SEELAUS
ASSET MANAGEMENT

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Covered in this Report:

- Stocks slump as investors worry about higher rates and slower growth
- While manufacturing has slowed somewhat, services-based economy remains strong
- Equity valuations reasonable and opportunities have increased

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Equity Market Commentary

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Investment Rules 101

You got to know when to hold 'em,
Know when to fold 'em,
Know when to walk away,
And know when to run.

You never count your money
When you're sittin' at the table.
There'll be time enough for countin'
When the market's done.

- *Apologies to Kenny Rogers, The Gambler*

In the fourth quarter of 2018, the U.S. stock market hit an air pocket, plunging by more than 14% and creating the worst annual performance for equities since 2008. While no one thing sparked the fall, investors seemed most concerned that the Federal Reserve was raising short-term interest rates too quickly and would cause an economic slowdown. It didn't help that trade issues between the U.S. and China continued, the British move to exit the European Union seemed to threaten trade within the region, economic data from China indicated a marked slowdown in activity, and oil and other commodity prices sank. Finally, a government shutdown at year end due to a budget impasse was more than most investors could stomach, with the turbulence sending most indices into bear market territory. While it's hard to put a positive spin on losses, our client accounts performed well versus their relevant market benchmarks.

We all knew it was too good to be true and that stocks couldn't go ever higher without a correction, but few of us expected it would happen in the fourth quarter, historically a strong seasonal period for equity markets. After all, the domestic economy remains robust, unemployment levels are near the lowest levels in decades (1969 to be exact), displaced workers are re-entering the workforce, job creation continues at a solid pace and Consumer Confidence is high. Tax reform and lower oil prices have strengthened consumers' ability to spend and not surprisingly, retail activity was especially strong this holiday season. With labor markets tight, wage gains have begun to accelerate and the December report of a 3.4% jump in wages over a year earlier indicates real gains on an inflation-adjusted basis, further benefitting consumers. That is why the Federal Reserve has continued to raise short-term interest rates: they are afraid conditions are on the verge of becoming too good and they are trying to stop the economy from overheating. So far, it appears they have succeeded with auto sales plateauing and the housing market showing signs of weakness.

Unfortunately, while the Fed is trying to finesse slower growth for our economy, China and emerging market economies are weakening due to trade squabbles with the U.S. and Europe is struggling due to Brexit uncertainties. Many global corporations have put large capital-intensive projects on hold or, at a minimum, are slowing their development. No one likes uncertainty and the issues noted above have given corporate leaders more than their fair share, so caution has become the buzzword. That caution hasn't created a slowdown in the U.S., but more likely a temporary pause in manufacturing. The recent weakness in the Institute of Supply Management's Index of industrial activity to a 2-plus year low and very weak new order activity confirms the softness in manufacturing. We believe these increased signs of economic weakness at home and abroad combined with low inflation readings will cause the Federal Reserve to pause and not likely hike short-term rates in the near term. In its December earnings update, FedEx summarized the situation well: "The U.S. economy remains solid, but international trends weakened during the quarter, especially in Europe, as global trade has slowed." With that backdrop, investors are struggling to determine appropriate valuations for equities in a slower growth world economy. Therefore, we believe now more than ever you should have professionals manage your investment portfolio focusing on the relative risk/reward of stocks and sectors, rather than those who chase fads, don't respect valuation and make decisions based upon fear, greed and emotion.

The news isn't all bad and don't go and sell all your stocks just because the market has had a correction and some sectors have entered bear market territory. Indeed, you should buy more stocks when they are cheaper than when they are expensive, and many stocks are on sale. We have been warning of the excesses in the technology sector and pointed out the speculative fervor of bitcoin and other crypto-currencies, so we feel vindicated to have missed the 75% plunge of Bitcoin in 2018 and the full impact of the nearly 25% drop in the Nasdaq 100 from their respective highs. The good news for investors is that many companies whose shares were already valued at attractive levels have had further markdowns. We've talked before about swinging at fat pitches and amidst the tax selling mania and de-risking of investors' portfolios in December, some juicy fastballs came right down the middle of the plate.

Let's not forget that according to the Bureau of Economic Analysis, services are nearly 80% of the U.S. economy and the strength in the Labor Department's December payrolls (a 312,000 increase) is evidence that the overall economy remains robust. As such, we are confident that barring exogenous events (e.g. trade wars, government shutdowns and all the other unknowns), we should avoid a recession in 2019. If the Federal Reserve raises rates twice more in 2019, we think the odds of a recession will greatly increase. President Trump and others are afraid the Federal Reserve has taken away the proverbial punch bowl too early and have called for a stop to the increases in short-term rates.

Thankfully, last week Federal Reserve Chairman Powell noted, “With the muted inflation readings that we’ve seen coming in, we will be patient as we watch to see how the economy evolves.”

The 25% fall in oil prices during the quarter caused many investors to give up on the sector. While fracking of oil and gas wells has increased domestic production, the Saudis have made it clear that they will cut production to bring the oil markets back into balance. Their own budget requires an oil price of $80 per barrel, so we are confident that they will work with Russia and other OPEC nations to restrain production. Venezuela’s political and economic problems have sharply reduced its oil production capabilities and crude oil’s drop below $50 per barrel in the U.S. has caused producers to restrict drilling activity. We are confident that the price drop is temporary. As such, we remain enthralled by the juicy total return potential of the major international oil companies, some of whose dividends yield in excess of 6%! We also find the refiners an interesting investment opportunity as consolidation has reduced competition and the industry leaders sell at intriguing valuations.

With the strong economy and robust conditions for consumer spending, we see attractive opportunities in those retailers who have been proactive in dealing with the Internet age of home delivery and have developed competitive ecommerce alternatives. We are less enamored with the outlook for home builders and housing industry suppliers due to our concern about the impact on housing of rising interest rates. Therefore, we have reduced our exposure to the group in recent months. The biotech sector had a brutal year and even though the group should be able to grow earnings in excess of 10% for the next few years, leading companies from the sector sell at a modest 12 times earnings and some even pay dividends. We think the group is ripe for consolidation and outperformance in the years ahead and are pleased that Bristol Myers has just made a cash and stock bid for Celgene, underscoring the value inherent in the group.

There was no place to hide in the fourth quarter of 2018 as virtually every industry and sector was pummeled, with technology and small capitalization stocks suffering the most. Small- and mid-capitalization stocks were also crushed and were the worst-performing sectors for the year, creating significant long-term capital gains opportunities. Mutual fund investors redeemed shares in mid-December at the fastest rate since October 2008 (a really bad time to sell) and at year end 2018, the broad market was selling at only 14 times estimates of 2019 earnings. At these levels, stocks are reasonably priced and if inflation remains subdued, downright attractive. Corporate insiders (a.k.a. “the smart money”), sure thought so and according to The Washington Service, increased their rate of stock purchases versus sales at the fastest rate since August of 2011. We are glad that we took money off the table in certain overvalued sectors and are encouraged by the performance of our holdings thus far in the new year. It proves once again that in the long term, valuation matters.

We are honored to manage a portion of your investment portfolio and, as always, welcome your comments and questions.

Sincerely,

James P. O'Mealia
Head of Equity Portfolio Management

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five private limited partnerships.

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