



Investment Strategy Outlook

Another year is in the history books and as is often the case, global equity markets behaved in a manner most investors were not expecting. U.S. large cap stocks booked their first negative year in a decade and only their second negative year since 2003. U.S. small cap equities and non-U.S. equities underperformed U.S. large cap equities; bonds were flat to negative; and hedge funds had a difficult year again. Ned Davis Research found that 2018 was the first year since at least 1972 in which no major public asset class returned at least 5%.

Ironically and somewhat predictably, this all transpired just as the last wave of stubborn investors finally began to embrace the bull market and economic recovery that began in March 2009. A good indication of this observation is the American Association of Individual Investors Sentiment survey, which asks investors if they are bearish, neutral or bullish in their forecast for U.S. equity markets. In early January of 2018 59.75% of investors surveyed said they were *bullish* on the stock market, which was the second highest bullish reading since 2004 (December 2010 was 63%). Conversely, only 15.56% of investors surveyed said they were *bearish* on U.S. equity markets, which was in line with the other lowest readings on record since 2005. As of December 28, 2018, 50.30% of investors have a *bearish* view on U.S. equities and 32% are *bullish* (up from 21% bullish 2 weeks ago).

“Global synchronized growth” was the frequent buzz word in 2017 and the first half of 2018. As we begin 2019, “global growth slowdown” is a new favorite term amongst financial media as the current macro backdrop becomes increasingly similar to 2015 / 2016 in many ways. 2015 was characterized as a “violently flat” year for U.S. asset prices as we experienced major episodes of volatility in the late summer and fall months before markets finally bottomed in February 2016. The culprits for an unpleasant return environment in 2015 and the beginning of 2016 were (i) plummeting oil prices, (ii) slowing growth in China along with a currency devaluation, (iii) a strong U.S. dollar and (iv) what was perceived to be a hostile Federal Reserve (Fed hiked in December 2015 for the first time in several years and forecasted 4 hikes in 2016).

2016 and 2017 ended up being very good years for global risk assets as China stimulated its economy, oil stabilized, the U.S. dollar weakened, and the Fed paused – only hiking rates once in (December) 2016.

All of the above headwinds are present again today along with a trade war added into the mix. We could endlessly elaborate on each of these issues, however we would simply note that slowing economic growth and tighter financial conditions are not a combination that risk assets have reacted well towards historically.

Liz Ann Sonders, Chief Investment Strategist for Charles Schwab & Co., Inc. likes to remind us that “better or worse” often matters more than “good or bad” for asset prices. The real economy and corporate earnings had their best year of this entire business cycle in 2018, but markets were priced for perfection a year ago and assets were re-priced in a rapid fashion during Q4 2018. We will need to see the issues enumerated stabilize in order for volatility to begin to subside in the months ahead.

Thoughts for 2019

MBL Advisors uses Strategas Research Partners as our primary source for economic and investment research. We also use multiple other resources to build out our independent assessment of macro-economic and financial conditions.

- Many investors were overly optimistic in their forecasts for risk assets for 2018. Have investors become overly pessimistic in their expectations for 2019? In our base case scenario, MBL Advisors believes that the answer to this question is yes, but clearly downside risks have increased over the last few months.
- MBL Advisors believes that corporate profits will grow by mid-single digits next year. This is less than the 8%-9% consensus figure being used in forward estimates, but more optimistic than an earnings recession, toward which markets may be extrapolating. The United States has never had a recession with corporate profits growing. January earnings reports will be watched very closely in the weeks ahead. We will likely see several companies revise earnings estimates lower in an effort to more accurately

reflect headwinds from a lack of clarity around global trade and decelerating global growth. Lower guidance could also be a strategic decision by management to a small degree, positioning to possibly set themselves up for more favorable expectations over the next few quarters. Management confirming that increased uncertainty has not become overwhelming will be important.

- MBL Advisors believes that the U.S. economy will grow at a rate of around 2% in 2019. This is not nearly as attractive as the 3%+ economy which we experienced in 2018. Nonetheless, 2% is not a recession, although the average person may not be thriving in this environment.
- We are very aware that the large majority of Wall St. believes that U.S. GDP growth will be somewhere between 2% and 2.5% next year, and the 2019 S&P 500 targets from the largest 20+ financial institutions are all somewhere between 2750 to 3100. Consensus forecasts have less than stellar track records as has been proven through numerous statistical studies on this topic.
- Nonetheless, we agree with the consensus scenario of higher stock prices over the months ahead – under the assumption that we do not go into a recession in 2019. Volatility and P/E ratios are strongly inversely correlated. At the end of 2017, volatility was at record low levels (the VIX was under 10) and the P/E ratio on the S&P 500 was at a cycle high. More recently, volatility has sustained an elevated level (VIX 25 – 35) and the forward P/E ratio is 4 to 5 points lower. If volatility subsides (when there is more clarity on the economy and the Fed) to an average (VIX 17 – 20) level, regression analysis shows it would be reasonable for stocks to trade at 15x to 17x forward earnings estimates. Today, this would indicate a fair value midpoint on the S&P 500 of around 2750. History teaches us that stocks move higher with earnings growth over long periods of time, and earnings growth will be a necessary catalyst for stock price increase in 2019 and 2020. It should be noted that markets rarely trade at “fair value” – as “fair value” is more of an opinion than a precise calculation.
- The equity risk premium on the S&P 500 is roughly 3%. Thus, we believe that stocks offer value vs. bonds for long term investors. As a reference point, equity risk premiums were negative during the tech bubble in 2000.

- Absolute valuations are inline to slightly expensive relative to 15 year averages. Having said this, absolute valuations on U.S. equities may be the most attractive they have been in the last few years. Valuations are not a useful tool for short term forecasting, and all we can really say with confidence is that stocks are nowhere near as cheap as they were in 2009 (which was as inexpensive as we have seen in multiple decades,) nor are they anywhere near as expensive as they were in 2000 (which was the most overvalued market in the last 100+ years). Low inflation, which we have today, is favorable for valuations all else being equal.

S&P 500 Valuations

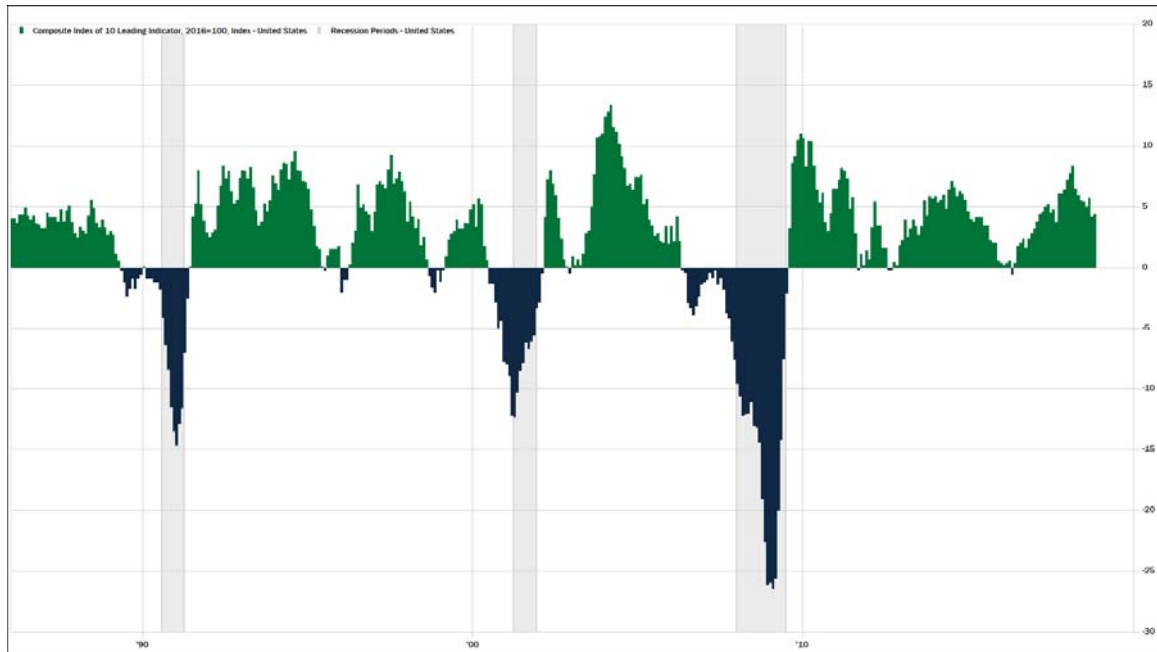
S&P 500 Index	January 2019	January 2018	15 Year Average	2008/2009 low	2000 High
Forward P/E	14.34x	18.72x	14.66x	8.75x	25.75x
Trailing P/E	17.29x	24.18x	17.34x	9.45x	31.32x
Shiller P/E	29.01x	33.31x	24.62x	13.32x	43.77x
Price to Sales	1.75x	2.20x	1.52x	0.76x	3.01x
Price to Book	2.72x	3.29x	2.42x	1.35x	4.05x
Price to Cash Flow	11.05x	14.66x	9.79x	4.20x	18.59x
Dividend yield	2.33%	1.85%	2.15%	3.83%	1.26%
1 Year Treasury yield	2.60%	1.88%	1.48%	0.26%	6.32%

Source: FactSet

- We monitor many macro-economic indicators on a frequent basis and have come up with 8 chosen indicators which have generally turned negative before the last several recessions.

While we are aware that macro-economic data is backward looking in comparison to market prices, these indicators have a good track record over the last few decades and 7 of the 8 data points (not all of equal importance) remain in positive territory. The ECRI Economic Climate Indicators Index is the one indicator which is currently giving a neutral reading. It is important to note that most of these data points have peaked and are now decelerating but remain at acceptable levels on an absolute basis.

U.S. Composite Index of Leading Economic Indicators 6 Month % change Annualized



Source: FactSet

The concern about global growth is a real issue which markets will need to digest and have stabilize in the next few months. The combination of uncertainty from the trade war and a supply glut in oil have produced some weak manufacturing data (U.S. & China) over the last week.

Nonetheless, the majority of economic conditions are not currently indicative of previous recessions. Labor markets are the best example, as they remain very healthy with the unemployment rate and initial jobless claims both at multi-decade lows. While there is a precedence for bear markets without recessions, stocks rebounded sharply in most of these instances. The economic data and market conditions will eventually re-synchronize with each other, exactly what that convergence looks like is the huge question investors are contemplating.

Major S&P Declines Without a Recession <i>1945 to Present</i>			
<u>Start Date</u>	<u>End Date</u>	<u>% Decline</u>	<u>Recession?</u>
5/20/2015	2/11/2016	-15.2%	<i>No</i>
5/2/2011	10/4/2011	-21.6%	<i>No</i>
7/20/1998	10/8/1998	-22.5%	<i>No</i>
8/25/1987	10/20/1987	-35.9%	<i>No</i>
9/21/1976	3/6/1978	-19.4%	<i>No</i>
2/9/1966	10/7/1966	-22.2%	<i>No</i>
12/12/1961	6/26/1962	-28.0%	<i>No</i>
5/29/1946	5/19/1947	-28.5%	<i>No</i>

Source: Strategas Research Partners

- Market data points are at least equally as important, and the bond market is giving us more cautionary signals than economic data is currently depicting. A few examples of this are (i) yields continuing to move lower, (ii) the flattening of the yield curve and (iii) credit spreads widening. The 10 year minus 2 year spread is now less than 0.20% and the 10 year minus 3 month spread is just over 0.20%. “Flat” is not the same as “inverted,” but it will be concerning if the yield curve inverts at these spread levels, due to this indicator having an accurate history of forecasting of recessions . However, with respect to the 10 - 2 year spread, the last three yield curve inversions happened in 2005, 1998 and 1988. According to Strategas Research Partners, the number of days from yield curve inversion to equity market peak was 651 days, 668 days and 579 days respectively.
- Most trend models for global equity markets have flipped into negative territory. This is confirmation of a different type of equity market environment where (i) intermediate term uptrends in equity markets have been broken, (ii) volatility will remain elevated and (iii) a durable move higher will need more positive evidence on the side of the bulls than it might have required in the past.

- The single most consensus forecast on Wall Street is for yields to move higher over the next several months. Chris Verrone from Strategas Research Partners pointed out that Bloomberg surveyed 58 Wall Street economists and fixed income strategists and only 1 person had a forecast for the 10 year yield to be below today's levels (2.75%) on June 30, 2019. This is almost identical set up to 2016 when yields went dramatically lower in the first half of the year, before eventually bottoming in July.

Risks

It is always good to remind ourselves of the sheer power and complexity of the capital markets. Risks are usually plentiful, and the only thing we can say with certainty is that there will be both positive and negative catalysts over the coming years which we aren't even thinking about today.

We have mentioned the headline concerns about global economic growth, but there are three additional and related risks that we believe deserve a lot more attention than they are currently being given.

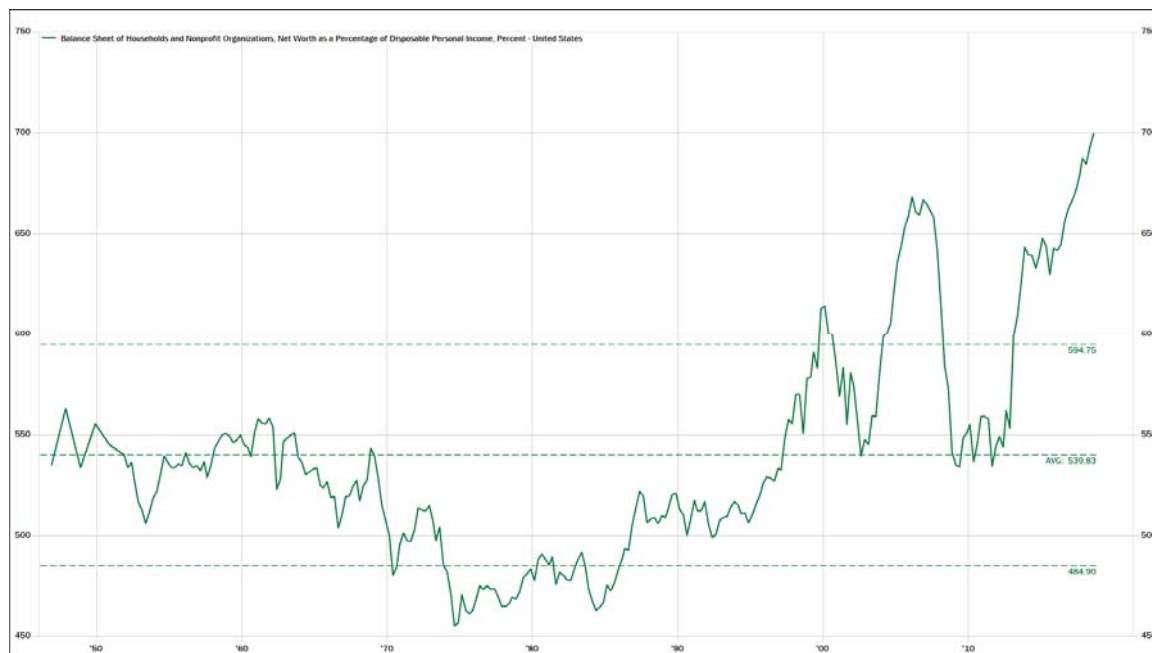
The first concern is frequently mentioned but often far too casually. The unwinding of the Fed's balance sheet, or "reverse QE" is not something we have ever seen before, and thus it is difficult to know exactly how this will influence financial conditions. From the fall of 2008 through the end of 2014 the Federal Reserve grew their balance sheet from less than \$1 trillion to roughly \$4.5 trillion. The Fed's primary purpose of quantitative easing was to stimulate the real economy; however most experts would agree that the primary result was to boost asset prices. This is not necessarily to say that the Fed has created a bubble in asset prices, as economic fundamentals have tremendously improved over the last decade as well. Nonetheless, just as the economic models did not accurately predict the benefits of QE, we don't know how the Fed reducing their balance sheet by \$600 billion per year is going to affect the economy or asset prices.

Second, most investors are aware that the U.S. economy is 2/3 consumer driven. The following chart depicts household net worth as a percentage of disposable income, which has steadily risen for the last 40 years. In other words, U.S. consumption is becoming more and more dependent on asset prices relative to income. This is likely due to a variety of factors including

an aging population, a lack of adequate wage growth, and a phenomenal 40 year run for U.S. asset prices despite two major bear markets.

The big question from this data then becomes “is the U.S. economy (i.e., consumer spending) more sensitive to fluctuations in asset prices than it has been in the past?” We believe prior Fed regimes were very aware of this data. It is yet to be determined how relevant Chairman Powell believes this information to be, but the market certainly believes that the “Powell put” is much further out of the money than it was his two immediate predecessors.

Balance Sheet of Households and Nonprofit Organizations, Net Worth as a Percentage of Disposable Personal Income



Source: FactSet

- Third, U.S. non-financial debt has steadily risen over the last several years, partially due to companies borrowing to repurchase stock and issue dividends. A “maturity wall” will begin in 2019 as a significant portion of this debt will need to be refinanced (likely) at higher interest rates over the next several years. This could have a negative impact on corporate earnings, cash flows, capex plans, etc.

The fact that the U.S. financial system is far better capitalized today than it was a decade ago should not be underestimated. This may have been responsible for creating systemic risks in 2008 which we do not believe are present today.

Conclusion

We believe closely monitoring the capital markets and formulating prudent investment recommendations is an integral part of our duty to our clients. We thank you for taking the time to read through how we are currently viewing the world as we move into 2019. Nonetheless, year by year we have continually been humbled regarding anyone's ability to precisely forecast financial markets and asset prices. In this light, we believe that long term returns will be far more dependent on how an investor behaves vs. what an investor knows.

Over the last 100 years, stocks have returned an average of 4% - 5% more than long-term high-quality bonds. The reason for the excess returns in stocks vs. bonds over long time horizons is to compensate equity investors to assume risk (volatility) over short and intermediate periods of time. Thus, uncertainty is a natural and healthy part of investing. Without it stock prices would be bid up and forward return premiums would no longer exist. Low volatility and high forward returns simply cannot sustainably exist together.

Since uncertainty is a fact of investing, we need to learn how to embrace it by following Howard Marks advice which is to "prepare rather than predict." We believe this means being prepared for a wide range of outcomes over shorter time frames while constructing portfolios in which we have high levels of confidence in achieving longer term financial goals. Do we feel comfortable that our portfolio will adequately participate in the upside and tolerably endure the inevitable downturns? Allowing financial success to be dependent on our ability to forecast massively complex capital markets is not a strategy that a prudent, humble or disciplined investor would pursue.

We are tremendously excited for the opportunity to work with our clients in the years to come and we are grateful for your trust in all of us. On behalf of everyone at MBL Advisors, thank you for the privilege of serving you and your families.

Sincerely,

A handwritten signature in black ink, appearing to read 'B. Gift', with a stylized, cursive script.

Brian J. Gift, CFA
Managing Director

Actionable items

- As returns normalize and volatility increases, having a through investment plan and process becomes increasingly imperative. We want to spend time with each of our clients establishing, reviewing and reiterating our investment plans in the first quarter of 2019.

Investors should understand the strategic asset allocation for their portfolios and why it is appropriate in pursuing their long term financial goals.

- Current portfolio positioning relative to long term strategic guidelines deserves a high degree of analysis and consideration.

Although we believe equities can move higher in 2019, the cost of owning equities has increased in the form of higher volatility / uncertainty. With this in mind MBL Advisors continues to recommend having a marginally lower equity weighting in portfolios

relative to the majority of the last several years. For most investors this likely means a neutral positioning vs. strategic guidelines.

- Overweight U.S. large cap equities and tilt towards quality in the form of companies who exhibit several of the following characteristics; high free cash flow, low financial leverage, high return on equity, stable earnings streams and consistent return of capital to shareholders.
- Underweight lower quality investments in the form of U.S. small cap equities, Europe and high yield bonds.
- Valuations on Emerging Markets are attractive, and we believe the asset class could do well next year. Stabilization of growth in Chinese economy will be a key to monitor and a lack of strength in the U.S. dollar will be necessary in order for emerging markets to have a positive year. Interestingly, Emerging Market equities outperformed U.S. equities by more than 5% in Q4 2018.
- Accentuate income within portfolios. Total returns = capital appreciation plus dividends / interest income. Great return years are primarily attributable to capital appreciation. Congruent with our belief that multiples should stabilize / not expand beyond 16x - 17x forward EPS (multiples expanded from 2012 – 2017), capital appreciation should moderate. Thus, dividends and interest will become a higher percentage of total returns and investors should incorporate this viewpoint into their portfolios.
- Hedged equity strategies and / or lower beta equities should be considered for a portion of an investor's equity allocation.
- Own high-quality bonds to dampen volatility and increase diversification within portfolios. For most investors, several years of liquidity should be invested in high quality bonds.
- We recommend building benchmark weightings to uncorrelated assets as an additional hedge to portfolios.

Investment Wisdom

“I spend about half of my time wondering why I have so much in stocks and about half wondering why I have so little.”

-Jack Bogle

“Every past decline looks like an opportunity; every future decline looks like a risk.”

- Morgan Housel

“The key to making money in stocks is not to get scared out of them.”

- Peter Lynch

“Prepare rather than predict.”

– Howard Marks

Disclosures

Investments in securities involve risks, including the possible loss of principal. When redeemed, shares may be worth more or less than their original price.

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