Wealth Management Group

First American Bank

INVESTMENT PERSPECTIVES

FOURTH QUARTER 2018

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First American Bank

4th Quarter 2018

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IN THIS ISSUE

Equity Markets

4th Quarter Review

The markets left equity investors reeling in the fourth quarter. Large-cap stocks got off to a slow start with the S&P 500 falling about 1% during the quarter's first week. Oct. 10 brought a 3.3% one-day decline and ushered in a bout of increased volatility that would persist throughout the quarter.

October's nearly 7% decline was followed by a brief rally to start November before another swoon of more than 6% mid-month. The S&P 500 rallied over the last week of November to finish the month up 2%.

The gales of November came late this year as December saw large-cap equities plunge nearly 15% by Christmas Eve. The downward pressure was nearly relentless during December's first three weeks as negative investor psychology met limited liquidity to produce near panic. The 4Q18 correction found at least a temporary bottom on Dec. 24 with a final 2.7% plunge for the S&P 500. Equity performance in December ended up being the worst since 1931 during the Great Depression.

The holiday pause refreshed investors and the S&P 500 rallied nearly 7% in the final week of the year. Even after the rally, the index ended the quarter with a 13.4% decline.

As poorly as large-caps performed, smaller stocks did even worse. The Russell 2000 officially entered bear market territory with a decline of 20.2%. Mid-caps did little better with the S&P 400 falling 17.3% for 4Q18.

Value outperformed growth across capitalization levels in the fourth quarter as investors sought refuge among the more defensive shares that tend to populate the value indices.

International equities actually held up better than domestics in the quarter but the performance still wasn't pretty. Developed markets fell more than 12% and emerging markets fell more than 7% as measured by their respective MSCI indices.

So what caused the equity sell-off in 4Q? Complacency had clearly crept back into the market during the third quarter but quickly evaporated in October. Trade friction with

China, which had been a concern for the market most of the year, was the first thing to pressure equities in the fourth quarter. Shortly thereafter, higher interest rates, which helped spark the equity sell-off in 1Q18, returned as a concern when the 10-year U.S. Treasury reached a seven-year high yield of 3.24%.

As the quarter progressed, dark clouds increasingly began to gather. Concerns that trade issues, the stronger dollar and higher expenses would pressure corporate margins began to drive down earnings estimates. The price of oil collapsed, economic metrics weakened and talk of an impending recession soon appeared. The rush to get out of still crowded trades in tech-related stocks added to the selling pressure. While many fears about profits and the economy were well founded, prices appear to have declined more rapidly than fundamentals. The sharp snapback we've seen since the Christmas Eve bottom seems to give credence to that view.

Global Equity Index Total Returns (as of 12/31/2018) **** Periods beyond 1 year annualized.***

	4Q 2018	1 Year	3 Years	5 Years	10 Years
S&P 500	-13.52%	-4.39%	9.24%	8.48%	13.10%
S&P 500 (Equal Weight)	-13.91%	-7.65%	8.01%	7.12%	14.68%
Dow Jones Industrial Average	-11.31%	-3.48%	12.92%	9.69%	13.15%
NASDAQ Composite	-17.28%	-2.81%	11.16%	11.06%	16.85%
S&P 400 Mid Cap	-17.28%	-11.10%	7.64%	6.01%	13.65%
Russell 2000 Small Cap	-20.21%	-11.03%	7.34%	4.40%	11.95%
MSCI EAFE (Non-U.S. Developed Markets)	-12.49%	-13.32%	3.44%	1.10%	6.91%
MSCI EM (Non-U.S. Emerging Markets)	-7.60%	-14.49%	9.59%	1.96%	8.35%
MSCI All-World Excluding US	-11.45%	-13.82%	5.00%	1.20%	7.12%

Equity Markets

2019 Outlook

The rally that began on Dec. 26 has already produced a fair portion of the gains we expect for 2019. While the swift drop in equity prices in December appeared to overstate the depth of economic and profit challenges facing the U.S., the rally may have presumed too rapid a return to normal.

The 4Q18 correction brought equity valuations to the least demanding levels than we've seen since 2016 or earlier. This occurred in part because 2019 earnings estimates deteriorated significantly as 4Q18 progressed. At the bottom on Dec. 24, equity valuations were below the five-year median levels even on the lower earnings estimates.

While we believe the rally that began at the end of December can continue, we think the path to substantially higher levels on the major equity indices is narrow.

After investors paused to realize that the economy wasn't collapsing and credit markets were merely tightening rather than freezing up, Fed Chairman Powell provided a post-Christmas gift. First during a conference appearance with his two immediate predecessors, Janet Yellen and Ben Bernanke, Powell seemed to reverse course sharply from recent pronouncements. Suddenly the Fed discount rate wasn't approaching neutral (the point where it neither restrains nor spurs economic growth), it was already there. No longer were further rate hikes baked-in, now a pause to examine the data was necessary. Even the reduction in the Fed's balance sheet was no longer sacrosanct and on autopilot. It was ripe for a pause as well.

All of these things can make sense from an economic perspective. If the economy is teetering then certainly the Fed needs to respond to that. Yet, Powell termed the economy still solidly on a growth path. If that's true, the dovish turn sounds more like a revival of the "Fed Put," i.e. the Fed promises to deliver liquidity with a fire hose whenever financial markets panic. This is contrary to Powell's renunciation of the Fed Put just a few months earlier.

Whatever the intention, the new dovishness looks like it may hem in the Fed, and in turn, financial markets. If economic growth bounces back and the newly lowered earnings estimates prove too conservative, the Fed likely will have to return to hiking rates and letting the balance sheet run off unfettered. We've already seen that the markets don't like higher rates. If, on the other hand, the economy is really in need of liquidity support and can't take even modestly positive real interest rates and a gradual retreat from unprecedented liquidity and fiscal stimulus, then we have difficulty believing we can have an extended and durable equity rally much beyond current levels.

Equity Market Valuation

	12-Month Forward 12/31/2018	12-Month Forward 12/29/2017
S&P 500 P/E	14.6	17.0
S&P 500 Dividend Yield	2.2%	1.9%
S&P 400 Mid Cap P/E	14.8	22.1
Russell 2000 Small Cap P/E	22.8	34.9
NASDAQ Composite P/E	19.8	24.4
MSCI EAFE P/E	12.0	16.0
MSCI Emerging Markets P/E	11.3	14.2
MSCI World Excl-US P/E	12.2	15.5

Economics

4th Quarter Review

3Q18 real GDP grew 4.2%, according to the second and final revision from the Bureau of Economic Analysis. This was an improvement from the first revision, which pegged growth at 3.5%.

Growth was balanced between consumption and investment. Within consumption, services were a little stronger than goods and within goods non-durables were stronger than durables.

The quality of growth in investment was suspect. Fixed investment, while still growing, weakened substantially from 2Q18. Residential fixed investment declined from 2Q levels and fell as a percentage of total GDP for the third consecutive quarter. The bulk of growth in investment came from inventory building. Inventory growth isn't bad per se since inventories are at relatively low levels, but it's also unlikely to be a sustainable source of economic growth.

Trade was a negative for 3Q GDP. Imports rose and exports weakened. The U.S. trade deficit with China reached a record high. These figures don't include any material impact from the tariffs enacted to-date.

Among the major metrics we watch, housing is struggling due largely to home price appreciation far outstripping median income growth. Automobile sales have also pulled back after climbing back to levels that prevailed before the financial crisis. Inflation seems to have come off the boil as oil prices receded. Manufacturing and service sector measures have retreated but remain suggestive of trend growth in GDP (2.0% to 2.5%) continuing for now.

Economics

Outlook

The report for 4Q18 GDP growth has been delayed due to the federal government shutdown. The Atlanta Fed GDP Now forecast and the New York Fed's GDP Nowcast for 4Q18 call for 2.7% real growth on average. The Blue Chip Consensus ranges from 2.3% to 3.0%. That range seems reasonable. Growth has clearly slowed from 3Q levels but appears to remain a little above trend for the recovery to-date. We currently do not foresee a recession beginning in 2019.

We're expecting domestic economic growth to moderate further in 2019. We expect real GDP will grow between 2.0% and 2.5% for the year. The retreat in interest rates, continued growth in employment and rising wages should help sustain growth. The impact of last year's fiscal stimulus (both spending hikes and tax cuts) will begin to wane as the year progresses. Barring a new stimulus package out of D.C., we think the federal fiscal impulse in 2020 will be neutral at best.

Beyond the end of 2019, our crystal ball gets even more cloudy than usual. The current expansion will almost surely break the post-WWII record for duration by midsummer. Yet despite the unprecedented staying power, the cumulative growth from the bottom in 2009 remains substantially weaker than average. That could help the expansion linger longer, but we fear that rising debt levels at the both the federal government and corporate levels, as well as limited labor force growth, could present serious challenges to substantive further expansion.

Fixed Income

4th Quarter Review

After hitting a more than seven-year peak high in November, the benchmark 10-year U.S. Treasury fell fairly sharply over the last seven weeks of the quarter as fears of declining economic vigor increased. Overall, the 10-year yield fell 23 basis points over the quarter to end at 2.71%. That worked out to a 25 basis point increase for all of 2018.

The Fed enacted its fourth hike in the discount rate for the year in December to reach 2.50%, a level not seen in more than a decade.

Credit spreads widened significantly in the quarter. The Barclay's benchmark high-yield bond spread jumped from 318 basis points on the final day of the third quarter to 533 basis points on the Christmas Eve apex of panic in the financial markets. Investment grade bond spreads rose as well but not nearly to the extent of high-yield spreads as investors fled risk and embraced the safety of capital rather than maximizing return on capital. This investor caution was also evident in returns for the Barclay's benchmark U.S. Treasury; investment grade corporate and municipal bond indices were all positive for the quarter and handily outpaced equities.

Fixed Income Rates

	12/31/2018	12/29/2017	Change
U.S. Treasury 10-Year Note	2.69%	2.40%	+29 bps
U.S. Treasury 2-Year/10-Year Spread	19 bps	52 bps	-33 bps
U.S. High-Yield/U.S. Treasury 10-Year Spread	527 bps	331 bps	+196bps
Federal Reserve Discount Rate	2.50%	1.50%	+100 bps

Perspectives

We Think the Furor over Share Repurchases is Misplaced

Share repurchases among America's largest public companies have become a controversial topic over the last couple of years. The subject's prominence is somewhat understandable as the total value of announced share buybacks for the S&P 500 totaled over $900 billion in 2018, according to data from J.P. Morgan.

Opponents of share repurchases have several primary objections. We only have room to address a few. They believe that share repurchase chokes off corporate investments that could lead to higher and more widespread economic growth as prosperity; that it enriches executives and shareholders at the expense of workers; that it allows management to artificially juice earnings per share and game incentive compensation; and that it is an often inefficient use of capital. We'll address each of these concerns in turn.

The first argument, share buybacks choke off investment, is perhaps the easiest to refute. While share repurchase expenditures among the S&P 500 have been rising steadily over the past decade, so too has corporate investment. Total aggregate corporate investment (capital expenditures + research & development spending) has increased at a compound rate of nearly 7% annually since 2008 for S&P 500 companies and R&D expenditures are at all-time record highs.

Additionally, while all of this investment and repurchase has been going on, total cash held on S&P 500 balance sheets has grown from $2.8 trillion to $4.3 trillion over that same year period. Surely corporate managers with their unquenchable thirst to maximize profit and wealth would have deployed a lot of that cash on projects with attractive potential returns had they been available. Unfortunately, there's no real way to measure this as a compendium of all possible options to deploy corporate cash, and the returns they would have produced doesn't exist.

Furthermore, the idea that the cash spent on corporate share buybacks simply vanishes into the ether with no benefit to anyone other than corporate executives is laughable. Research indicates that the vast majority of the cash from buybacks is recycled into the repurchasing companies (through the sale of newly issued shares either to investors or employees through stock option redemptions) or returns to the corporate market through investments in other public or private companies. Is there the odd billionaire who takes his share repurchase cash and buries it in his backyard? Maybe, but this represents only a vanishingly small minority of share repurchase cash.

As far as repurchases increasing inequality in the economy, this also seems doubtful. It can be argued that corporate executives have an incentive to buy back shares at opportune times in order to increase per-share earnings and thus artificially inflate incentive compensation. Such manipulation undoubtedly happens, but when it does, it mostly enriches management at the expense of their public shareholders rather than society broadly. If one were to assume that the 10 most highly compensated executives at every S&P 500 company are in on such a scheme (a ridiculous overestimation in our opinion but roll with us for the sake of illustration), those executives would account for only 4% of the top 0.1% of U.S. households by earnings and 0.4% of the top 1%.

As to the question of how wise share repurchases are from the perspective of creating shareholder value, we think that varies by company. In our experience, high-quality management teams know their businesses and as a part of that also know the approximate value of their stock. If the stock is undervalued in their view and the return on buying it exceeds the value of available investment alternatives, then they're creating value. The transaction can even make sense from a corporate finance perspective by replacing relatively expensive capital (equity) with lower cost capital (debt). This cost advantage was even more substantial before the recent tax reforms reduced debt's tax shield.

Asset Class Returns

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	10-YR Annualized
MSCI EM 78.5%	REITs 28%	REITs 8.3%	REITs 19.7%	Russell 2000 38.8%	REITs 28.0%	REITs 2.8%	Russell 2000 21.3%	MSCI EM 37.5%	Barclay's Agg. Bond 0.01%	S&P 400 13.7%
S&P 400 37.4%	Russell 2000 26.9%	Barclay's Agg. Bond 7.8%	MSCI EM 18.2%	S&P 400 33.5%	S&P 500 13.7%	S&P 400 - 2.2%	S&P 400 20.7%	MSCI EAFE 25.7%	REITs -4.2%	S&P 500 13.1%
MSCI EAFE 31.8%	S&P 400 26.6%	S&P 500 2.1%	S&P 400 17.9%	S&P 500 32.4%	S&P 400 9.8%	S&P 500 1.4%	S&P 500 11.9%	S&P 500 21.8%	S&P 500 -4.4%	REITs 12.0%
REITs 28%	MSCI EM 18.9%	S&P 400 -1.7%	MSCI EAFE 17.3%	MSCI EAFE 22.8%	Barclay's Agg. Bond 6.0%	Barclay's Agg. Bond 0.6%	DJ UBS Commodity 11.8%	S&P 400 16.2%	Russell 2000 -11.0%.	Russell 2000 12.0%.
Russell 2000 27.2%	DJ UBS Commodity 16.8%	Russell 2000 -4.2%	Russell 2000 16.4%	REITs 2.9%	Russell 2000 4.9%	MSCI EAFE -0.8%	MSCI EM 11.2%	Russell 2000 14.6%.	S&P 400 -11.1%	MSCI EM 8.4%
S&P 500 26.5%	S&P 500 15.1%	MSCI EAFE -12.1%	S&P 500 16%	Barclay's Agg. Bond -2.0%	MSCI EM -2.2%	Russell 2000 -4.4%	REITs 6.7%	REITs 3.8%	DJ UBS Commodity -11.3%	MSCI EAFE 6.9%
DJ UBS Commodity 18.9%	MSCI EAFE 7.8%	DJ UBS Commodity -13.3%	Barclay's Agg. Bond 4.2%	MSCI EM -2.6%	MSCI EAFE -4.9%	MSCI EM -14.9%	Barclay's Agg. Bond 2.7%	Barclay's Agg. Bond 3.5%	MSCI EAFE -13.3%	Barclay's Agg. Bond 3.5%
Barclay's Agg. Bond 5.9%	Barclay's Agg. Bond 6.5%	MSCI EM -18.4%	DJ UBS Commodity -1.1%	DJ UBS Commodity -9.5%	DJ UBS Commodity -17.0%	DJ UBS Commodity -24.7%	MSCI EAFE 1.6%	DJ UBS Commodity 1.7%	MSCI EM -14.5%	DJ UBS Commodity -3.8%

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