

Nauset Market Commentary Fourth Quarter 2018

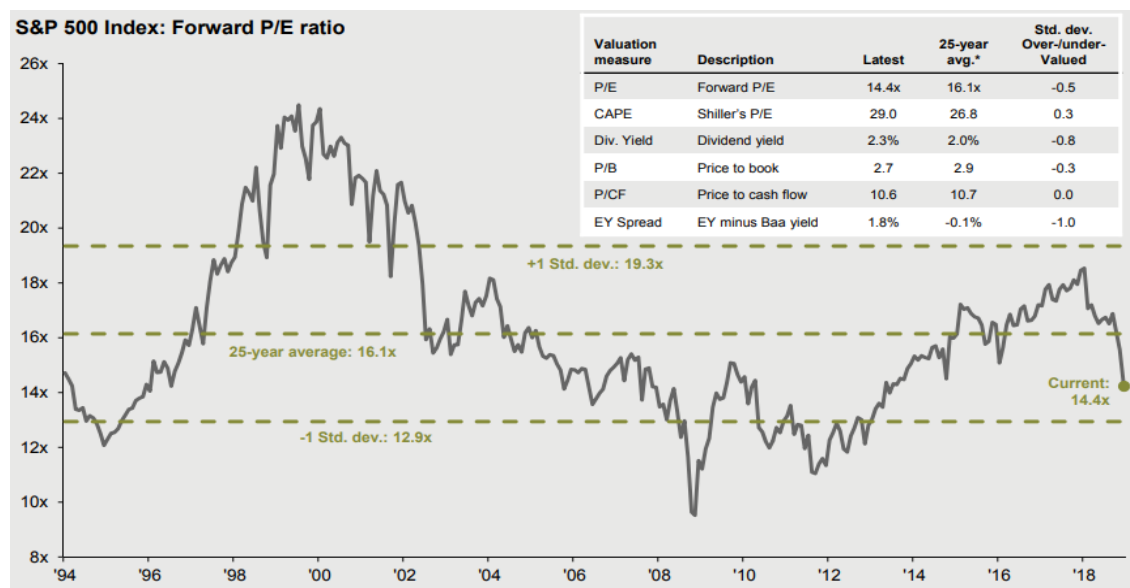
Market Performance Recap: **Stocks Tumble in Major Decline**

Nearly all major US and global stock indices suffered double-digit losses in the final quarter of 2018 to finish the year in negative territory. After hitting record highs in Q3, investors sold off equities in the face of multiple concerns – slowing US and global growth, higher rates, and policy uncertainties. The Russell 1000 US stock index dropped -13.8% in Q4, to end -4.8% for 2018, driven by losses in tech, energy and industrials. International stocks followed suit as MSCI EAFE index fell -12.5%, a decline of -13.8% for the year. MSCI Emerging Markets index fell -7.5% for a 2018 loss of -14.6%. Bond prices moved up as stocks fell during the quarter despite a December rate hike. Barclays Intermediate Gov't/Credit bond index gained +1.6% in Q4, up +0.9% for the year.

Economic & Market Discussion: **2019 Outlook**

We enter 2019 after a Q4 shock to investor confidence that has driven down US stock prices. While the US economy does face multiple headwinds, the long US economic expansion continues into 2019. With stocks at cheaper levels, our review of major stock factors indicate that gains are possible this year despite our expectation for continued bouts of volatility.

- **On Sale?** – The sharp market sell-off of the past three months has dramatically reduced the forward price-earnings (P-E) ratio of the S&P 500 as shown below. Lower P-E ratios from lower stock prices create a more attractive entry point for stocks. Investors may have oversold stocks in anticipation of slower earnings growth. Therefore, this lower valuation of stocks is a positive for the markets in 2019.



- **Slow Ride** – In the midst of record-setting earnings growth in 2018, the fear of slower earnings growth was a primary driver of the Q4 sell-off. This year, earnings are expected to fall off to single digit growth. We foresee a solid, though slowing, US economy with a low probability of recession, at least in the first half of the year. While earnings growth may be lower, a GDP above 2.0% without a major economic stall can support higher stock prices. That makes earnings growth a neutral, turning negative only if earnings disappoint from current lower expectations.
- **Uncertain, unsettled** – Market volatility is often driven by uncertainty. Markets remain sensitive to several issues: Will the Fed continue to hike rates and stuff out growth? Can the US and China reach some type of trade accord? How much will growth slow? We expect news flow around these issues

to swing market sentiment up and down causing more of the sharp moves experienced last year. However, if uncertainties fade and earnings can stay positive, we see potential growth for US stocks.

Portfolio Strategy: Bracing for More Volatility

During the past quarter, we rebalanced portfolios to an equal or target weight for equities according to each portfolio's investment policy. And we slightly underweighted real assets and liquid alternatives in favor of higher cash and defensive income holdings. Here are our thoughts on specific allocation areas.

- Change in Equity – We moved to an equal weight in equities with an emphasis on tech and health care sectors given the uncertainties facing the market. And we added a low volatility US stock ETF to assist in dampening market volatility.
- Fixed Income Defense – Although rates ticked down in Q4, we continue to be defensive in the income allocation as we expect rates to move higher in 2019 from current levels. We added a floating rate US Treasury ETF to our mix of defensive income holdings during the quarter.
- Managing Volatility – At this point in the market cycle, we are using multiple tools to manage risk. With few effective options available in the alternative and real asset areas, we have expanded our search for volatility-dampening elements, adding the securities mentioned above in the income and equity asset classes.

Market Performance % Change for Periods Ended 12/31/2018

Market Index	Fourth Quarter	2018 YTD	1-Year	3-Year Annual.	5-Year Annual.
Russell 1000	-13.82	-4.78	-4.78	9.09	8.21
MSCI EAFE – Non-US	-12.54	-13.79	-13.79	2.87	0.53
Russell 2000	-20.20	-11.01	-11.01	7.36	4.41
MSCI Emerging Markets Equity	-7.48	-14.58	-14.58	9.25	1.65
DJ US Real Estate	-5.97	-4.03	-4.03	4.28	8.06
NASDAQ 100	-17.29	-2.84	-2.84	11.10	10.97
Barclays Gov't/Credit Interm. Bond	1.65	0.88	0.88	1.70	1.86
Wilshire Liquid Alternative	-3.72	-4.24	-4.24	0.96	0.19
3-Month T-Bill	0.56	1.86	1.86	0.99	0.60