MARKET
Insights

Webster Private Bank®

January 2019

"Down Shifting"
2019 Client Outlook and Positioning

2018 Review

2018 was a year of manic outcomes for investors. Most capital markets reached their highest levels in the third week of January – the US stock market (S&P 500) gained **+7.5%** from January 1st to 26th alone. However, by the fourth quarter an overwhelming and sudden market correction took hold. The S&P 500 declined **-14.8%** from its all-time high on September 21st. The 101 day drop in the stock market has been the worst correction in seven years (since the Euro Crisis of 2011).

The US stock market (S&P 500) delivered eight positive months in 2018, yet returned **-4.4%** for the year. The fourth quarter was a roller coaster ride for stock investors: down **-6.9%** in October, up **+1.8%** in November, then down a historic decline of **-9.2%** in December, which was the worst December result on record. International markets fared even worse, amid the US dollar rising in the face of the Federal Reserve's interest rate hikes. Developed foreign markets (MSCI EAFE) fell **-13.8%** and emerging markets (MSCI EM) declined **-14.6%**, respectively, in dollar terms for the year. Investment-grade bonds ended the year flat at **+0.01%**, while high-yield bonds dropped precipitously starting in October to end the year down **-2.1%**. With almost no market serving as a haven, cash turned out to be a top "investment" for the year, as US 3-month Treasury bills returned **+1.9%**.

Asset Class	Market Index	Q1	Q2	Q3	Q4	Year 2018	Year 2017
US Large Cap	S&P 500	-0.8%	3.4%	7.7%	-13.5%	-4.4%	21.8%
US Small Cap	Russell 2000	-0.1%	7.8%	3.6%	-20.2%	-11.0%	14.6%
International	MSCI EAFE	-1.5%	-1.2%	1.4%	-12.5%	-13.8%	25.0%
Emerging Mkts	MSCI EM	1.4%	-8.0%	-1.1%	-7.5%	-14.6%	37.3%
Inv Grade Bonds	Barclays US Aggregate	-1.5%	-0.2%	0.0%	1.6%	0.0%	3.5%
High Yield Bonds	Barclays US Corp HY	-0.9%	1.0%	2.4%	-4.5%	-2.1%	7.5%
Cash	US T-Bill 90 Day	0.4%	0.6%	0.5%	0.6%	1.9%	0.9%

Source: Morningstar database, total returns in US dollar through Dec 31, 2018.

Final Reckoning: How We Fared in 2018

Last year we identified three core investment themes for the year. Each of the themes unfolded mostly as expected in 2018, but final portfolio results were disappointing because of the overwhelming volatility in markets at year end. There was virtually no place to generate positive returns outside of holding cash. We do not take pleasure in others' misfortune, yet consider it a small consolation to have avoided the worst investments in 2018, such as Chinese stocks, commodities like oil and gold, or investment fads such as cryptocurrencies and cannabis stocks.

THEME 1: THE HAND-OFF FROM MONETARY POLICY TO FISCAL POLICY, INCREASING INTEREST RATES

We recommended maintaining maturities of less than five years in fixed income allocations, and emphasized short-term investment grade (including municipal bonds), floating-rate investments and inflation-indexed debt over high-yield bonds. We also increased allocations to alternative strategies, such as convertible arbitrage and equity options funds, in order to earn returns uncorrelated to the overall stock and bond markets. This positioning worked well, insofar as long-term bonds declined in 2018 while the alternative mutual fund strategies held steady through the year.

THEME 2: MAINTAIN EQUITY RISK LEVELS, BUT HAND OFF TO GREATER DIVERSIFICATION

We expected stocks to offer higher returns than bonds, but believed that the mix of stocks with the greatest potential required gradual reallocation during the year. We recommended maintaining overall levels of stock investment, while broadening the allocation to include small and midcap US stocks. We also recommended adding to international equities, but implemented the trade only partly as we observed weakening growth in foreign markets. The inclusion of small and midcap stocks did not prove profitable, because smaller companies declined more than large ones in 2018 (as noted in the table above). Holding off on additions to international equities helped our performance relative to the global stock markets. The Federal Reserve's interest rate hikes led to a rally in the US dollar during the year, and stocks outside the US declined significantly in US dollar terms.

THEME 3: EXPECT LOWER RETURNS IN 2018

We noted last year that it is uncommon for stock markets to deliver double-digit results with low volatility, as was the case in 2017. Boy, were we correct! Rising US interest rates, combined with a slowdown in Chinese economic growth and European industrial output, sent almost all global stock markets down for the year. Even credit markets began to sour by October, as expectations for lower growth combined with higher nominal coupon rates, weighed on bonds issued by companies with the least reliable credit.

We recommended holding higher than usual cash balances and making greater use of alternative, absolute return mutual funds in order to preserve capital and maintain stores of "dry powder" that could be deployed to reinvest in stocks and bonds at more attractive valuations. We anticipate this kind of portfolio positioning will be useful in 2019, and our clients should expect to see higher cash balances in their accounts as a result.

Key Investment Themes for 2019

We believe that 2019 investment outcomes will be driven by the consequences of lower economic growth rates and corporate earnings that shift down to lower levels. Indeed, some of this down shift already occurred in the past few months. As automobile enthusiasts can attest, a down shift provides sharp deceleration as well as rapid acceleration given the pressure on the fuel pedal. In a similar way, the current correction is a sharp response to lower economic expectations for 2019. However, investment valuations are more attractive now and any revival of growth expectations can reward investors with higher earnings, dividend yields or price appreciation.

In providing these key investment themes, we aim to identify the factors that will influence how we manage client portfolios during the year. The themes are intended not to deliver specific predictions of market levels or rates, but rather to provide a map of the journey our clients can expect in 2019.

THEME 1: THE PATH OF INTEREST RATES IS CHANGING

The Federal Reserve is almost certain to stop hiking interest rates this year. The pricing of interest rate futures indicates no more than one increase in the overnight Fed Funds rate in 2019, with the possibility of a rate cut in the first quarter of 2020. As a result of the uncertainty surrounding Fed policy, the short end of the Treasury yield curve is actually inverted at this time, with one-year interest rates higher than those out to seven years.

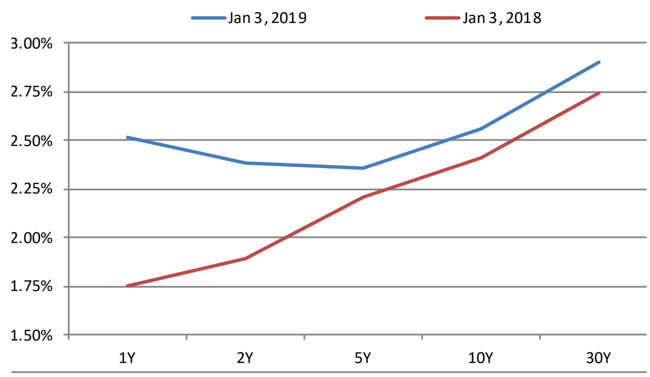
What is the bond market trying to tell us? Clearly there are conflicting signals. The future path of interest rates might unfold in two ways:
1) Long term rates rise due to accelerating growth, inflation or because of enormous Treasury issuance fueled by last year's tax cuts; or,

2) Short term rates decline as the Federal Reserve cuts the overnight Fed Funds rate in the face of a slowing economy, increasing unemployment and a decline in inflation.

As fiduciaries for client assets, we are not inclined to make a directional call on the overall movement of interest rates at this point. The current levels of interest rates (which have been volatile lately) favor holding shorter maturities over longer ones. Yields on short-term fixed income securities far exceed current inflation, and longer term debt offers insignificant additional return.

The Bond Market Expects Little Growth For Several Years

US Treasury Yields By Maturity, Now vs. Last Year



Source: FactSet Indexes, as of Jan 3, 2019.

Portfolio Strategy: *We recommend avoiding bonds with long maturities (7+ years), focusing on higher credit quality fixed income in corporate and mortgage-backed sectors. We prefer investment grade over high yield bonds, as the level of defaults is cyclically low and we have not yet seen a peak in credit spreads (the additional yield of corporate bonds over US Treasury bonds).*

Risk to this theme: *A flight-to-quality scenario in which long-term bonds rally sharply; the Federal Reserve continues hiking interest rates and drives short-term yields above all long-term maturities.*

THEME 2: VOLATILITY IS HERE TO STAY

We expect market volatility to remain the norm in 2019. This means that daily swings of at least +/-1% in the stock market will be common this year. Measures of volatility, such as the VIX index, will likely remain above 20, indicating that the market believes stock prices might break to the upside or downside by +/-20% or more.

Under such conditions, investors might be tempted to trade aggressively, in the hope of correctly timing markets, sectors or individual company price movements. We caution that this approach presents two layers of risk for investors. First, investors must establish a process for such timing activity that maintains the long-term asset allocation to meet their goals. Short-term timing often negates long-term returns because, by repeatedly shifting away from the intended asset allocation, the investor ends up with a portfolio that is not fully invested. Secondly, any incorrect market calls deliver negative results that further erode returns, compounding the missing returns from an underinvested portfolio.

Portfolio Strategy: *We recommend holding fast to asset allocation levels and using unusual volatility (greater than +/-20% annualized) only to rebalance into assets and securities that have traded out of favor. An environment of uncertainty leads to greater dispersion in returns among sectors and companies. The benefit of our recommended approach is to realize more consistent, process-based outcomes. Rebalancing enforces a "buy lower, sell higher" discipline that leads to compounding of portfolio wealth. Also, portfolios that remain invested close to target asset allocation levels rebound quicker in the early stages of a rally than portfolios that try to time the market cycle.*

Risk to this theme: *Our recommended approach could decline more in an extended bear market than simply cutting the risk level abruptly. However, the potential to capture upside, whenever it comes in the future, is compensation for this risk. For any portfolio with a multi-year horizon, this approach is appropriate.*

THEME 3: EARNINGS GROWTH BECOMES MORE DIFFICULT

The abrupt drop in the stock market since September already anticipates significant economic and earnings weakness this year. US stock market valuations (S&P 500) are now more attractive than they have been in years. The current price/earnings ratio of 14.1x next year's earnings is lower than both the five year (16.4x) and ten year (14.6x) averages (per FactSet Earnings Insight, Jan 4th). Either good companies truly are on sale now, or even worse times lie ahead.

We expect stocks can generate a modest positive return in 2019, with more potential to surprise on the upside than on the downside. Investors should position with a moderately pro-growth stance, by holding their stock allocations close to their long-term asset allocation targets and focusing on higher quality companies than those with more economically cyclical businesses. While extreme reactions to market and geopolitical events will continue to stoke volatility, eventually this process paves the way for another rebound in stock prices.

In foreign markets, both challenges and opportunities abound. Global GDP growth remains a concern, yet European stocks and emerging markets continue to look attractive from a historical valuation standpoint. Market activity overseas for 2018 was driven by steady economic disappointments, increasing political threats, and the ratcheting up of trade tensions between the US and China. This has resulted in a more favorable position for international markets to shine in 2019, as much of the bad news is already priced. Any positive economic or political surprises should have more potential to drive international markets higher in 2019, as fears about a recession in Europe, a hard "Brexit" in the UK, and a protracted trade war between the US and China begin to wane.

Portfolio Strategy: *We recommend holding current levels of equity (stock) allocations, but using stock market rallies as a potential source of funds to build up positions in cash, short-term fixed income and absolute return mutual funds when stock allocations drift above target. This dry powder can be used to purchase high-quality companies, international stocks and emerging markets stocks at more attractive valuations. Portfolio rebalancing may enhance returns and help to dampen volatility. Fixed income (bond) allocations should focus on investment-grade issuers (corporate or municipal), agency and mortgage-backed securities and inflation-indexed bonds. We advise clients to beware lower quality credit issuers, even if relative yields appear compelling in the short term. We also caution against chasing defensive sectors that are interest rate-sensitive, such as utilities, real estate and consumer staples, which are relatively expensive.*

Risk to this theme: *US economic growth reaccelerates in 2019, resulting in the US dollar and interest rates rising further; speculative value stocks outpace those of higher quality companies; foreign markets continue to stumble, with a major geopolitical crisis leading to recession.*

CONCLUSION – THE COMING HARVEST

There's an old farmer's saying: "crops don't bloom without a lot of manure." It certainly seemed like a lot of manure was spread across markets in 2018, which was the worst year for investors since 2008. However, today's markets offer lower prices with higher earnings than last year, a desirable situation for investors with cash to invest.

The question, then, is ***how much can we expect to harvest when markets bloom again?*** We answer this question by examining instances when the stock market sustained a "deep correction" (defined as a decline between -10% to -20%). Over the past 68 years, there were eight instances of deep corrections that did not become full-blown bear markets. Unlike today, three of them occurred while the economy was entering or already in a recession. The average decline for such a deep correction was -14.9%. The average return from the bottom of a deep correction over the next 12 months was +30.1%. We can neither predict nor guarantee that history will repeat itself exactly in this manner. Yet, at today's lower valuations amid a healthy economic environment, the odds favor those who remain invested.

We will continue holding fast to asset allocation levels, as dictated by each client's investment objective, and will maintain long-term targeted stock exposure. For now, we emphasize that stock valuations and return prospects are among the most compelling they have been for the past five years. Our first course of action would be to "true up" stock holdings to their intended long-term allocations. Entering a potentially longer era of volatility, we recognize that markets can explode to the upside as well as to the downside. In the future we would consider using significant stock market rallies as a potential source of funds to build up positions in cash, short-term fixed income and absolute return mutual funds when stock allocations drift above target.

Fixed income investing presents more of a challenge at this point. Longer-dated debt offers neither significant portfolio protection nor much additional yield relative to shorter term securities. We intend to focus on higher credit quality bonds in the corporate and mortgage-backed sectors, and we will maintain overall maturity profiles at the shorter end (i.e., 5 years or less).

Seeing your portfolio fluctuate under current market conditions can be worrisome and provoke strong reactions. The themes here are a guide of what to expect in the coming year, but they are no substitute for professional, personally tailored advice. Please reach out to your Webster Private Bank portfolio manager with any questions, concerns or ideas. As always, we are honored to remain entrusted with your investment and stand ready to serve you.

Stock Market Corrections of -10% to -20% Since 1950

S&P 500 Index Monthly Total Returns

Start	End	Duration In Months	Total Decline (with dividends)	Next 12 Month Total Return	State of Economy
May 2011	Sep 2011	5	-17.0%	+27.3%	Expansion
Jul 1998	Aug 1998	2	-15.6%	+37.9%	Expansion
Jun 1990	Oct 1990	5	-15.8%	+29.1%	Recession
Jul 1983	May 1984	11	-10.4%	+25.9%	Expansion
Feb 1966	Sep 1966	8	-17.6%	+26.3%	Expansion
Aug 1959	Oct 1960	15	-11.8%	+28.5%	Recession
Aug 1956	Dec 1957	17	-19.0%	+38.1%	Expansion
Jan 1953	Aug 1953	8	-12.2%	+27.9%	Recession
Average		*9*	*-14.9%*	*+30.1%*	
Current Market Correction…					
Sep 2018	Dec 2018	4	-14.0%	?	Expansion

Source: Morningstar database, monthly total returns.

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