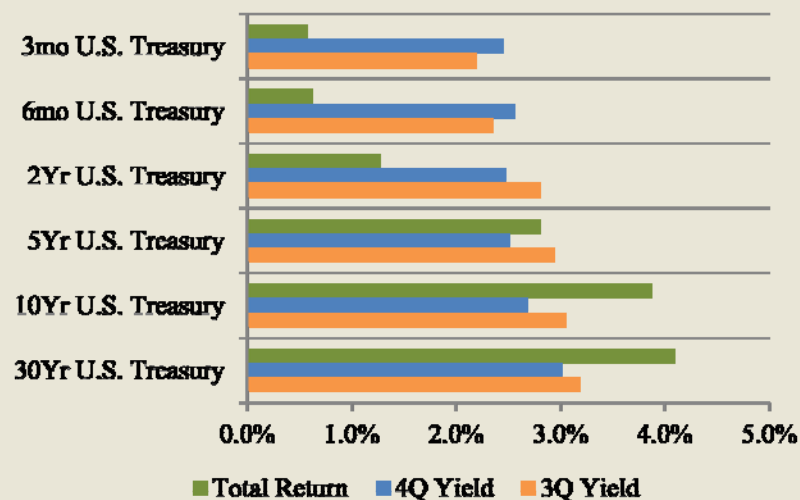
FED POLICY

- In December, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate 0.25% to a target range of 2.25% - 2.50%, which was widely expected. The rate increase was the fourth in 2018 and the ninth since the Fed started raising rates in 2015. However, the Fed reduced their projections for interest rate hikes from three to two in 2019 and also lowered their economic growth and inflation expectations for the year.
- In addition, the Fed reduced their neutral estimate for the federal funds rate to 2.75%. Considering the current effective funds rate is not too far away from the neutral stance, the Fed may pause on hiking rates for much of 2019. As such, market expectations are for zero rate hikes during the year.

FIXED INCOME

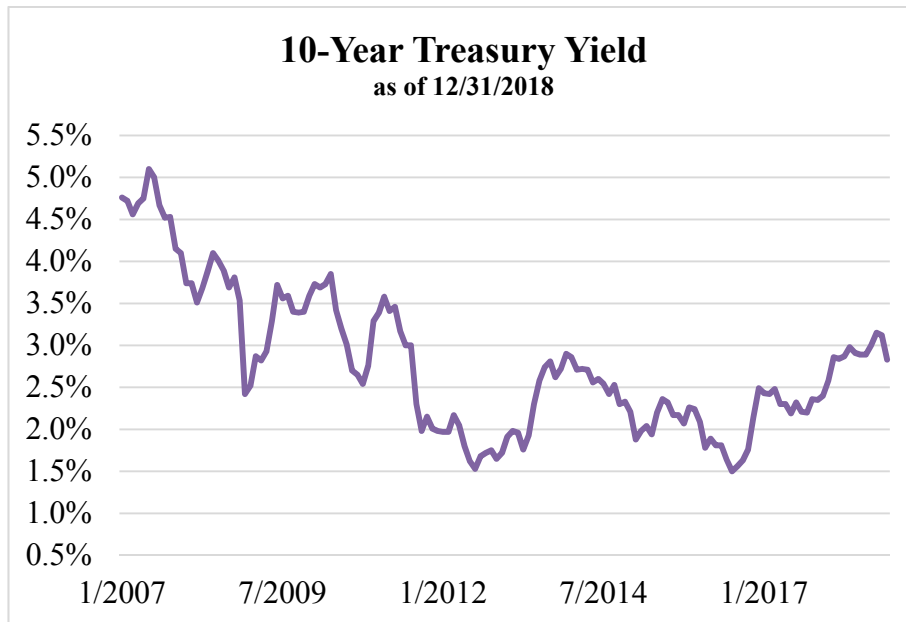
- During the fourth quarter, Treasury interest rates beyond 1 year decreased, causing the yield curve to flatten. Interest rates rose for much of the year, until November, when rates suddenly moved lower in the risk off environment at the end of the year. Short-term interest rates are controlled or heavily influenced by central banks, where-as long term interest rates are controlled by market forces and economic growth.
- Market expectations of lower economic growth pushed longer-term bonds lower, which flattened the 2-Yr. to 10-Yr. Treasury spread and inverted the 2-Yr. to 5-Yr. Treasury spread. The 2-Yr. to 10-Yr. Treasury spread is the lowest it has been since prior to the financial crisis in 2007. Historically, the yield curve has flattened as the Fed raises interest rates and the business cycle matures. The yield curve is viewed as a recession indicator as it has inverted typically a year prior to the majority of the U.S. recessions over the past 50 years. However, the yield curve can remain relatively flat for extended periods without inverting, such as the case in the mid-1990s.

Treasury Yields & Returns Fourth Quarter 2018

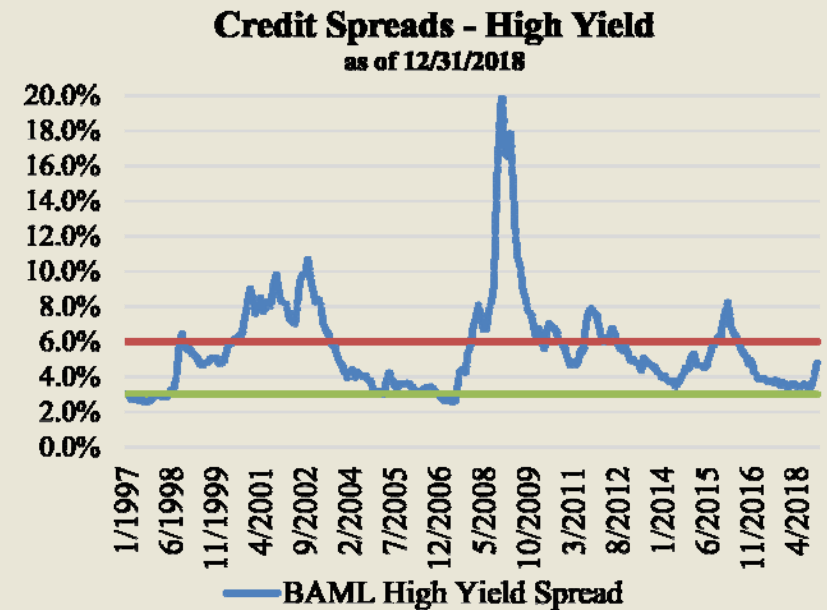
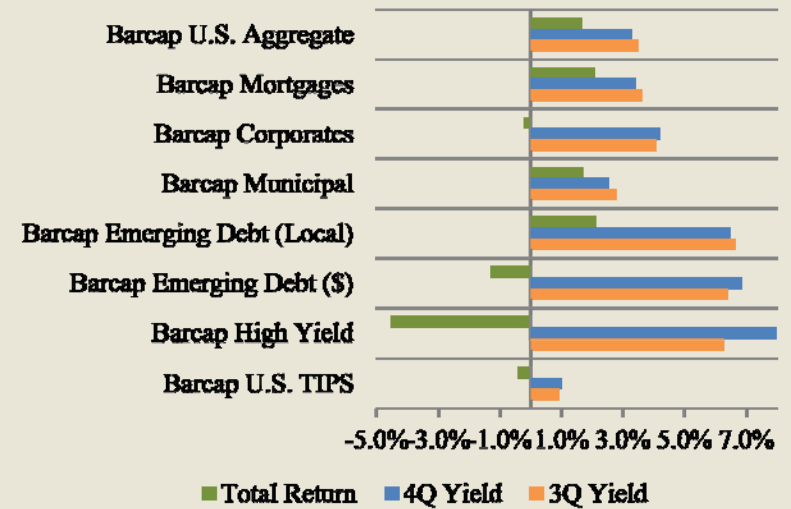


FIXED INCOME (continued)

- During the quarter, the Barclays U.S. Aggregate was up 1.6% as investors sought safety from equity volatility. Since 1929, during years when U.S. large company equities had negative annual returns, intermediate-term bonds have had positive returns 23 out of 25 years.
- Sectors with more credit risk, such as corporates, high yield, and dollar-denominated emerging market debt posted negative returns for the quarter. Credit spreads widened with the “flight to safety” that we saw in the past few months. Spreads still remain low relative to historical averages.
- A common narrative during the quarter was an increased awareness of the large amount of debt that is maturing in the investment grade corporate and high-yield sectors over the next few years. This debt will likely need to be refinanced at higher interest rates. Additionally, higher leverage among companies with investment grade debt could cause a greater than expected amount of downgrades to junk bond status in the next recession.

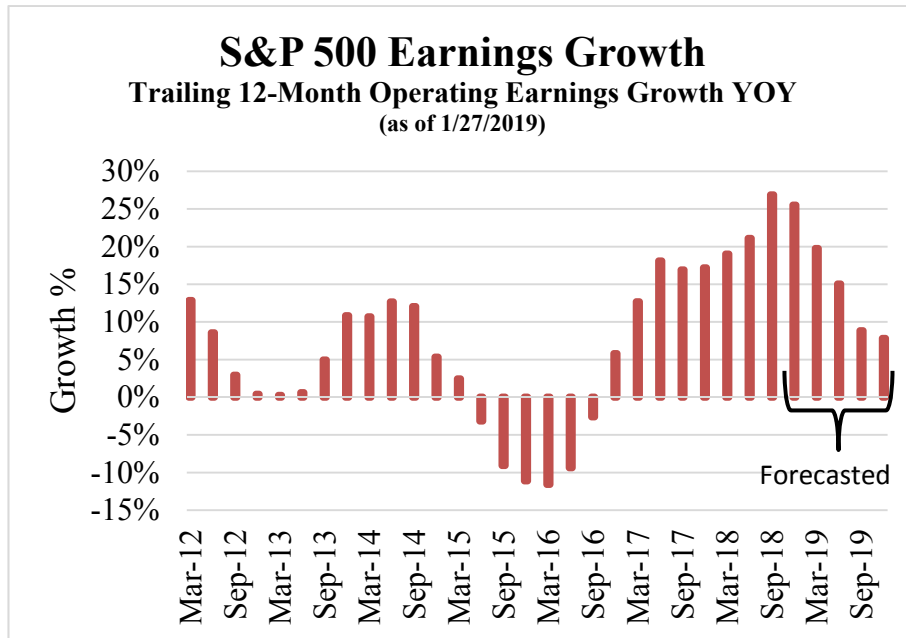


Fixed Income Yields & Returns Fourth Quarter 2018

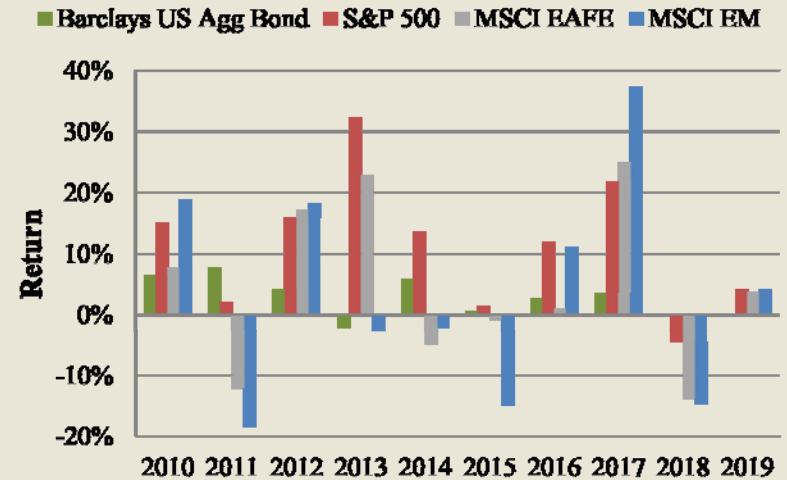


EQUITIES

- Market sentiment deteriorated considerably during the quarter, which led to one of the worst Decembers for risk assets in history. During the year, the S&P 500 endured two 10% corrections, which has only happened three other times since 1946.
- The uncertainty of macro policy increased during the quarter, as the China/U.S. trade issues were not resolved and the U.S. government shutdown after not settling a funding gap for government operations. These issues contributed to a material decline in global manufacturing surveys and production.
- S&P 500 earnings estimates for 2019 have fallen from over double-digit growth to mid-single-digit growth.
- When the S&P 500 has had a drawdown of 10-20%, the subsequent quarter or two have historically had positive returns. With the recent pullback, valuations have come down considerably. However, just as we warned when they were elevated, valuations aren't a good short-term predictor.

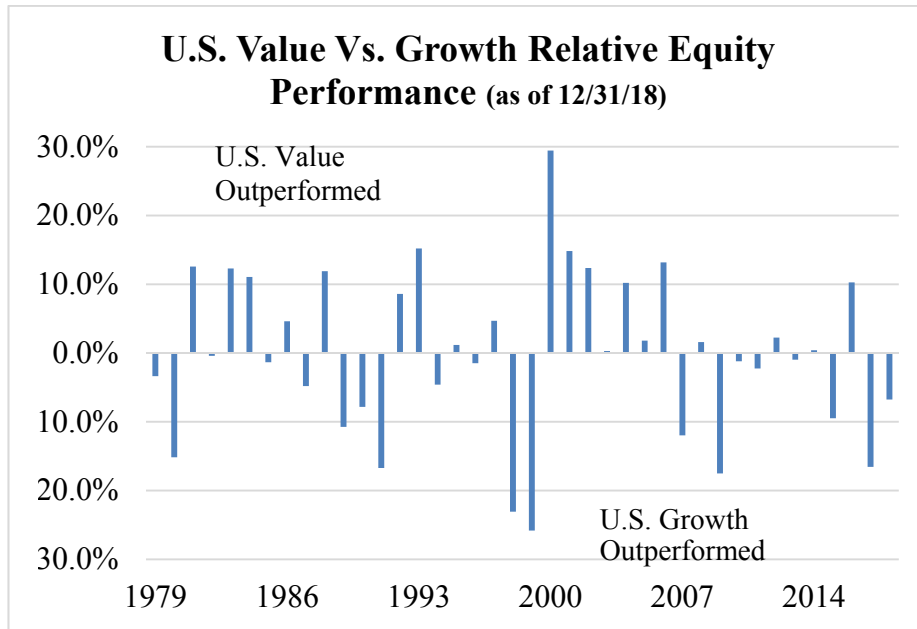


Equity & Fixed Income Market Annual Returns (as of 1/15/2019)



DOMESTIC EQUITIES (continued)

- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a negative total return of 13.8% during the fourth quarter. On a year-over-year basis, the Russell 1000 Index has decreased 4.8%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a negative total return of 20.2% during the fourth quarter. On a year-over-year basis, the index has decreased 11.0%.
- Economic data is softening, though still expansionary. Businesses seem to be delaying capital investment due to uncertainty. The U.S. consumer appears to be in good shape – low unemployment, rising wages and lower debt service levels. However, studies have shown that large declines in equity markets negatively impact consumer spending due to the wealth effect. Thus, while individual net worth's are at all-time highs and unemployment is at the lowest level since 1960s, the recent market pullback could give consumers pause.
- While it is a small sample size, following mid-term elections, U.S. equities have posted positive returns in the following year every time since 1950.

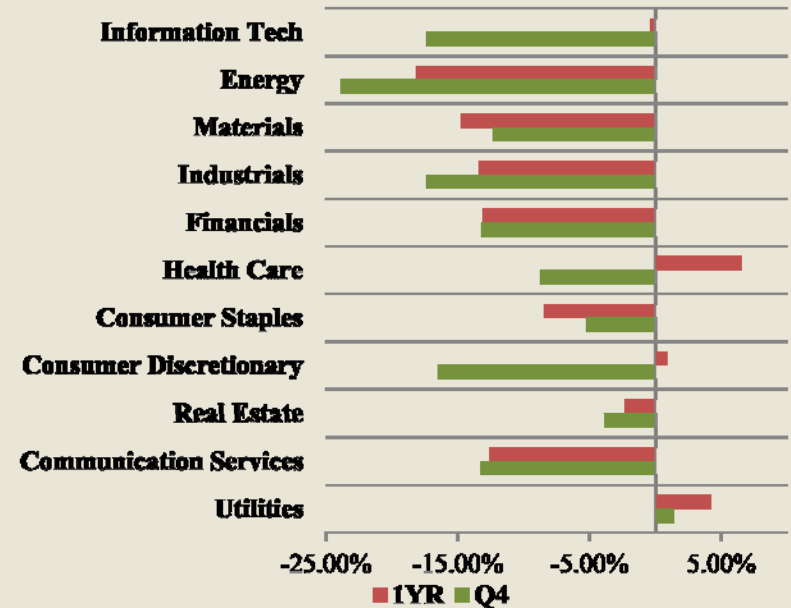


Russell 1000 Growth TR vs. Russell 1000 Value TR

Fourth Quarter 2018 Returns

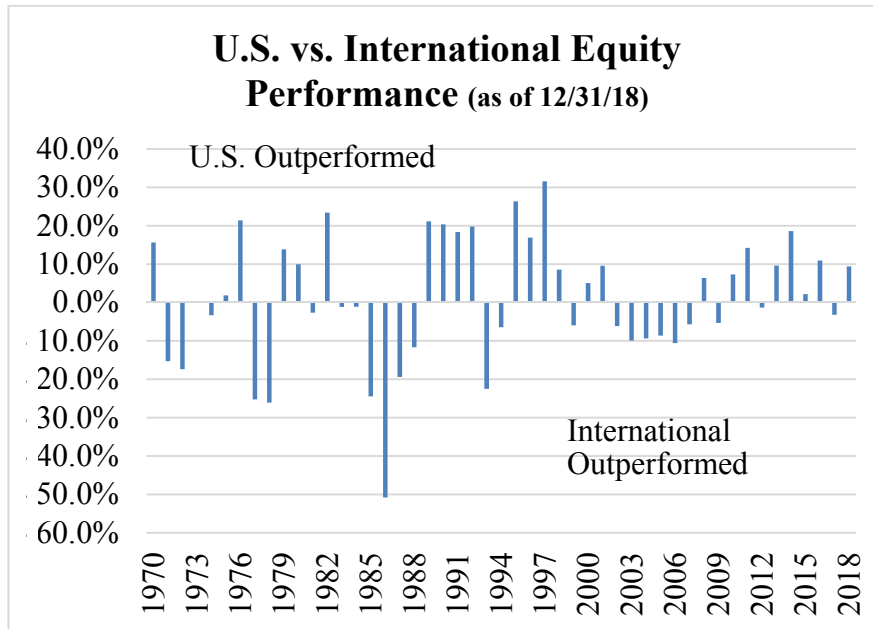
	Value	Core	Growth
Mega Cap		-13.2%	
Large Cap	-11.7%	-13.8%	-15.9%
Mid Cap	-15.0%	-15.4%	-16.0%
Small Cap	-18.7%	-20.2%	-21.7%
Micro Cap	-19.5%	-22.1%	-24.9%

U.S. Equity Market Returns by Major Sector (Securities in S&P 500, Fourth Quarter 2018)



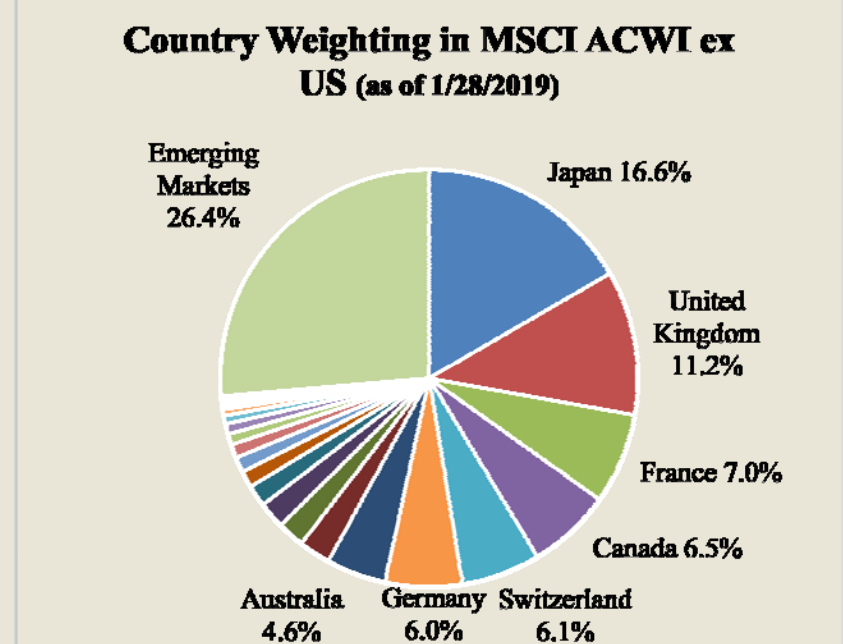
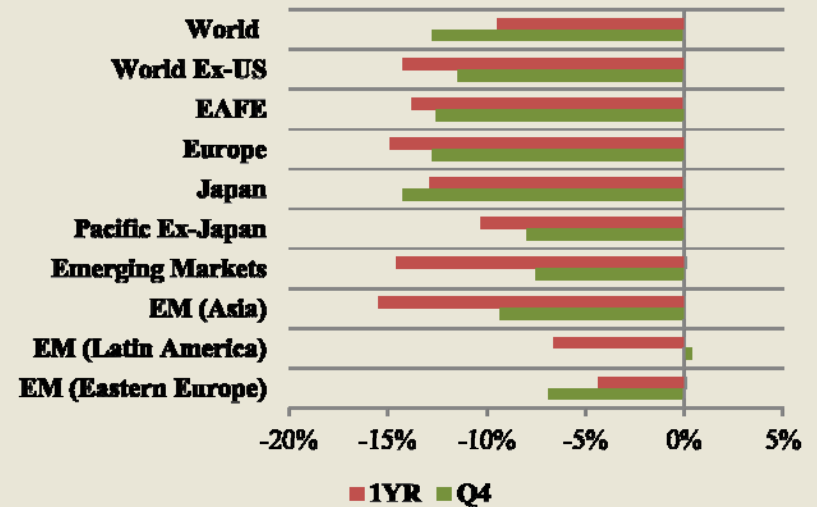
INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were down 12.5% during the quarter. On a year-over-year basis, the EAFE is down 13.8%, performing worse than U.S. domestic equities. Brexit negotiations, Italy's budget issues and lower global trade have pressured international returns.
- Emerging market stocks outperformed developed markets during the fourth quarter as the MSCI Emerging Markets Index decreased 7.5%. Growth in China is slowing more than expected; however, the Chinese government is taking steps to stimulate their economy.
- Over the past year, the U.S. dollar was strong relative to global currencies; however, many investors and economists expect the U.S. dollar to depreciate over the next few years.
- International economies and corporate earnings were generally positive in 2018; however, gloomy sentiment led to negative equity returns. Going into 2019, if sentiment rebounds and the U.S. dollar does not continue to appreciate, international equities would have a more favorable environment.



S&P 500 TR vs. MSCI EAFE NR

Non-U.S. Equity Market Returns Fourth Quarter 2018



Disclaimer:

Information and analysis provided in this market summary are for general and educational purposes only. Any opinions expressed in this summary are not intended to be accounting, legal, tax or investment advice.

Information contained in this market summary has been gathered from third parties, which are believed to be accurate and reliable. However, SilverOak Wealth Management LLC does not guarantee the accuracy or completeness of the data.

Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.