January 2019

Piedmont Wealth Management

Client Newsletter

To Our Clients

We hope you had a wonderful holiday season and your New Year has started well. We normally focus a significant portion of our newsletter on planning. However, given the upheaval in the financial markets for the fourth quarter of 2018, this letter will focus on the markets.

Overview of 2018

Let's take a moment to hit on key themes from the past year and revisit the following comments included in our January 2018 letter.

> ***"The momentum generated by a growing U.S. and global economy is likely to carry over into the new year. As of this date, S&P earnings are forecasted to rise as much as 14% for the next year. The odds of a recession which could produce a longer-term downward bias in the market appear to be very low.***
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> ***Unexpected events can create short-term emotional responses in the market that are best avoided by long-term investors. The market last year enjoyed very little volatility with the biggest drop in the S&P at just 2.8% according to the St. Louis Federal Reserve and LPL research. This was the smallest decline (correction) since 1995."***

Looking back at 2017, the lack of market volatility was remarkable. The U.S. economy exhibited strong growth in both the second and third quarters, and a recession did not ensue. We knew it would not last forever; however, predicting an expected exit date is impossible.

January 2018 began with optimism and on firm footing, building on highs in the wake of tax reform, low interest rates, low inflation, and strong growth of corporate profits. If stocks rise or fall on the fundamentals (as they usually do), then the outlook was quite favorable as the year began.

So what happened to change the upward bias of the market in 2018?

A spike in Treasury bond yields tripped up bullish sentiment early in the year. President Trump's attempt to level the playing field on international trade had little impact in the first half of the year. Investors decided trade simply wasn't important, until later realizing that tariffs had the potential to slow economic growth. The ongoing trade war between the United States and China created uncertainty that could not be overcome by the good news of corporate profits or continued historically low interest rates.

The continued stalemate in Washington created further uncertainty about growth in the economy and the Federal Reserve Bank moved toward normalizing interest rates. Caution quickly entered the picture, and most major U.S. indexes began to experience their first downturn since 2008. Selling began in October and the decline accelerated in December. Key tech stocks that had been market leaders for several years lost their mojo and pulled down major averages.

The factors contributing to the decline include heightened uncertainty over the ongoing trade war and fear that continued rate hikes may stifle economic activity in 2019, resulting in lower profits. We know that news from other parts of the world impacts U.S. markets. Combine today's 24-7 news feed with computerized trading platforms allowing trade to occur somewhere in the world nearly every day, the markets react to news much faster.

Overview of 2018 *(continued)*

As the year came to a close, the peak-to-trough decline in the S&P 500 Index totaled 19.8% (St. Louis Federal Reserve thru 12.24.18). We exceeded the long-term average annual peak-to-trough drawdown by six percentage points. Still, we are just shy of the 20% threshold, which is the commonly accepted definition of a bear market.

Here is a chart from Yahoo Finance that reflects the movement in price in the S&P 500 Index for 2018.

If Christmas Eve marks the bottom of the sell-off, it won't be the first time we have experienced a steep correction that side-stepped a bear market. We witnessed similar declines in 1998 and 2011, and a profit-crushing recession was avoided in both cases. The recent fourth quarter decline may have been unsettling, the total decline in the S&P 500, including reinvested dividends, amounted to just over 4% (S&P Dow Jones Indexes) for the calendar year in 2018.

Overseas stocks fared quite a bit worse, as the global economy shifted into a lower gear earlier in the year, and trade tensions, which are more likely to rattle foreign economies, added to woes. Table 1 shows major market index price returns for 2018 and for the last three years.

Table 1: Key Index Returns	YTD %	*3-YR%
Dow Jones Industrial Average	-5.6	10.2
NASDAQ Composite	-3.9	9.8
S&P 500 Index	-6.2	7
Russell 2000 Index	-12.2	5.9
MSCI World ex-USA**	-16.4	0.4
MSCI Emerging Markets**	-16.6	6.7
Bloomberg Barclays U.S. Aggregate Bond TR	0	2.1

Source: Wall Street Journal, MSCI.com, Morningstar

YTD returns: Dec 29, 2017-Dec 31, 2018

**Annualized*

***in U.S. dollars*

We believe no one can consistently time the peaks and valleys of the market. As with any market to much good news in the short term, followed by any disappointment can create volatility. The reverse is true when too much bad news enters the market. This is clear as you look at a chart for 2018. We had major market peaks, followed by a correction, followed by another major peak, and then a correction; which, for the most part, qualifies as a bear market.

What's in Store for 2019?

As we begin 2019, we have the opposite image of what we saw the prior year—cautious sentiment, ongoing trade issues, a partial government shut down, and lower economic forecasts.

Markets in the short term can be unpredictable as investors try to anticipate events that may impact the economy and corporate profits, and the so-called January barometer typically gets some play in that arena. Loosely defined, some say that January performance sets the tone for the rest of the year. When stocks perform well in January, the bulls have a leg up on the bears. When you add reinvested dividends and a natural upward bias in stocks, this explains why a positive January usually results in a positive year. However, this has not always been the case, as proven in 2016 and 2018.

2019 *(continued)*

A recent piece by LPL Research found that the S&P 500 has lost an average of 31% every five years since WWII; included are declines at other times of 19%. Yet, the index has registered an annual advance 75% of the time (Macrotrends) and almost 80% when dividends are reinvested (NYU Stern School of Business Stock/Bond Returns). Further, the S&P 500 has averaged an annual advance of nearly 10% since the late 1920s (CNBC/Investopedia). Again, this demonstrates the need to stay invested to achieve your goals.

We talk constantly about the upward bias of the U.S. economy and remainder of the world. As Warren Buffett opined a few years ago, “It’s been a terrible mistake to bet against America, and now is no time to start.” (Investment U, Motley Fool).

We do not forecast a recession in the United States, but we are likely to see slower growth because of capacity constraints in our work force, as well as our national lack of investment in property, plant and equipment in the US. Our forecast of 2019 is for more of the same volatility we experienced in 2018. If the trade war with China results in a positive outcome, the Federal Reserve slows rate hikes and adopts a neutral policy; and if our President and Congress can reach a resolution on the budget impasse, this would be positive for the stock markets.

It is rarely profitable to make decisions based on current market sentiment, i.e., panic selling or euphoria that sends us chasing the latest trends. We know that stocks will hit bumps in the road, and a major pothole on occasion, but the long-term data highlights that stocks easily outperform bonds, T-bills, CDs, and inflation. Long term stocks trade on the continued growth in the economy and therefore in corporate profits.

As we meet with you through the year, we will continue to emphasis your financial plan and Investment Policy Statement, which outlines your risk tolerance. We know that stocks can be unpredictable over a short period and sell-offs are normal and sometimes unpleasant. Therefore, we take precautions to minimize volatility and keep you on track toward your long-term financial goals through allocation to bonds and diversification of your portfolio.

As you receive or have received your performance report for the quarter ending December 31, 2018, you may be concerned about the results. However, most of you are not invested 100% in the stock market so your portfolio will not be totally reflective of major market indexes.

We feel a little explanation needs to be made about our Investment Strategy for your portfolios. During our meetings with you we talk about our "Value" Strategy which focuses on companies that are profitable over long periods of time and pay dividends to shareholders. During 2018, our strategy underperformed the "Growth" stocks in the market. We believe this is a short-term occurrence, as a consistent Value Strategy has outperformed Growth over longer periods of time.

We are honored that you have chosen us to help you with your financial planning and investment needs. We look forward to meeting with you during the next several months. If you have any questions from this newsletter or anything else in the meantime, please contact us.

Thank you,

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Our Office Hours

Monday—Friday, 9:00AM—5:00PM

Upcoming 2019 Holidays / Office Closures

Monday, January 21 — *Martin Luther King, Jr. Day*

Monday, February 18 — *Washington's Birthday*

Friday, April 19 — *Good Friday*

Monday, May 27 — *Memorial Day*