2018: The Year Without a Santa Claus

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Every past decline looks like an opportunity, while every future decline looks like a risk.

2018 was certainly a year for the record books. It was the first year in the last century that all asset classes showed a negative return for the year. Energy and commodity prices, gold, domestic bonds and stocks, and bitcoin all traded lower for the year. There was nowhere to hide globally either. Each of the 50 largest economies in the world saw their equity markets post negative returns for the year, and both developed market and emerging market stocks and bonds traded lower in 2018.

Fourth quarter 2018 was not only bad, but historically terrible for the stock market as well:

- In fourth quarter 2018, the S&P 500 declined -14.2 percent. In the 73 years since World War 2, there have been 294 quarters, and fourth quarter 2018 was the 10th worst quarter during that long period.
- Fourth quarter 2018 was also the third worst fourth quarter in 73 years, lagging only the Black Monday Crash quarter of 1987 and the financial crisis of 2008.
- On a positive note, during the last 73 years, the index declined greater than 10 percent in 19 individual quarters. Following 16 of these quarters, or 84 percent of the time, the next quarter showed positive performance. And one-year performance was positive after each of these 19 poor performance quarters.

There were many things that investors worried about this year:

Rising interest rates – After many years of a near-zero level of short-term interest rates, the Federal Reserve raised rates four times in 2018. Rates now sit at 2.25 percent, which is still at a very low level, especially given that the “real” rate of interest (the short-term rate minus the inflation rate) is still close to 0 percent.

Threat of a global trade war – While the trade dispute between the U.S. and Canada/Mexico appears to have been settled, the larger uncertainty in U.S. and China trade issues will drag on into 2019, casting a pall over business sentiment and industrial production planning in both countries. While the dispute could be settled quickly given that it is in both countries’ best interest to come to an agreement, the end game is still uncertain.

Party division and daily chaos in Washington, D.C. – The level of cooperation between parties in Congress seems to be extremely low, and we would expect that animosity to continue in 2019 with an upcoming election year in 2020.

Slowing economic growth – S&P 500 earnings grew 21 percent in 2018, and the rate of growth will slow in 2019 to a more normal but still healthy 8-10 percent range. Growth in global developed economies will also slow in 2019.

Threat of rising inflation – While a strong economy, a tight labor market and a very low unemployment rate have given rise to a normal level of wage growth, we have not seen inflation rise beyond the Fed’s preferred 2 percent level. While the Fed will remain focused on a steady price level, new sources of inflation are not apparent or a cause for alarm yet. In fact, inflation will decline over the next six months due to the sharp decline in consumer gasoline prices.

Reasons for optimism

Stock valuations are attractive: The S&P 500 traded down 5.0 percent in 2018 while earnings for S&P 500 companies rose 21 percent. The S&P 500 now trades at 14.2 times estimated 2019 earnings of $175 per share. This market multiple is very reasonable given that inflation is low and well-contained at 2.0 percent. A target of 17 times 2019 S&P 500 earnings affords the equity market a one-year upside target of 2,975, a gain of 19 percent from current levels.

Energy prices are much lower than a year ago: Oil prices declined in 2018 from a high of $75 a barrel to close the year at $45.50. This decline in energy prices translates into an extra $210 billion in U.S. consumers' wallets for the full year of 2019, as low oil prices translate into much lower gas prices at the pump. Recessions in the past have a rapid spike in energy prices as a concurrent cause, not large declines in energy prices like we have seen in the past two months. The U.S. consumer is optimistic, with higher paychecks from lower tax rates, rising wages in a tight labor market and lower energy costs.

Lack of excesses: The end of a business cycle typically coincides with the popping of a financial bubble. In 2000, the dot-com craze had pushed the valuations of technology stocks into the stratosphere, and the bubble finally popped that year leading to the recession of 2001-02. In the mid-2000s, the housing market mania pushed consumer debt and housing prices into unforeseen territory, and that bubble finally popped in 2008. But as we begin 2019, excesses in any asset class are not apparent. Lending standards are still very stringent, and home values are declining, so there is no bubble there. The S&P 500 trades at 14 times earnings, which is a very reasonable level given that inflation is low at 2 percent. Consumer debt remains well within reason, as the deleveraging of personal balance sheets after the financial crisis has not led to a resumption of overspending on debt.

Most of the issues that the market is worried about are temporary: The trade war with China, the government shutdown and the rise in short-term rates are all within our control and can be adjusted or solved quickly, if their negative effects on the financial markets become too great. The economy, business optimism and consumer financial health remain in solid positions, and there are no signs of an impending economic recession.

And finally, a sports story with a stock market lesson…

Go big or go home

In the last 15 years, there has been a revolution in the NBA in where on the court players attempt their shots. The Golden State Warriors are the subject of a lot of headlines these days for their remarkable shooting efficiency and their focus on the three-point shot, but the evolution of NBA scoring is seen widely in all NBA teams' stats. This season, the average NBA team is attempting an astounding 32 three-point shots per game, compared to only 15 three-point shot attempts per game in the 2003-04 season.

The Houston Rockets rely heavily on the efficiency of the three-point shot. This season, they are attempting three-point shots at an incredible rate of 42 per game, while making 35 percent of them. Ten years ago, in the 2008-09 season, only one NBA team scored an average of 10 or more three-pointers per game. This season, two-thirds of teams are converting three-point shots into points 10 or more times per game. Ten years ago, only seven of 30 NBA teams attempted more than 20 three-point shots per game. Now, all teams are attempting at least 20, and the NBA average is more than 30 three-point attempts per game. Shooting three-point shots at a 40 percent success rate gives a team a higher average point score per possession, and that slight advantage is large when spread over 100 possessions per game.

Scoring analysis shows that the most inefficient shot a player can attempt is in the area between 16 feet from the basket and the three-point line. It is for this reason that in today's game you will frequently see a player with a wide-open, 17-foot shot pass the ball out to a player beyond the three-point line to attempt a shot. Although the team is choosing to take a much lower percentage shot, the attempt is more efficient at scoring points over an entire game. This season, only 8 percent of superstar shooter Steph Curry's shots come from this inefficient area, down from 30 percent a decade ago. Teams now routinely only shoot from 8 feet or closer to the basket, or from beyond the three-point line. NBA teams have decided that "go big or go home" is the only way to play the game.

While the concept of "go big or go home" may be a new paradigm for the NBA, for stock market investors, the all or nothing nature of equity returns has been around as long as the stock exchange itself. While most investors do not realize it, the stock market over the past 100 years has generated returns in this same "go big or go home" manner. While the S&P 500 shows average annualized returns of more than 9 percent a year over this period, the actual results are very much "go big or go home." Like the 18-foot NBA shot, a calendar year return in the range of 0-10 percent is very rare, as a yearly return in this range has only occurred in 15 percent of all market years. Much more likely is the "go big" range of market gains (more than 10 percent in a year), as we see these large returns in 60 percent of all market years. More common than 9 percent gain years are years in which stock market performance is below 0 percent; these years are seen in 25 percent of all years.

In some years, stocks rise far more than anyone expected, and sometimes stocks fall much more than expected. In 2009, during a crippling recession and at a time when sentiment about the future of the U.S. economy and the stock market was at its most negative, stocks rose 26.4 percent. In 2018, in an economy with strong corporate earnings growth, low unemployment, high consumer confidence and low inflation, stocks have declined sharply, down 5 percent. Nobody is an expert at predicting the direction of the stock market in the short term, so you should not try, or even listen to, seemingly smart folks who claim they have more vision about the future than a Magic 8 Ball.

While it would be far more pleasant to simply chug along every year enjoying stock market returns of 9 percent, the market has a mind of its own. The stock market went big in 2013, gaining 32.4 percent, but went home in 2015, rising only 1.4 percent. The market went big in 2017, rising 21.8

percent, but went home in 2018, losing 5 percent. It may be frustrating that all these years are considered normal equity market performance, but that is the cold reality of stock market investing, and is what makes it so confounding, interesting and rewarding for patient, long-term investors. To enjoy the years when the market goes big and delivers strong returns, an investor must stay strong and persevere through the years in which the market goes home, as it did in 2018.