TOWNELEY CAPITAL MANAGEMENT

2018 IN PERSPECTIVE

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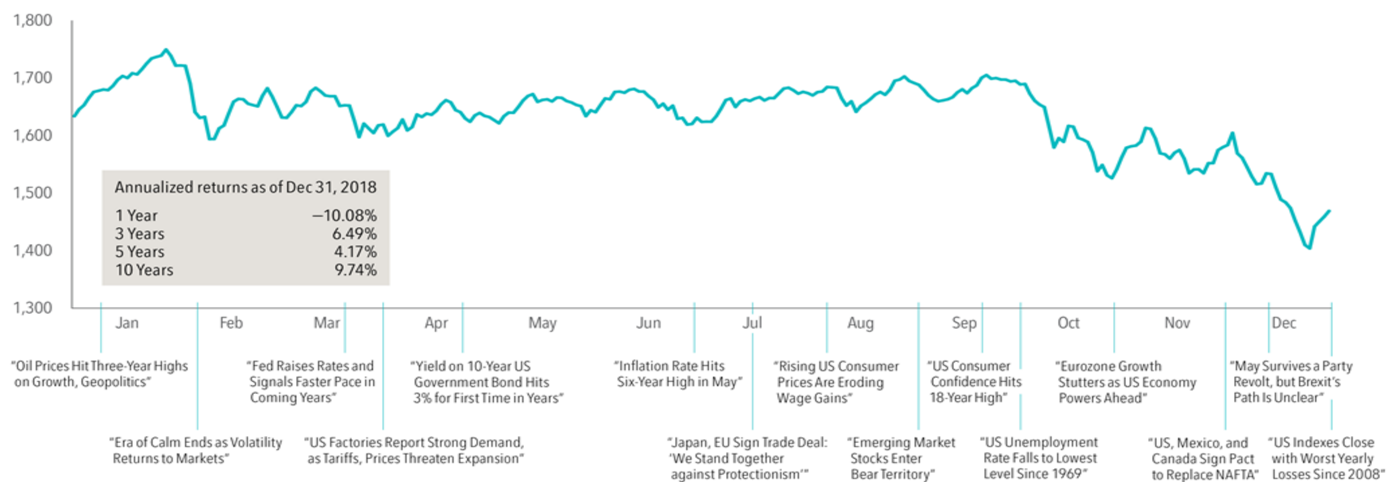
ANNUAL MARKET REVIEW

After logging strong returns in 2017, global equity markets delivered negative returns in US dollar terms in 2018. Common news stories in 2018 included reports on global economic growth, corporate earnings, record low unemployment in the US, the implementation of Brexit, US trade wars with China and other countries, and a flattening US Treasury yield curve. Global equity markets delivered positive returns through September, followed by a decline in the fourth quarter, resulting in a –4.4% return for the S&P 500 and –9.4% for the MSCI All Country World Index for the year.

The fourth quarter equity market decline has many investors wondering how equities may perform in the near term. Equity market declines of 10% have occurred numerous times in the past. The S&P 500 returned –13.5% in the fourth quarter, while the MSCI All Country World Index returned –12.8%. Historically, after declines of 10% or more, equity returns over the subsequent 12 months have been positive 71% of the time in US markets and 72% of the time in other developed markets.[1]

Exhibit 1: World Stock Market Performance

MSCI All Country World Index (IMI) with selected headlines from 2018



Source: MSCI. Past performance is not a guarantee of future results. In US dollars, net dividends. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Exhibit 1 highlights some of the year's prominent headlines in the context of global stock market performance as measured by the MSCI All Country World Index (IMI). These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

[1] Declines are defined as points in time, measured monthly, when the market's return since the prior market maximum has declined by at least 10%. Declines after December 2017 are not included, but subsequent 12-month returns can include 2018 returns. Compound returns are computed for the 12 months after each decline observed and averaged across all declines for the cutoff. US markets (1926–2018) are represented by the S&P 500 and Developed ex US markets (1970–2018) are represented by the MSCI World ex USA Index.

All non-US equity market returns are in USD, net dividends, unless otherwise noted.

Market Volatility

Exhibit 2 shows the performance of markets subsequent to declines of 10%, 20%, and 30%. For each decline threshold, returns are shown for US large cap, non-US developed markets large cap, and emerging markets large cap stocks in the following 12-month period. While declines in equity markets may cause investor concern, the data provides evidence that historically markets have, on average, generated positive returns during the 12-months following a 10% or larger decline.

Exhibit 2: Average Compound Returns for Stocks in a Following 12-Month Period

Market Decline Cutoff	US Large Caps	Non-US Developed Markets Large Caps	Emerging Markets Large Caps
10%	11.25%	11.18%	13.51%
20%	11.61%	14.44%	21.52%
30%	14.31%	19.07%	30.05%

Past performance is not a guarantee of future results. Declines are defined as points in time, measured monthly, when the market's return since the prior market maximum has declined by at least 10%, 20%, or 30%, depending on the cutoff. Declines after December 2017 are not included, but subsequent 12-month returns can include 2018 returns. Compound returns are computed for the 12 months after each decline observed and averaged across all declines for the cutoff. US Large Cap is the S&P 500 Index, from January 1926 through December 2018, provided by Standard & Poor's Index Services Group. Non-US Developed Markets Large Cap is the MSCI World ex USA Index (gross div.), from January 1970 through December 2018. Emerging Markets Large Cap is the MSCI Emerging Markets Index (gross div.), from January 1988 through December 2018. MSCI data © MSCI 2019, all rights reserved.

The increased market volatility in the fourth quarter of 2018 underscores the importance of following an investment approach based on diversification and discipline rather than on prediction and timing. Instead of attempting to outguess market prices, investors should take comfort that market prices quickly incorporate relevant information and that information will be reflected in expected returns. While we cannot control markets, we can control how we invest.

WORLD ECONOMY

During 2018, the global economy continued to grow, with 44 of the 45 countries tracked by the Organization for Economic Cooperation and Development (OECD) on pace to expand. Argentina was the only country expected to contract.[2] While market participants may consider the economic outlook of a region, it is just one of many inputs that determine realized market performance.

Exhibit 3: Real GDP Growth by Region (%)
(annual rate)

	2017	2018		
	Q4	Q1	Q2	Q3
US	2.3	2.2	4.2	3.4
Canada	1.7	1.7	2.9	2.0
Euro Area	2.7	1.5	1.7	0.6
Japan	1.5	−1.3	2.8	−2.5
China	6.1	6.1	7.0	6.6
Australia	2.2	4.3	3.6	1.0
UK	1.5	0.4	1.6	2.5

Sources: BEA, Statistics Canada, Cabinet Office (Japan), National Bureau of Statistics (China), Eurostat, Australian Bureau of Statistics, Office for National Statistics (UK).

[2] OECD Real GDP Forecast, 2019. Accessed Jan. 4, 2019. Https://data.oecd.org/gdp/real-gdp-forecast.htm#indicator-chart

2018 MARKET PERSPECTIVE

Equity Market Highlights

Global equity markets, as measured by the MSCI All Country World Index, ended the year down –9.4%, with significant dispersion by country.

US equities generally outperformed other developed markets for the year, although they lagged other developed and emerging markets in the fourth quarter. The S&P 500 Index recorded a –4.4% total return for the year and –13.5% return in the fourth quarter.

Returns among other developed equity markets were negative. The MSCI World ex USA Index, which reflects non-US developed markets, was down –14.1% for the year and –12.8% for the fourth quarter, and the MSCI Emerging Markets Index fell –14.6% for the year and –7.5% for the fourth quarter. US small cap stocks, as measured by the Russell 2000 Index, returned –11.0% for the year.

Impact of Global Diversification

While markets around the world generally had negative returns in the fourth quarter, the dispersion in their returns highlights the importance of global diversification during market declines. The MSCI All Country World ex USA Index (IMI) outpaced the S&P 500 for the quarter (–11.9% vs. –13.5%). Given the strong returns of US markets through September, however, the US equity market was one of the stronger performing markets for the year, ranking seventh out of the 47 countries in the MSCI All Country World Index (IMI).

The S&P 500 Index's –4.4% return marked the end of nine consecutive positive annual returns. Despite the negative return this year, the S&P 500 has still produced a 13.1% annualized return for the 10 years ending December 31, 2018.

When considering individual countries, 46 out of 47 countries were down for the year. Using the MSCI All Country World Index (IMI) as a proxy, no countries posted positive returns among developed markets, and only Qatar managed a positive return among emerging markets. As is typically the case, country-level returns varied significantly. In developed markets, returns ranged from –24.1% in Belgium to 0.0% in New Zealand. In emerging markets, returns ranged from –41.3% in Turkey to 27.1% in Qatar—a spread of almost 70%. Large dispersion among country returns is common, with the average spread in emerging markets over the past 20 years of 90%. Without a reliable way to predict which country will deliver the highest returns, this large dispersion in returns between the best and worst performing countries again emphasizes the importance of maintaining a diversified approach when investing globally.

To emphasize this point, Israel went from being the worst performer in developed markets in 2017 (10.4%) to the second-best performer in 2018, returning –3.6%. Likewise, Qatar went from being the second worst performing emerging market country (–12.5%) in 2017 to the best performer in 2018.

When considering investing outside the US, investors should remember that non-US stocks help provide valuable diversification benefits, and that recent performance is not a reliable indicator of future returns. It is worth noting that if we look at the past 20 years going back to 1999, US equity markets have only outperformed in 10 of those years—the same expected by chance. We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on the period in global markets from 2000-2009, commonly known as the "lost decade" among US investors. While the S&P 500 recorded its worst ever 10-year cumulative total return of –9.1%, the MSCI World ex USA Index returned 17.5%, and the MSCI Emerging Markets Index returned 154.3%. In periods such as this,

[3] Source: MSCI country investable market indices (net dividends) for each country listed. Does not include Greece, which MSCI classified as a developed market prior to November 2013. Additional countries excluded due to data availability or due to downgrades by MSCI from emerging to frontier market. MSCI data © MSCI 2019, all rights reserved. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

investors were rewarded for holding a globally diversified portfolio.

Currencies

Currency movements reduced US dollar returns in 2018 for non-US dollar assets. The strengthening US dollar vs. weakening non-US currencies had a negative impact on returns for US dollar investor holdings in unhedged non-US dollar assets. The strong US dollar reduced returns 3.5% as measured by the difference in returns between the MSCI All Country World ex USA Index (IMI) in local returns vs. USD. The US dollar strengthened against most currencies, including the euro, the British pound, and the Canadian dollar, and weakened against the Japanese yen.

As with individual country returns, currency movements are difficult to predict. Investors should be cautious about trying to time currencies based on the recent strong or weak performance of the US dollar or any other currency.

Fixed Income

For the full year, return on the US fixed income market was relatively flat; Bloomberg Barclays US Aggregate Bond Index returned 0.0%. Non-US fixed income markets posted positive returns in 2018, contributing to Bloomberg Barclays Global Aggregate Bond Index (hedged to USD) return of 1.8%.

Yield curves were upward sloping in many developed markets for the year, indicating positive expected term premiums. Realized term premiums were negative in the US as long-term maturities underperformed their shorter-term counterparts, and positive in developed markets outside the US. For example, FTSE Non-USD World Government Bond Index 10+ (hedged to USD) returned 4.4% for the year vs. 3.0% for the 1-10 Index.

Credit spreads, which are the difference between yields on lower quality and higher quality fixed income securities, widened during the year, as measured by the Bloomberg Barclays Global Aggregate Corporate Option Adjusted Spread.

Realized credit premiums were negative both globally and, in the US, as lower-quality investment-grade corporates underperformed their higher-quality investment-grade counterparts. Treasuries were the best performing sector globally, returning 2.8%, while corporate bonds returned –1.0%, as reflected in the Bloomberg Barclays Global Aggregate Bond Index (hedged to USD).

In the US, the yield curve flattened as interest rates increased on the short end of the yield curve relative to the long end. The yield on 3-month US Treasury bill increased 1.06% to end the year at 2.45%. The yield on 2-year US Treasury notes increased 0.59% to 2.48%. The yield on the 10-year US Treasury note increased 0.29% during the year to end at 2.69%. The yield on 30-year US Treasury bonds increased 0.28% to end the year at 3.02%.

Interest rates declined in Germany and Japan and rose in the United Kingdom. Yields on Japanese and German government bonds with maturities as long as 10 years finished the year in negative territory.

SUMMING IT UP

While recent market volatility may scare some investors out of the market, we believe such conditions present opportunities for strategic portfolio rebalancing. We have gone through many market cycles with our clients; we urge you to stay the course and maintain your current portfolio allocation unless you are experiencing changes in your life or organization. If so, please let your portfolio manager know so we can evaluate whether your current allocation is still appropriate.

Sources:

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Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

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