Quarterly Commentary

4Q18

The great Orson Welles, one of history's premiere raconteurs, suggested that a happy ending depends upon where you decide to stop your story. Unfortunately, equity investors could not stop the story in 2018 as a year that began with much promise and robust gains ended with a resounding thud! Equity markets started the year on solid footing as stronger economic activity, spirited business and consumer confidence, and lower corporate taxes provided fuel to propel markets to record highs. However, as the year progressed, changes in trade policy and the continued normalization of Fed interest rate policy weighed increasingly on market sentiment. Higher market volatility and slower global growth negatively impacted equity valuations as multiples contracted sharply. Though there appeared to be no evidence of a foreboding recession, investors began to extrapolate negative changes in business cycle trends and liquidated riskier assets in earnest during the fourth quarter. As a result, the Russell 2000 Value Index, which had risen more than 9% at its peak, experienced a devasting 18% decline in the fourth quarter to end the year with a loss of 12.9%.

As the year commenced, rising assets prices along with business and consumer confidence drove incremental corporate and consumer spending trends that were expected to sustain favorable economic growth. Encouraging fundamental results from companies, driven in part by the benefits from lower corporate taxes, produced correspondingly positive earnings growth trends. Throughout the year, broad leading indicators such as the ISM index, the regional activity indices along with solid employment trends and higher wages helped sustain beneficial trends for U.S. economic activity.

However, increasingly antagonistic trade policy rhetoric and higher tariffs on foreign goods began to have a negative impact on certain areas of the economy. Furthermore, the U.S. dollar moved higher and pressured the performance of internationally focused industrial companies during the second half of the year. Finally, economic data in China and Europe weakened further, suggesting that trade policy was contributing to a drag on global growth. The Fed, which earlier in the year indicated its desire to stay-the-course on tighter monetary policy, increased the federal funds rate again in December, although subsequently moderated its tone and expressed more flexibility regarding future rate policy.

At year end, market leadership was dominated by the Utilities sector, which was the only sector to produce positive returns. Every other sector was down more than 10%. Energy and Materials were meaningful laggards, as both sectors were negatively impacted by slower global demand and a rising U.S. dollar. During the year, we reduced our total exposure to cyclical sectors as we became more cognizant of emerging threats to global growth. We maintain a very slight cyclical emphasis in the portfolios based upon solid U.S. economic activity, higher fiscal spending levels, and potential trade policy clarity.

Though economic trends remain favorable and a recession is not expected in the U.S. in 2019, we are beginning to observe some slowing in global activity and growth levels. While the Fed is now expected to be more "data dependent" regarding future restrictive monetary policy moves, the spread between long-term and short-term interest rates has narrowed considerably over the last year, which has historically been a precursor to slower growth. Although trade policy has already begun to produce a negative impact on global growth, we are hopeful that U.S. fiscal stimulus, meaningfully easier China monetary policy and supportive fiscal policy will provide some offset until we get more clarity regarding the global growth outlook.

To learn more about how Mesirow can help you, please contact Eric Welt at 312.595.2281 or ewelt@mesirowfinancial.com.

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