FROM THE DESK OF BOB CENTRELLA, CFA: ***January 9, 2019***

2018 Summary & 2019 Outlook

Forza wishes you a Happy New Year and a healthy and prosperous 2019 for you and your families. Last year started lousy as I had a flu that wouldn't go away for 2 months. Then it ended lousy with the markets declining sharply in December. In between it was a fun year for us with plenty of great memories, but one thing I will happily bid adieu to is all the rain. My sump pumps are still going nonstop and I've decided to turn my yard into a lake. My Lake Roberto will be an ice-skating rink if we get some freezing weather😉 Since I am not sick to start this year, I'm looking forward to a nice ending to it as well! But first let's enjoy the ride in between.

As I reflect on 2018 from a financial perspective, I find it can be summed up by a quote from a Wall Street strategist: "2018 was a pretty good year for stocks, until it wasn't!" First, the good news is that since the stock market bottomed on Christmas eve, we have rallied 9% in the S&P 500 as of this writing (Jan 8th). The 2019 year started with a bang as Apple preannounced lower revenues for the first time in 15 years causing a major selloff on the second trading day of the year. Then the market rallied sharply as the Fed walked back earlier comments about future rate increases as we also received good news on trade and the economy. We are still on an uptrend. Now the recap of the bad news of 2018 -- Heading into October stocks were at an all-time high, the economy was coming off a 3.4%+ growth quarter, corporate profits were growing at close to 25% and the year was looking rosy. It was looking like a repeat of 2017 with just a quarter to go. What could go wrong? Then, investor psychology turned on a dime. Instead of buying the dips, it was selling the bounce. All the uncertainty finally came to a boil. A trade war with China looked imminent, the Fed was raising rates like a drunken sailor raising his glass of whiskey, Brexit was teetering on disaster, world economies were slowing, and any news was interpreted as bad news including corporate earnings. In hindsight, that was probably the "tell" that psychology had turned. Rather than celebrating strong earnings gains, investors sold on good news looking at it as the peak in earnings growth with tougher comps ahead. Algorithmic and program trading took over and caused wild swings and increased volatility. There were no buyers (many managers on vacation in December) so selling begot selling. And the next thing you know, the stock market was off 20% from the highs and we technically entered Bear Market territory. Wild swings in stocks included a 500-point drop in the Dow on Christmas Eve, the worst ever for this day, and a 1,100-point gain on Boxing day (Dec 26), the highest point gain ever. Fortunately, a small post-Christmas rally made a horribly bad December into just a really bad one. December's loss of close to 10% in the S&P 500 was the worst December since 1931 and the quarterly loss of 13.53% was the worst since the financial crisis. For the year, the S&P lost 4.6%. Meanwhile, bond yields made a sharp move downward as investors de-risked portfolios and the 10-yr UST yield which peaked at 3.25% moved all the way down to under 2.7% with an inversion occurring at parts of the yield curve (an inversion is when shorter maturity bonds yield more than longer maturity bonds).

So, this dark move in stocks and rush into bonds begs the question heading into 2019 "Are we firmly in a bear market on our way to a recession?" Market action clearly was signaling that. Of course, the stock market has famously predicted 9 out of the last 5 recessions! Or, is this a correction in midst of a bull market? It's easy to make a case for either scenario and until we have some clarity on trade, interest rates and world growth, stocks are likely to remain volatile. However, we still see strong fundamentals and no recession in sight with enough growth to forecast higher prices by year-end. More on that later.

ASSET RETURNS

It was a wild and volatile year for returns. For instance, Apple declined over 30% in Q4 but finished the year with a decline of only about 8%. Amazon declined over 30% in Q4 but finished the year up over 25%. For the year it was reported that 93% of all asset classes provided negative returns. Oil prices dropped almost 20% in 2018 while Gold rallied in Q4 by 7.5% yet still finished the year with a loss of 1.9%. In terms of stock sectors, Healthcare rose 6.3% and utilities 3.9% on the winning side while Energy fell 18.2%, Materials -14.5% and Financial -13% on the losing side. Following is a list of Asset class performance for December, Q4 and the year 2018. In general, large cap outperformed md- and small-cap while US outperformed the rest of the world. Bonds were flat but better than stocks. Notice the contrast between the periods. It was a good year until it wasn't…

Asset Class Performance YTD 2018, Q4, and December - Total Return (%)

US Related

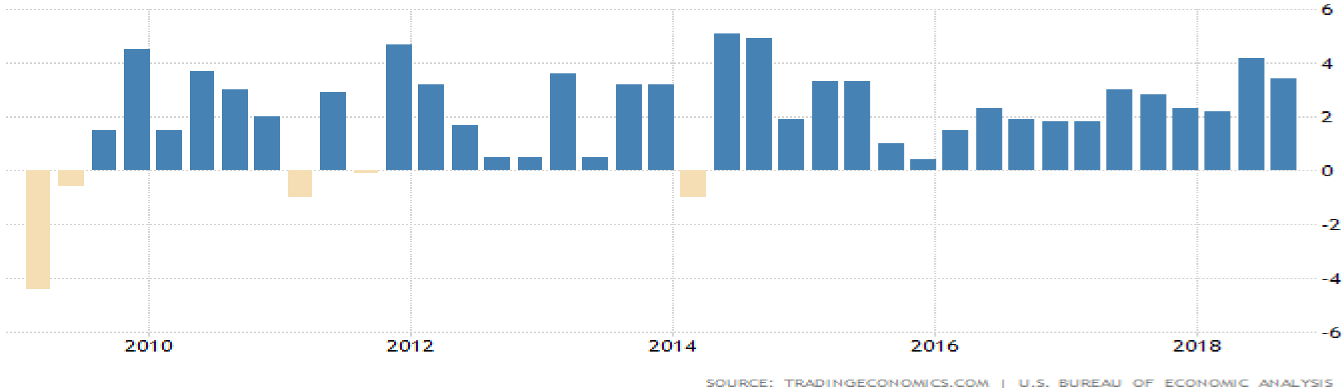
ETF	Description	December	Q4	YTD 2018
SPY	S&P 500	-8.79	-13.52	-4.56
DIA	Dow 30	-8.48	-11.29	-3.74
QQQ	Nasdaq 100	-8.65	-16.73	-0.12
IJH	S&P Midcap 400	-11.33	-17.28	-11.18
IJR	S&P Smallcap 600	-12.19	-20.18	-8.49
IWB	Russell 1000	-8.91	-13.74	-4.88
IWM	Russell 2000	-11.97	-20.29	-11.11
IWV	Russell 3000	-9.14	-14.25	-5.41
IVW	S&P 500 Growth	-8.46	-14.68	-0.19
IJK	Midcap 400 Growth	-11.29	-17.69	-10.52
IJT	Smallcap 600 Growth	-12.06	-19.77	-4.39
IVE	S&P 500 Value	-9.38	-12.06	-9.19
IJJ	Midcap 400 Value	-11.39	-16.89	-12.04
IJS	Smallcap 600 Value	-12.38	-20.64	-12.84
DVY	DJ Dividend	-7.98	-9.74	-6.32
RSP	S&P 500 Equalweight	-9.54	-13.90	-7.82
FXB	British Pound	0.06	-2.19	-5.75
FXE	Euro	1.12	-1.51	-5.30
FXY	Yen	3.43	3.52	2.31
XLY	Cons Disc	-7.95	-15.20	1.59
XLP	Cons Stap	-8.91	-4.97	-8.07
XLE	Energy	-12.43	-23.57	-18.21
XLF	Financials	-11.12	-13.08	-13.04
XLV	Health Care	-9.35	-8.66	6.28
XLI	Industrials	-10.65	-17.33	-13.24
XLB	Materials	-6.88	-12.22	-14.87
XLK	Technology	-8.36	-17.35	-1.66
XLC	Comm Services	-7.98	-15.47	--
XLU	Utilities	-3.99	1.37	3.92

Global

ETF	Description	December	Q4	YTD 2018
EWA	Australia	-3.88	-9.62	-12.02
EWZ	Brazil	-2.56	14.98	-2.57
EWC	Canada	-8.55	-15.35	-17.16
ASHR	China	-5.19	-12.40	-28.44
EWQ	France	-5.12	-15.13	-12.88
EWG	Germany	-5.55	-14.76	-21.37
EWH	Hong Kong	-1.05	-4.53	-8.73
PIN	India	0.82	1.91	-7.55
EWI	Italy	-3.43	-11.35	-17.19
EWJ	Japan	-7.69	-15.19	-14.09
EWW	Mexico	3.06	-18.87	-14.59
EWP	Spain	-4.10	-7.69	-15.32
RSX	Russia	-3.64	-8.60	-7.10
EWU	UK	-4.58	-12.10	-14.28
EFA	EAFE	-5.35	-12.62	-13.81
EEM	Emerging Mkts	-3.50	-7.64	-15.31
IOO	Global 100	-7.43	-12.26	-6.22
EEB	BRIC	-5.65	-6.48	-11.34
DBC	Commodities	-3.99	-18.31	-11.62
USO	Oil	-9.97	-37.76	-19.57
UNG	Nat. Gas	-33.79	-0.48	5.96
GLD	Gold	4.94	7.53	-1.94
SLV	Silver	9.01	5.75	-9.19
SHY	1-3 Yr Treasuries	0.76	1.30	1.46
IEF	7-10 Yr Treasuries	2.80	3.86	0.99
TLT	20+ Yr Treasuries	5.85	4.59	-1.61
AGG	Aggregate Bond	1.98	1.85	0.10
BND	Total Bond Market	1.87	1.64	-0.11
TIP	T.I.P.S.	0.53	-0.52	-1.42

ECONOMY

GDP growth for 2018 should average about 3.125% for one of the strongest years in the past decade, peaking at 4.2% in Q2, followed by 3.4% in Q3 (Q1 was 2.2%). Q4 is expected to be around 2.7%. Estimates for 2019 tend to range around 2.3 to 2.5% but are dependent on a lot of uncertain issues.



The US economy is likely in the latter stages of expansion, but still expanding. A look at recent conflicting data confirms this. The ISM index of manufacturing fell sharply in December from 57.9 to 54.1, a steep drop but still expanding (readings above 50 indicate expansion). Then 2 days later a very strong labor report blew away estimates showing big gains and wage growth. Unemployment finished the year at 3.9%, up from a low of 3.7% (due to a rising labor force) in November but down from 4.1% at YE 2017. Prior to this data, the Fed raised rates for the 4th time in mid-December much to the chagrin of many. This added fuel to the stock selloff in December and it wasn't' until early January that the employment report and comments from Fed Chair Powell walking back comments about future rate increases appeased the market and helped stocks rally to the aforementioned 1100-point gain. The weak spot in the economy seems to be housing. Maybe the recent backup in rates may spur some activity in housing.

BONDS

The yield on the 10-yr UST rose from 2.41% at the end of 2017 to 2.69% at the close of 2018. It reached a high of 3.24% in early November prior to the market selloff. Overall, the Barclays Bond Aggregate Index finished the year with a total return of about .3%. Not much, but better than stocks in the end. The bond market has been an enigma to me the last several years. The Fed has lifted rates 7 times since the beginning of 2017 when the yield on the 10-yr was 2.45%. That equated to 1.75% in higher rates. Meanwhile, the 10-yr UST has only risen .24%, causing a severe flattening of the yield curve. If the 10-yr Yield moved lockstep, it would be at least 4%. So, forecasting the 10-Yr bond yield has been very difficult since it also factors in many other things such as relative yields around the world, demand for low risk assets in volatile times, the future path of the economy and many other factors. Currently, forecasts are for the Fed to possibly raise rates 2 more times in 2019. If that is the case, then the 10-yr should go back above 3%. But I wouldn't count on it. If the US economy stumbles, the Fed can lower rates in 2019. So, I'd look for the 10-yr UST to trade in a range of 2.4% to 3.25% again in 2019. Where it finishes, I have no idea as I and many others haven't gotten it right in several years.

STOCKS

Stocks aren't dirt cheap like during the financial crisis, but they are definitely cheaper than they were a year ago. As a matter of fact, they haven't been this cheap since 2012-2013. The S&P started the year 2018 at about 18.4x forward earnings. Earnings grew about 24% and are forecasted to grow around 7-8% in 2019. Stocks declined around 5% in 2019. Therefore, the forward PE ratio now stands at 14.1x, below both the 5-year average (16.4) and the 10-year average (14.6). For 2018, I thought we'd get a double-digit return on stocks. We were heading there until October. After the market declined it was a good time to upgrade portfolios. I was able to buy some quality stocks that were previously too expensive while shedding some underperformers. We enter 2019 in good position if stocks can rebound. For 2019, with earnings expected to grow let's say around 7.5% and stocks being somewhat cheap relative to history, I think we can see a return of 10% for the year as my base case, give or take a couple percent either way (8-12%). I think stocks were oversold in December, so we gain back the oversold and then rise with earnings growth. With good stock picking you can find some bargains and get higher returns as well as find great stocks with dividend yields around 3%

and higher. Our downside case would be a weaker economy and bigger slowdown in world growth for a decline back to the prior lows and then some, so around a decline of 10% in 2019. Our upside case would be for a positive trade resolution and a goldilocks scenario of low inflation and 2.5%+ GDP growth and better than expected earnings with stocks gaining 12-17% in 2019. We assign a lower probability of maybe 25% to those 2 scenarios. Overall, that would give a range of -10% to +17%. A pretty good risk/reward.

International stocks underperformed the US in most major markets around the world. The ROW is mostly lagging the US in economic growth. Perhaps the MSCI ex-US index has bottomed as well and will bounce back with US markets. Emerging markets are going to be more volatile with higher highs and lower lows. Most portfolio models are recommending too much international stock exposure in my opinion. I'd underweight international and avoid emerging markets unless you can withstand the volatility.

OUTLOOK & SUMMARY

Framing the year ahead let's summarize:

(1) Economic growth is slowing from 2018 but still likely about 2% to 2.5%. This would still be above the average growth rate since the crisis. Jobs growth remains solid and inflation is at the Fed's level of around 2%.
(2) Corporate earnings growth drops from 24% in 2018 to about 7-8% in 2019. Comps vs the tax overhaul skew numbers but on an apples-to-apples basis the numbers are higher in 2019 and lower in 2018.
(3) Equity valuations are below where we were a year ago and below 5 and 10-year averages on a PE basis.
(4) The Fed is still looking to raise rates but has walked back from its tightening campaign.
(5) China trade negotiations are likely pivotal to stocks and the economy.

Some of the other headwinds we face include:

(1) Global growth is slowing, especially in China.
(2) Political uncertainty for Trump and a prolonged government shutdown.
(3) The rising deficit and debt ceiling are worrisome and being talked about more and moving to the forefront.
(4) Other geopolitical events, such as Brexit, cause consternation.
(5) Central banks are mostly moving from providing liquidity to neutral and tightening following the lead of the Fed.
(6) Volatility in markets is here to stay.

In summary, Forza's recommendation is like last year in that we still prefer equities, are cautious on bonds but would maintain both in the overall allocation of assets for balanced portfolios. We are looking for stocks to rebound somewhat and return in the 8 to 12% range in a most likely scenario. But expect a volatile and bumpy ride. It will not be a straight line up. We will see ups and downs including another correction most likely. We overweight US stocks and underweight International. I remain cautious on bonds as the Fed could still have a few rate rises in store for 2019. At best I would see bonds return 3-5% in a flat rate scenario but could be 0 to -3% if rates rise and the 10-yr UST moves above 3%. I'd still buy individual bonds in a ladder up to 2-yr maturity until rates moved higher. We are entering the January corporate earnings season. Let's hope the Apple announcement is not a harbinger of things to come. Finally, remember the most important piece of investment advice I ever received, "Stay the course and keep emotions in check".

Have a great 2019 and let's talk in the New Year and review your goals and objectives.

Bob