Brinker Capital

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Market and economic outlook

After a roller coaster of volatility throughout the year, it was a disappointing finish for risk assets in 2018. The Federal Reserve (Fed) actions and escalating trade tensions in the fourth quarter led to a sharp market drawdown that more than erased the market gains experienced earlier in the year. In December, the Fed was not as dovish as hoped and sparked fears of a monetary policy mistake as they raised interest rates by 25 basis points and remained committed to balance sheet reduction, even though 2019 interest rate hike projections were reduced from three to two increases. Geopolitical concerns also weighed heavily on markets with an escalating trade war between the US and China. A temporary truce was called after the December G20 Summit, but there remained skepticism on whether the two countries could successfully come to a trade agreement. Looking ahead to 2019, the implementation of any additional meaningful fiscal stimulus is unlikely with a divided US Congress, but improvements to either monetary or trade policies could have a strong positive effect on risk assets.

The S&P 500 Index was down -13.5% for the fourth quarter and finished the year down -4.4%. Sector performance was mixed for the year. Healthcare (+6.4%), utilities (+4.1%), and consumer discretionary (+0.8%) were the only sectors to end in positive territory. Energy (-18.0%) suffered the largest drawdown, negatively impacted by falling oil prices spurred by rising supply and concerns of slower demand due to weaker global growth. Likewise, the implementation of new tariffs throughout the year created meaningful headwinds for materials (-14.7%) and industrials (-13.2%). Financials (-13.0%) and consumer services (-12.5%) were also negative. Large cap equities outperformed small and mid cap equities for both the fourth quarter and year. Growth finished ahead of value, maintaining its leadership for 2018.

Developed international equities, as measured by the MSCI EAFE Index, were down -12.5% for the fourth quarter and -13.3% for the year. Despite an evident slowdown in growth within the eurozone, the European Central Bank proceeded with ending its quantitative easing program in December, creating additional challenges for the region as they enter 2019. Political tensions within Italy and France led to decreased business confidence, and ongoing uncertainty surrounding Brexit negotiations throughout the year served as additional headwinds. Emerging markets, as a group, were down -7.4% for the fourth quarter and -14.2% for 2018. Emerging markets experienced meaningful headwinds in 2018 stemming from a stronger US dollar and escalating trade tensions between the US and China. However, a potential softening of US administration trade rhetoric and increased fiscal stimulus within China may serve as positives for the region as we enter 2019.

The Bloomberg Barclays US Aggregate Index was up +1.6% for the fourth quarter and ended the year flat. The 10-yield Treasury yield peaked at 3.2% during the fourth quarter before falling 55 basis points to end the year at 2.7%. Tightening monetary policy and slower growth expectations led to a meaningful flattening of the yield curve with the spread between the 2-year yield and 10-year yield, ending the year at 18 basis points, drawing concerns that the yield curve could invert. Credit spreads, which remained range-bound for the first three quarters of the year, surged 210 basis points in the fourth quarter but remain below historical averages.

Despite the recent sell-off in equity markets, a bear market is not our base case. We remain positive on risk assets over the intermediate term as fundamentals remain supportive and the recent market drawdown has created attractive valuations for risk assets. In determining our macro outlook, we continue to believe the weight of the evidence leans positive; however, we remain cognizant of the potential risks to that outlook.

We find a number of factors supportive of the economy and markets over the near term.

- **US economic growth:** Sound fundamentals and pro-growth fiscal policies such as tax reform have led to solid economic growth within the US. We see continued strength in the labor market.

- **Continuation of strong earnings growth:** The outlook for corporate earnings growth remains favorable.
- **Elevated business and consumer sentiment:** Measures like NFIB Small Business Optimism and Consumer Confidence remain at elevated levels. This typically leads to an increase in capital spending and hiring within corporations and an increase in spending among consumers, all of which should support economic growth.

However, risks facing the economy and markets remain, including:

- **Global fiscal and monetary policy uncertainty:** The Fed continues on its normalization path, but there is concern it will be too aggressive, pushing the economy into a recession. On the fiscal policy side, the development of tariffs and other restrictive trade policies have led to tensions between the US and its global trading partners. Rising populism and political turmoil have increased the possibility for global geopolitical missteps.
- **Interest rate environment/yield curve:** The yield curve has flattened meaningfully this year, but the curve has not yet inverted between longer and shorter-dated maturities, which would be cause for further concern.
- **Potential for accelerating inflation:** Inflation is manageable at current levels and inflation expectations remain muted. Should inflation move meaningfully higher, the Fed may be forced to shift to a more aggressive tightening stance.

Despite the recent heightened volatility, we believe the positives outweigh the negatives. US economic growth is positive, and business and consumer confidence remain elevated. Investor sentiment, a contrarian indicator, has moved into extreme pessimism territory given the recent market action. Credit conditions have weakened but are still supportive relative to historical values. Global policies and actions of central banks may lead to higher volatility, but our view on risk assets remains positive over the intermediate term. The higher volatility has resulted in wider dispersion of returns across and within asset classes, an attractive environment for our diversified, active investment approach.

Brinker Capital Market Barometer (as of 11/12/18)

Factors		Change	Negative	Neutral	Positive	Commentary
Short-term factors (<6 months)	Momentum	←	●			Momentum weaker acrosss global equity markets
	Trend	←	●			US equity above 200-day MA; US small cap and international below
	Investor sentiment			●		Remains neutral; recent sell-off not enough to wash out sentiment
	Seasonality	→			●	4Q strongest period for equities; positive following mid-terms
Intermediate-term factors (6-36 months)	Fiscal policy				●	Fiscal stimulus (tax cuts, deregulation), but uncertainty over tariffs
	Monetary policy			●		Global monetary policy directionally tighter; Fed continues on path
	Inflation	←		●		Wage growth has ticked higher; few signs of broader inflation
	Interest rate environment			●		Rates biased higher but choppy; flat yield curve a concern
	Macroeconomic				●	US GDP growth has accelerated; growth outside US slowing
	Business sentiment				●	CEO and small business confidence at high levels
	Consumer sentiment				●	Remains elevated; driven by income and employment conditions
	Corporate earnings				●	US earnings growth has accelerated; softened outside US
	Credit environment				●	Credit spreads still behaved; few signs of credit market stress
Long-term factors (36+ months)	Valuation			●		Multiples contracted in October; slightly below long-term averages
	Business cycle				●	Long recovery but has been muted; few signs point to recession
	Demographics			●		Mixed (US and EM positive; developed international negative)

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