In this Q4 recap: waves of volatility hit Wall Street, trade pacts and disputes make headlines, oil takes a plunge, and the economy continues to perform well.

Quarterly Economic Update

A review of Q4 2018, Presented by Greg B. Thomas

THE QUARTER IN BRIEF

Wall Street saw many ups and downs in the last three months of 2018. The fourth quarter concluded with bulls and bears vying for control of the market and with the S&P 500 suffering a 13.97%, three-month loss. The Federal Reserve sent conflicting signals about its implementation of monetary policy normalization, to the frustration of investors. No real progress was made in resolving the U.S.-China trade war, and the Brexit appeared to reach a standstill. The price of oil dropped sharply. The housing market gained a bit of momentum as home prices and mortgage rates both declined. The quarter was quite newsworthy, but its major headlines raised some troubling questions about the direction of the markets.[1]

DOMESTIC ECONOMIC HEALTH

On the whole, the economy looked quite good in the fall. Consumer spending increased 0.8% for October and 0.4% for November, with retail sales up 1.1% in the tenth month of the year and 0.2% in the eleventh. Retailers benefited from a great holiday sales season: on an annualized basis, consumer purchases made between November 1 and December 24 were up 5.1% compared to the same period in 2017.[2,3]

Consumer confidence indices declined from strikingly high levels, but were still notably strong. The Conference Board index hit 137.9 in October, 136.4 in November, and 128.1 in December. Having its best year since 2000, the University of Michigan's monthly consumer sentiment

gauge came in at 98.6 for October, 97.5 for November, and 98.3 for December; it averaged 98.4 for 2018.[4,5]

Both the service and factory sectors were booming, according to the Institute for Supply Management's monthly purchasing manager indices. ISM's non-manufacturing index was above 60 in both October and November (60.3, then 60.7); its manufacturing index rose from 57.7 in October to 59.3 in November.[6]

How was the jobs picture? Nonfarm payrolls expanded with 237,000 net new jobs during October; the November gain was 155,000. During both months, average yearly wage growth was at 3.1%. The main jobless rate held at 3.7%; the underemployment (U-6) rate moved north from 7.4% to 7.6%.[2,7]

Inflation was advancing just 2.2% a year by November; the 12-month increase had approached 3% as recently as July. Falling fuel costs helped tame inflation pressure. As a result, the average non-supervisory worker saw his or her inflation-adjusted income rise 1.0% in the 12 months ending in November, the most since 2016. On the wholesale front, producer prices jumped 0.6% in October, but rose only 0.1% during November. (Speaking of producers, industrial production was up 3.9% year-over-year in November; overall durable goods orders rose 0.8% for November after a 4.3% fall during the prior month.)[2,8]

In late December, the Bureau of Economic Analysis stated the economy had expanded 3.4% in the third quarter, revising its previous estimate of 3.5%. With growth like that, it not be surprising that the Federal Reserve made its fourth rate move of the year in December, taking the target range on the federal funds rate to 2.25-2.5%. Top Fed officials sounded alternately dovish and hawkish during the fourth quarter. In October, Fed chair Jerome Powell commented that interest rates were "a long way" from neutral, irritating Wall Street. A month later, both he and Fed vice chair Richard Clarida remarked that the benchmark interest rate was close to a "neutral" level. December's rate increase came with a relatively hawkish dot-plot, projecting two more hikes in 2019.[2,9]

The U.S. and China did little to address the tariffs they had imposed on each other earlier in the year. At the start of December, both nations did agree to a 90-day truce on introducing new import taxes. Even so, the U.S. was slated to hike tariffs on as much as $200 billion of Chinese imports as the year began.[10]

GLOBAL ECONOMIC HEALTH

Overseas, manufacturing economies in the east and west seemed to be decelerating. In fact, December marked the eighth consecutive month of a downward trend in weighted average Markit flash PMI readings of U.S., Japan, and European Union member countries. The mean factory PMI reading among those nations was the poorest in two years last month. China's

economy slowed in each month of the quarter, according to a Bloomberg Economics tracker, which cited reduced consumer demand for goods and services as much as the impact of tariffs. In November, the nation's official factory PMI sat at 50.0, the break-even point between sector growth and contraction. In Q3, China's annualized gross domestic product was expanding at a 6.5% pace; in Q1, the annualized GDP reading had been at 6.8%.[11]

The European Union (and the world) waited for the Brexit to proceed. U.K. leaders, however, spent the quarter debating if it should unfold according to the deal that Prime Minister Theresa May had presented to the European Union. By December, May's deal faced almost certain rejection in Parliament. There were three other options: another national referendum on the Brexit, a no-deal Brexit that would leave big businesses with headaches, or a "managed," no-deal Brexit with some bilateral trade arrangements put in place. The deadline for the Brexit was still set for March 29. On December 13, the European Central Bank confirmed that its longstanding, asset-purchase program would wrap up at the end of 2018. Interest rate hikes could be in the ECB's plans this year; euro-area consumer prices have been rising only about 1% annually for the past six years. Real, annualized GDP for the euro area through the first three quarters of 2018 was just 1.2%, a pace far off the 2.7% GDP seen in 2017.[12,13]

WORLD MARKETS

As bearish sentiment mounted in Q4, marquee equity indices steadily descended. Most of the 13-week declines were sizable: in the west, France's CAC 40 slid 13.89%; Germany's DAX, 13.80%; the United Kingdom's FTSE 100, 10.41%. In the east, India's Sensex lost just 0.44%; Hong Kong's Hang Seng, 6.99%; Japan's Nikkei 225, 17.02%; Australia's All Ordinaries, 9.74%; China's Shanghai Composite, 11.61%. To our north, the TSX Composite retreated 10.89% in Q4. MSCI's Emerging Markets index fell 7.85% during the quarter; its World index tumbled 13.74%.[14,15]

COMMODITIES MARKETS

While equities had a dismal quarter, some commodity futures posted significant Q4 gains. Take cocoa, which advanced 16.04%, and palladium, which rose 12.32%. Sugar improved 7.41% in Q4; gold, 6.61%; silver, 4.86%; soybeans, 2.68%; corn, 1.90%. The U.S. Dollar Index added 1.62%. At the closing bell on December 31, gold and silver were respectively worth $1,284.50 and $15.54 per ounce on the COMEX.[16,17]

What notable commodities lost value in the quarter? Here is a list. Platinum fell 3.22%; coffee, 3.78%; wheat, 4.55%; natural gas, 4.70%; cotton, 6.59%; copper, 6.63%; RBOB gasoline, 37.41%; WTI crude, 37.54%. WTI crude ended Q4 at just $45.83 a barrel on the NYMEX.[16,17]

REAL ESTATE

While the real estate market cooled off in 2018, the pace of home buying began to improve in the fourth quarter. By the estimations of the National Association of Realtors, existing home sales rose 1.4% in October and 1.9% in November. Perhaps sellers were lowering prices to meet prospective buyers on their turf. By November, NAR noted a median sale price of $257,700, which was merely 4.2% higher than in November 2017.[2,18]

A dip in mortgage rates could also have been a factor. In the last Freddie Mac survey of 2018 (December 27), the average interest rate for a conventional home loan was 4.55% nationally; it had been 4.72% three months earlier. (Rates on 15-year, fixed loans and 5/1-year, adjustable loans were respectively at 4.01% and 4.00% in the December 27 survey, compared with 4.16% and 3.97% in late September.)[19]

Even so, NAR's pending home sales index measuring monthly housing contract activity showed declines of 2.6% in October and 0.7% in November. New home purchases fell 8.9% in October. (We do not yet know about November new home sales, as the release of that Census Bureau report was delayed due to the federal government shutdown.)[2]

Home builders broke less ground in October, then started more projects (and took out more permits) in November. Census Bureau data showed housing starts down 1.6% for October, up 3.2% a month later; building permits were down 0.4% in the tenth month of the year, but up 5.0% in the eleventh.[2]

TIP OF THE QUARTER



If you are within a ***few years of retiring****, schedule a* ***review*** *of your* ***retirement strategy****. You do not want to risk basing your withdrawal rate or your investment selection on out-of-date assumptions.*

LOOKING BACK, LOOKING FORWARD

The fourth quarter is often hot for stocks, but this past one was ice cold. Equity investors grew concerned about the Federal Reserve's plans for 2019, the evident economic deceleration in China and Europe, and a narrowing spread between long-term and short-term Treasury yields that risked becoming an inversion. The S&P 500 closed out 2018 at 2,506.85; the Dow Jones Industrial Average, at 23,327.46; the Nasdaq Composite, at 6,635.28; their quarterly performances are noted in the table below. The CBOE VIX volatility index surged 109.74% in the quarter to 25.42.[1,9]

If you are wondering how the small caps fared, the short answer is: even worse than the big three. The S&P SmallCap 600 lost 20.43% in Q4; the Russell 2000, 19.39%.[1,20]

MARKET INDEX	Y-T-D CHANGE	Q4 CHANGE	Q3 CHANGE
DJIA	-5.63	-11.83	9.01
NASDAQ	-3.88	-17.54	7.14
S&P 500	-6.24	-13.97	7.20

YIELD	12/31 RATE	1 MO AGO	1 YR AGO
10 YR TIPS	2.69	3.01	2.40

Sources: barchart.com, wsj.com, bigcharts.com, treasury.gov - 12/31/18[1,21,22]

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends. 10-year TIPS real yield = projected return at maturity given expected inflation.

The fourth quarter of 2018 was the poorest quarter on Wall Street in 11 years. Was the welcomed, large-cap rebound at the end of December a hint of better times ahead? Earnings season is about to start, and it might be just what the Street needs; before it begins, investors may tread cautiously. Wall Street cannot "resume normal programming" fast enough for some market participants, but the path toward stability may not be an easy one; the volatility seen in December may take weeks to moderate. In sum, 2019 presents investors with many more uncertainties than 2018 did, and patience will be required to contend with them. Patience, in fact, may be an investor's greatest friend this quarter and year.[23]

QUOTE OF THE QUARTER



*"**Time** is the **most valuable thing** a man can spend."*

THEOPHRASTUS

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Shanghai Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The MSCI World Index is a free-float weighted equity index that includes developed world markets and does not include emerging markets. The CBOE Volatility Index® is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. MarketingPro, Inc. is not affiliated with any person or firm that may be providing this information to you. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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