



## Markets and Economic Update

Fourth Quarter 2018

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### BACK TO NORMAL – “RETURN OF VOLATILITY”

For most investors 2018 likely felt anything but normal. December was a particularly difficult month that saw the US equity market (S&P 500 Index) down 9%, the worst December since 1931. The equity markets were up or down more than 1% nine times in December alone, and 64 times in 2018. In contrast, we saw 1% moves only eight times in all of 2017. The year also saw the Dow Jones, an index representing the largest blue-chip stocks, post swings of 1,000 points five times. It's only done so eight times in its entire 100+ year history. So what's normal about this?

A closer look at volatility through a long-term historical lens shows a very different picture. The average daily VIX (a leading measure of volatility) in 2018 was 16.6, nearly identical to the median historical calendar year for the past 25 years. This compares to a VIX of 11.1 in 2017. This year-over-year change in the VIX is among the largest in history. Hence, our perception is likely skewed by a recent and extended period of historically low market volatility during an extended bull market.

The question then becomes what's driven this return of volatility? In short, monetary policy has been a leading contributor to both historically low volatility during an extended period of accommodative (easing) policy and now higher volatility as the Federal Reserve (Fed) transitions to a restrictive (tightening) policy. In our last quarterly market commentary we cited a domestic yield curve that indicated a disconnect between the Fed and the broader financial markets with respect to projected future economic growth and inflation. The tension created by these diverging views came to a flash point in the final quarter of 2018. Despite a strong contractionary demand shock from China and subsequent declining global growth forecasts, the Fed held steadfastly to its previous policy guidance. Global equity markets responded with a sharp selloff that took US equities down 13.5% and foreign stocks down 11.5% in the fourth quarter.

Despite the equity market declines, nowhere have the diverging views of economic growth been reflected more clearly than the recent bond market. 10-year Treasury yields marched steadily higher over most of the year, rising from 2.40% at the beginning of the year to 3.15% at the end of October. Yield increases were supported by strong economic growth, low unemployment and signs of modest wage inflation. Market opinions on global growth changed sharply as the fourth quarter progressed. Slowing economic data out of China seemed to suddenly make the impacts of tough trade rhetoric a tangible reality. Slower expected growth in combination with aggressive Fed tightening resulted in a near freefall in bond yields. Yields dropped from 3.15% to 2.69% by year-end, a largely unprecedented pace.

In reaction to a combination of new economic data and increasing political pressure the Fed appears to have acquiesced from its rigid policy stance to start off the new year. Fed Chairman Jerome Powell made a public statement acknowledging an economic slowdown and assuring markets the Fed would be patient and flexible in policy decisions this year. At least for now, it would appear views are converging around slower growth expectations going forward. Expect volatility to normalize, but understand that after 10 years of a bull market, “normal” may look and feel very different.

## GLOBAL ECONOMIC LANDSCAPE

- December's headline employment number came in well above estimates as employers added 312,000 workers, versus expectations of 184,000. On a rolling three-month basis, employers are adding 254,000 workers per month. Despite higher job creation the unemployment rate actually ticked up slightly to 3.9% due to an increase in the labor force participation rate. Average hourly earnings rose 0.4% for the month of December. This translates to annualized wage growth of 3.2%, the highest since 2009.
- The Fed raised short-term borrowing rates four times in 2018 and is forecasting two rate hikes for 2019. Recent policy language appears to signal an end to the current tightening cycle in the face of slowing global economic growth.
- Global central banks look poised to continue their path to normalized interest rates which may continue to be a headwind for global growth. The Bank of Canada raised interest rates three times and the Bank of England once during 2018. The European Central Bank and Bank of Japan have kept rates low and are expected to continue this policy through 2019.
- Economic global divergence has emerged over the course of 2018. Major economies appear to be in very different stages of economic cycles. The US and UK look to be in the very late stages of an economic cycle followed closely by Canada and China. The Eurozone appears to be near the middle of an economic cycle while India and Brazil are on the verge of accelerating into a new economic cycle. While the increasing divergence brings more uncertainty, the International Monetary Fund is projecting a relatively strong 3.7% global growth rate in 2019.
- The latest data shows China's economy growing at 6.5% annualized, the slowest pace since 2016 despite continued stimulus efforts. Consumer spending, manufacturing, credit growth and housing are all showing signs of weakness. A slower growth China is likely to have a large impact on other nations, especially emerging markets whose economies are dependent on Chinese imports of raw materials.

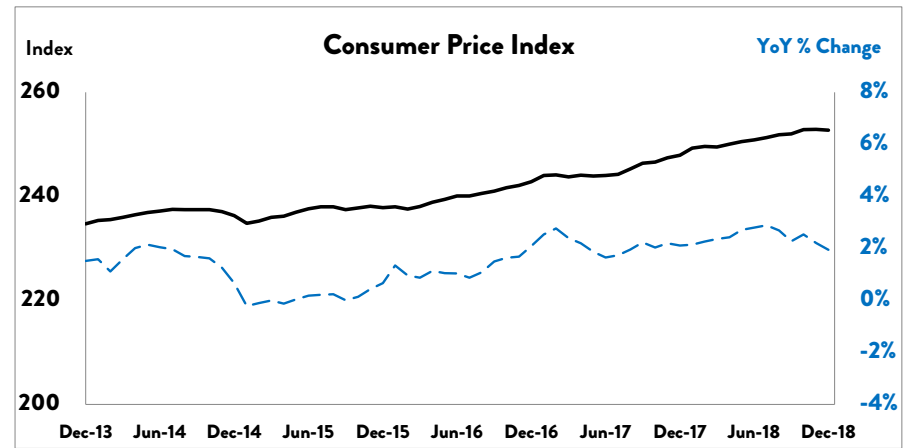
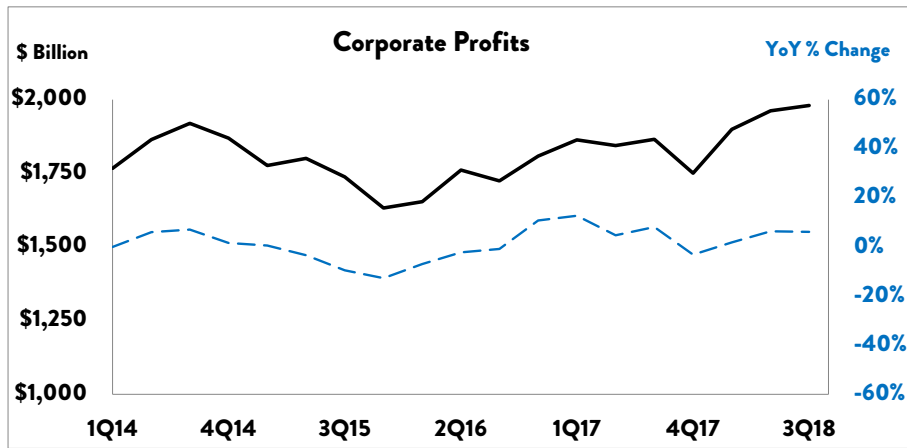
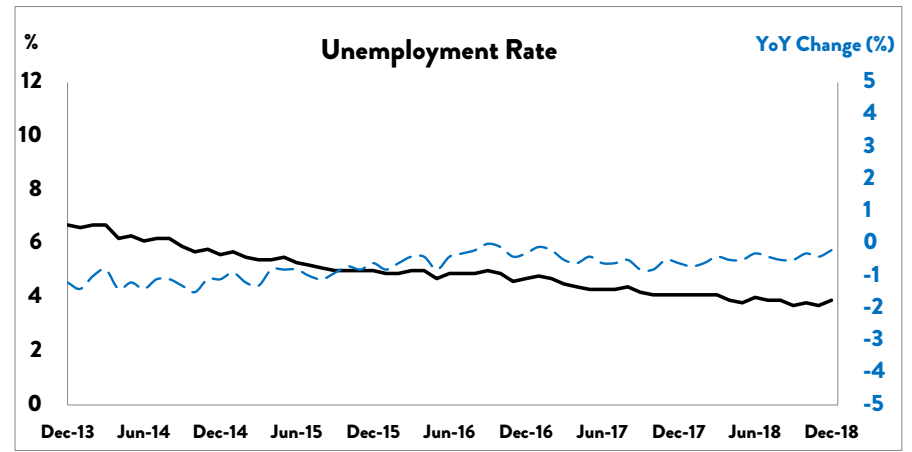
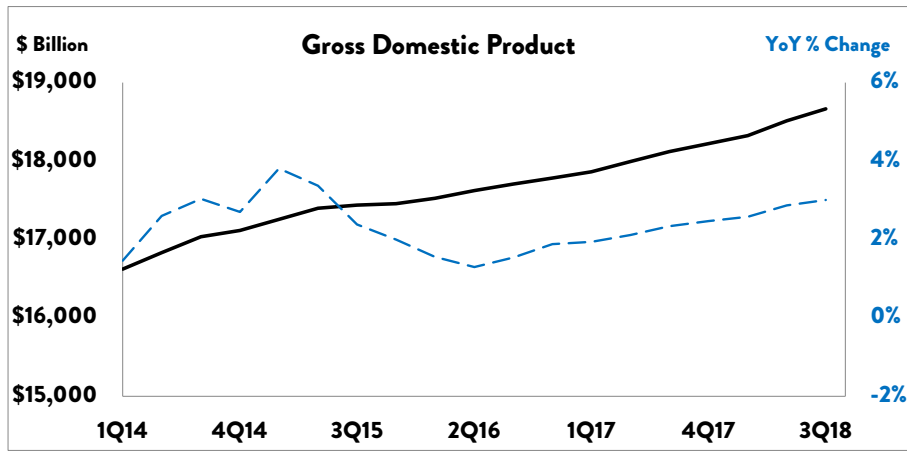
## GLOBAL FINANCIAL MARKETS

- Domestic credit spreads widened modestly throughout most of 2018, but suddenly gapped wider during the fourth quarter. Credit spreads on investment grade and high yield bonds ended the year at levels not seen since 2016. Despite the wider end of year spreads, investment grade and high yield bonds ended the year with only minor losses.
- Technology stocks (including the new communications services stocks) have grown to represent nearly 30% of the S&P 500 Index and increasingly provide market leadership. Technology stocks led the market sharply lower in the fourth quarter of the year despite largely strong earnings. Concerns over slowing growth rates coupled with relatively high valuations drove negative investment sentiment. It is worth noting that the technology sector has gained over 500% since the last bear market.
- Is this the turning point for value stocks? The past 10 years have been the most difficult in modern history for value stocks relative to growth stocks. On a rolling 3-year basis, global value stocks have underperformed growth stocks for more than 130 months! Some in the value investing community are referring to this lagging decade as the "nuclear winter".
- The MSCI All Country World Index entered the year trading at 21 times trailing 1-year earnings. As of the end of the year the Index traded at 17 times trailing earnings, the result of higher earnings and declining stock prices in 2018. While global valuations are broadly lower, emerging markets have been hit the hardest. Emerging markets now trade at 13 times trailing earnings.
- For nearly a decade, international and emerging equity markets have lagged domestic markets. In fact, the relative performance of US stocks vs. international stocks is at the highest level in nearly 14 years. However, the performance gap is not without credible support in the form of higher earnings growth rates.

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# 4Q2018 Economic Data



Labor Market Statistics (Monthly)					
Category	Recent	5-Yr High	5-Yr Low	5-Yr Avg.	Date
Jobs Added/Lost Monthly	312,000	351,000	14,000	214,783	Dec-18
Unemployment Rate	3.9%	6.7%	3.7%	4.9%	Dec-18
Median Unemployment Length (Weeks)	8.9	18.4	6.6	11.2	Dec-18
Average Hourly Earnings	\$27.48	\$27.48	\$24.22	\$25.70	Dec-18

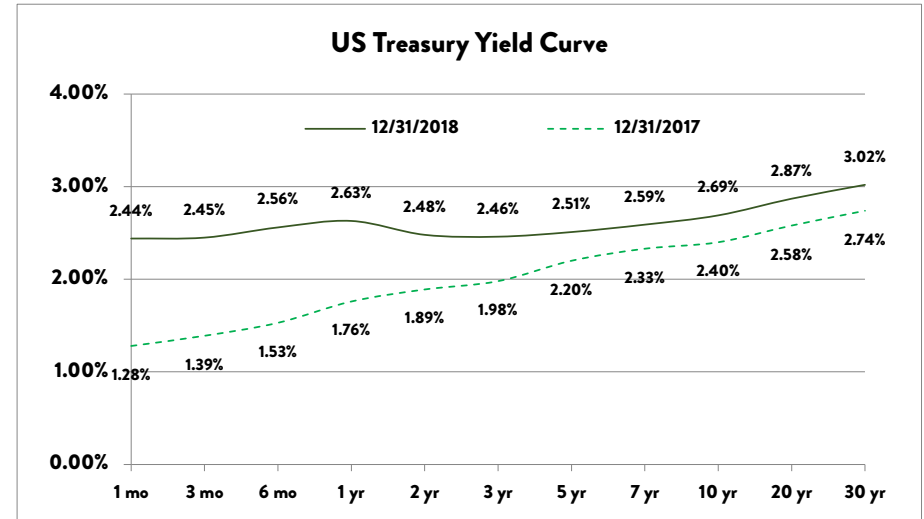
Other Prices and Indexes (Monthly)					
Category	Recent	5-Yr High	5-Yr Low	% Off Peak	Date
Gas: Price per Gallon	\$2.33	\$3.70	\$1.79	-36.9%	Dec-18
Spot Oil	\$49.52	\$105.79	\$30.32	-53.2%	Dec-18
Case-Shiller Home Price Index	214.2	214.2	166.9	28.4%*	Nov-18
Medical Care CPI	489.1	489.1	430.1	13.7%*	Dec-18

Source: Federal Reserve Bank of St. Louis and Bureau of Labor Statistics

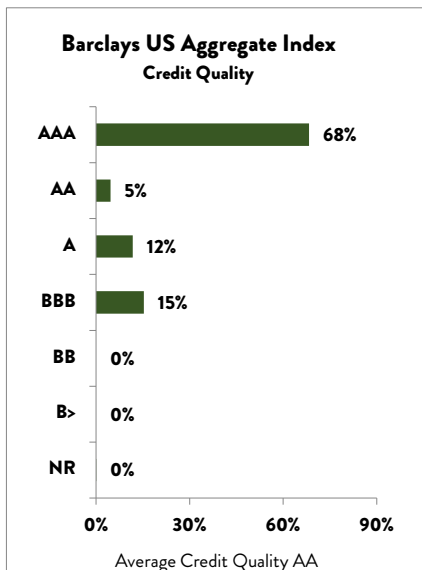
\*% Off Low

# 4Q2018 Bond Market Data

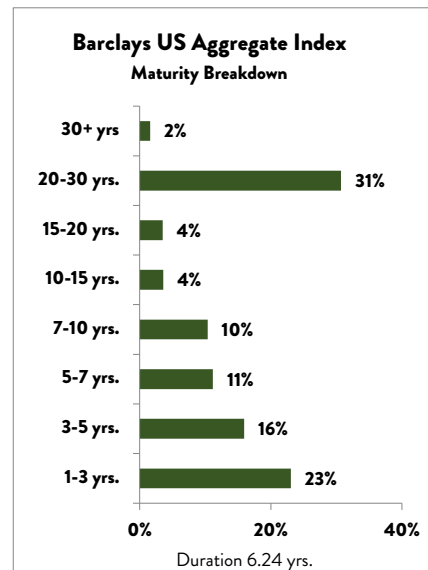
Index	QTR	YTD	1 yr.	3 yrs.	5 yrs.	10 yrs.
90-Day T-Bill	0.50%	1.69%	1.69%	0.88%	0.54%	0.32%
Barclays US Aggregate	1.64%	0.01%	0.01%	2.06%	2.52%	3.48%
Barclays Short US Treasury	0.60%	1.88%	1.88%	1.07%	0.68%	0.46%
Barclays Int. US Treasury	2.24%	1.41%	1.41%	1.20%	1.47%	1.79%
Barclays Long US Treasury	4.19%	-1.84%	-1.84%	2.58%	5.93%	4.09%
Barclays US TIPS	-0.42%	-1.26%	-1.26%	2.11%	1.69%	3.64%
Barclays US Credit	0.01%	-2.11%	-2.11%	3.16%	3.22%	5.52%
Barclays US Mortgage-Backed	2.08%	0.99%	0.99%	1.71%	2.53%	3.11%
Barclays US Asset-Backed	1.25%	1.77%	1.77%	1.78%	1.70%	4.55%
Barclays US 20-Yr Municipal	1.83%	1.08%	1.08%	2.96%	5.10%	6.32%
Barclays US High Yield	-4.53%	-2.08%	-2.08%	7.23%	3.83%	11.12%
Barclays Global	1.20%	-1.20%	-1.20%	2.70%	1.08%	2.49%
Barclays International	0.91%	-2.15%	-2.15%	3.15%	-0.01%	1.74%
Barclays Emerging Market	-0.18%	-2.46%	-2.46%	5.05%	4.23%	8.47%



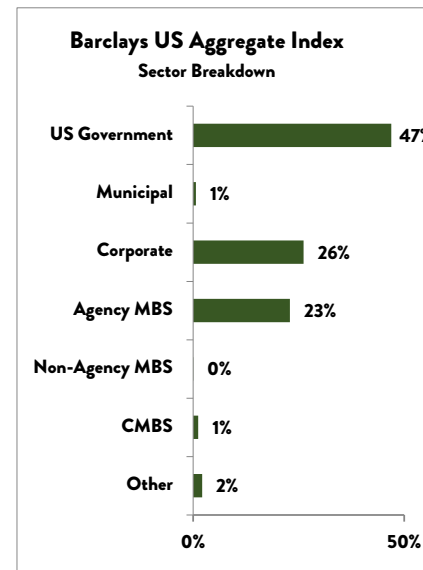
Source: Department of US Treasury



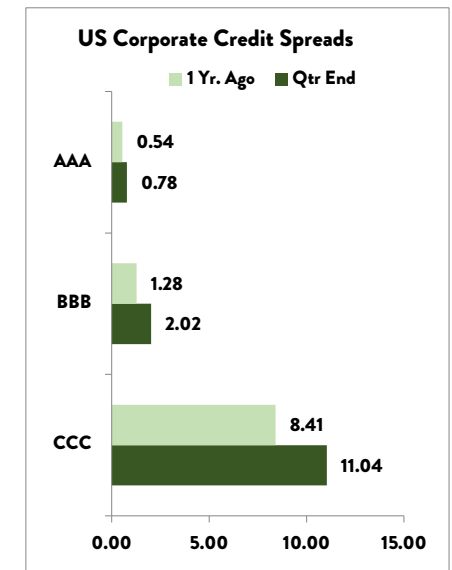
Source: Morningstar



Source: Morningstar



Source: Morningstar



Source: Federal Reserve / Bank of America

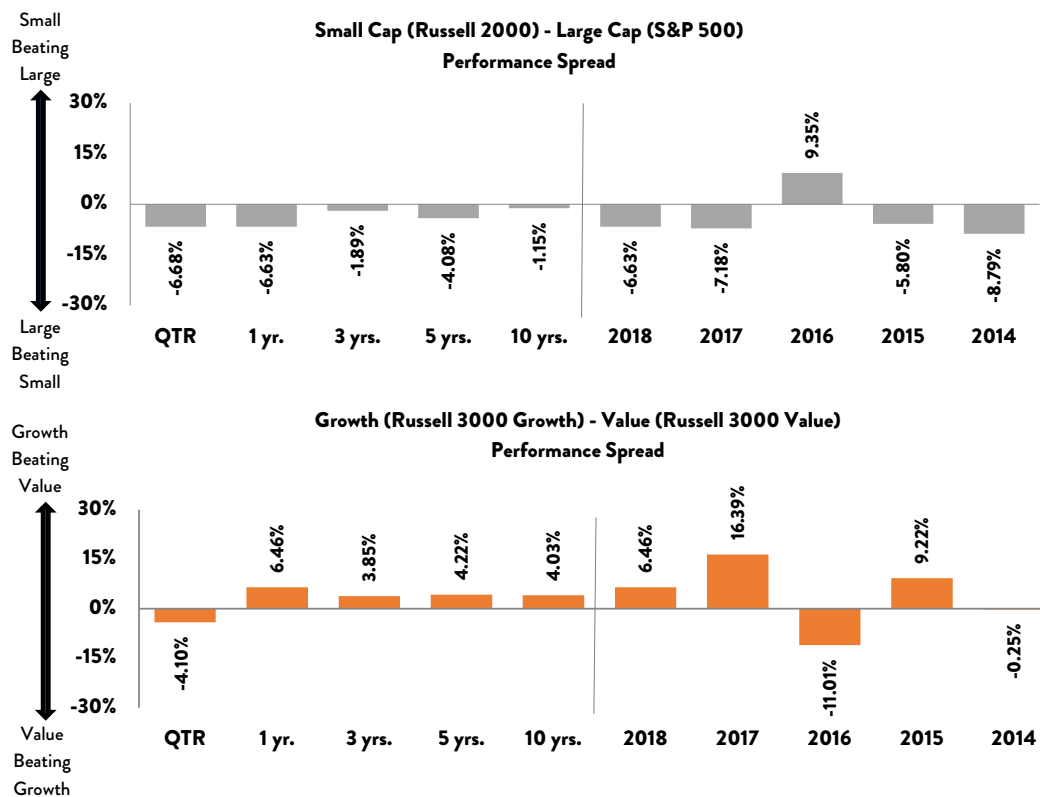
# 4Q2018 US Equity Market Data

## Sectors Weights/Returns (ranked by quarter performance)

	S&P 500 Index					S&P Midcap 400 Index					S&P Smallcap 600 Index				
	Wgt.	Sector	QTR	YTD	1 Yr.	Wgt.	Sector	QTR	YTD	1 Yr.	Wgt.	Sector	QTR	YTD	1 Yr.
	3%	Utilities	1.36%	4.11%	4.11%	6%	Utilities	-0.72%	6.81%	6.81%	3%	Utilities	-5.64%	-0.41%	-0.41%
	3%	Real Estate	-3.83%	-2.22%	-2.22%	3%	Consumer Staples	-8.01%	-7.15%	-7.15%	7%	Real Estate	-11.16%	-11.10%	-11.10%
	7%	Consumer Staples	-5.21%	-8.38%	-8.38%	3%	Communication Services	-9.97%	2.27%	2.27%	19%	Financials	-14.19%	-6.29%	-6.29%
	16%	Health Care	-8.72%	6.47%	6.47%	10%	Real Estate	-10.56%	-5.99%	-5.99%	4%	Consumer Staples	-14.34%	-4.86%	-4.86%
	3%	Materials	-12.31%	-14.70%	-14.70%	16%	Financials	-15.77%	-15.95%	-15.95%	14%	Information Technology	-17.67%	-8.93%	-8.93%
	13%	Financials	-13.11%	-13.03%	-13.03%	15%	Information Technology	-16.85%	-5.47%	-5.47%	14%	Consumer Discretionary	-19.53%	-8.12%	-8.12%
	10%	Communication Services	-13.19%	-12.53%	-12.53%	12%	Consumer Discretionary	-18.16%	-17.92%	-17.92%	2%	Communication Services	-21.06%	0.90%	0.90%
	10%	Consumer Discretionary	-16.42%	0.83%	0.83%	15%	Industrials	-18.58%	-14.89%	-14.89%	11%	Health Care	-23.07%	9.93%	9.93%
	9%	Industrials	-17.29%	-13.29%	-13.29%	7%	Materials	-19.50%	-20.37%	-20.37%	19%	Industrials	-23.32%	-12.15%	-12.15%
	20%	Information Technology	-17.34%	-0.29%	-0.29%	10%	Health Care	-19.93%	6.51%	6.51%	4%	Materials	-26.46%	-22.25%	-22.25%
	5%	Energy	-23.78%	-18.10%	-18.10%	4%	Energy	-41.67%	-29.42%	-29.42%	3%	Energy	-45.80%	-42.77%	-42.77%

## Index Performance Data

Index	QTR	YTD	1 yr.	Annualized		
				3 yrs.	5 yrs.	10 yrs.
<b>S&amp;P 500</b>	-13.52%	-4.38%	-4.38%	9.26%	8.49%	13.12%
<b>Russell 1000 Value</b>	-11.72%	-8.27%	-8.27%	6.95%	5.95%	11.18%
<b>Russell 1000 Growth</b>	-15.89%	-1.51%	-1.51%	11.15%	10.40%	15.29%
<b>Russell Mid Cap</b>	-15.37%	-9.06%	-9.06%	7.04%	6.26%	14.03%
<b>Russell Mid Cap Value</b>	-14.95%	-12.29%	-12.29%	6.06%	5.44%	13.03%
<b>Russell Mid Cap Growth</b>	-15.99%	-4.75%	-4.75%	8.59%	7.42%	15.12%
<b>Russell 2000</b>	-20.20%	-11.01%	-11.01%	7.36%	4.41%	11.97%
<b>Russell 2000 Value</b>	-18.67%	-12.86%	-12.86%	7.37%	3.61%	10.40%
<b>Russell 2000 Growth</b>	-21.65%	-9.31%	-9.31%	7.24%	5.13%	13.52%
<b>Russell 3000</b>	-14.30%	-5.24%	-5.24%	8.97%	7.91%	13.18%
<b>DJ US Select REIT</b>	-6.61%	-4.22%	-4.22%	1.97%	7.89%	12.05%



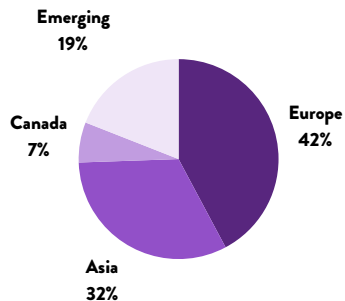
# 4Q2018 International Market Data

## Index Performance Data (net)

Index (US\$)	QTR	YTD	1 yr.	3 yrs.	5 yrs.	10 yrs.
<b>MSCI ACWI ex-US</b>	<b>-11.46%</b>	<b>-14.20%</b>	<b>-14.20%</b>	<b>4.48%</b>	<b>0.68%</b>	<b>6.57%</b>
<b>MSCI EAFE</b>	<b>-12.54%</b>	<b>-13.79%</b>	<b>-13.79%</b>	<b>2.87%</b>	<b>0.53%</b>	<b>6.32%</b>
<b>Europe</b>	<b>-12.72%</b>	<b>-14.86%</b>	<b>-14.86%</b>	<b>2.10%</b>	<b>-0.61%</b>	<b>6.15%</b>
United Kingdom	-11.78%	-14.15%	-14.15%	1.60%	-1.71%	6.84%
Germany	-15.48%	-22.17%	-22.17%	0.70%	-2.13%	5.55%
France	-15.05%	-12.76%	-12.76%	5.61%	1.17%	5.49%
<b>Pacific</b>	<b>-12.20%</b>	<b>-12.02%</b>	<b>-12.02%</b>	<b>4.54%</b>	<b>2.73%</b>	<b>6.76%</b>
Japan	-14.23%	-12.88%	-12.88%	3.41%	3.06%	5.33%
Hong Kong	-4.53%	-7.83%	-7.83%	8.68%	6.05%	12.22%
Australia	-10.01%	-11.99%	-11.99%	5.56%	0.46%	8.88%
<b>Canada</b>	<b>-15.30%</b>	<b>-17.20%</b>	<b>-17.20%</b>	<b>6.18%</b>	<b>-1.62%</b>	<b>5.72%</b>
<b>MSCI EM</b>	<b>-7.47%</b>	<b>-14.58%</b>	<b>-14.58%</b>	<b>9.25%</b>	<b>1.65%</b>	<b>8.02%</b>
<b>MSCI EM Latin America</b>	<b>0.36%</b>	<b>-6.57%</b>	<b>-6.57%</b>	<b>14.85%</b>	<b>-1.73%</b>	<b>4.98%</b>
<b>MSCI EM Asia</b>	<b>-9.29%</b>	<b>-15.45%</b>	<b>-15.45%</b>	<b>8.63%</b>	<b>3.94%</b>	<b>9.81%</b>
<b>MSCI EM Eur/Mid East</b>	<b>-4.31%</b>	<b>-8.07%</b>	<b>-8.07%</b>	<b>9.18%</b>	<b>-4.69%</b>	<b>4.09%</b>
<b>MSCI ACWI Value ex-US</b>	<b>-10.71%</b>	<b>-13.97%</b>	<b>-13.97%</b>	<b>4.75%</b>	<b>-0.38%</b>	<b>5.95%</b>
<b>MSCI ACWI Growth ex-US</b>	<b>-12.20%</b>	<b>-14.43%</b>	<b>-14.43%</b>	<b>4.19%</b>	<b>1.69%</b>	<b>7.15%</b>
<b>MSCI ACWI Sm Cap ex-US</b>	<b>-14.43%</b>	<b>-18.20%</b>	<b>-18.20%</b>	<b>3.82%</b>	<b>1.96%</b>	<b>10.02%</b>

## Regional Exposure

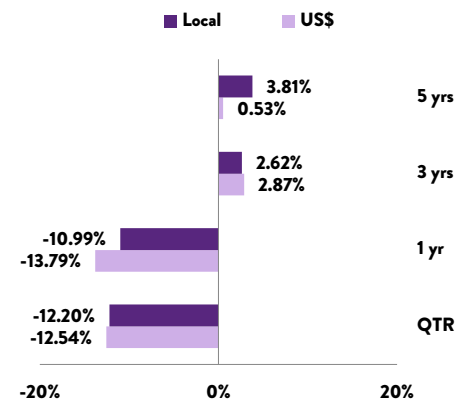
MSCI ACWI ex-USA



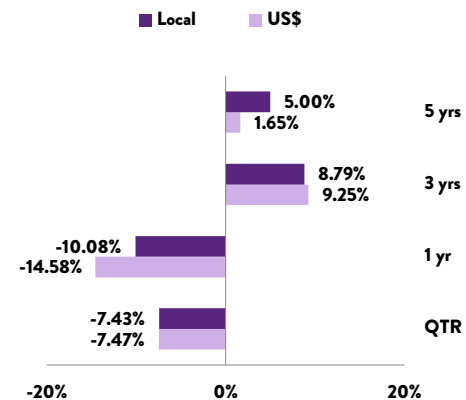
## Top 10 Countries (MSCI AC World ex-USA)

Japan	16%
UK	12%
China	8%
France	7%
Canada	7%
Germany	6%
Switzerland	6%
Australia	5%
South Korea	4%
Taiwan	3%

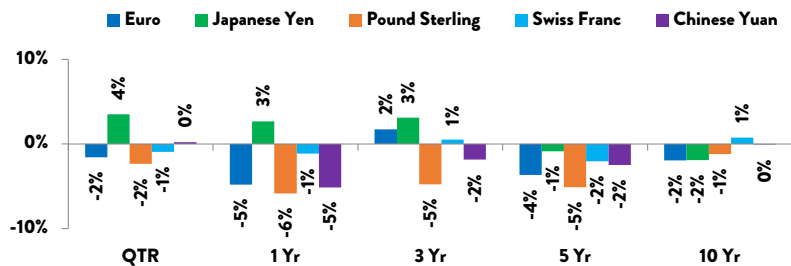
## MSCI EAFE Index Return



## MSCI Emerging Index Return

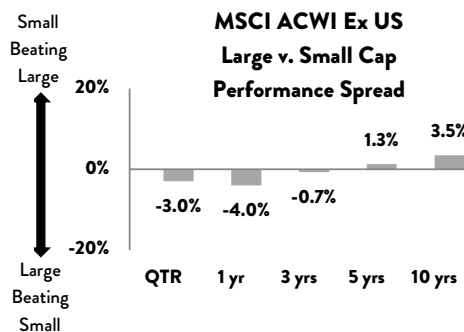


## Foreign Currency v. US\$ Returns

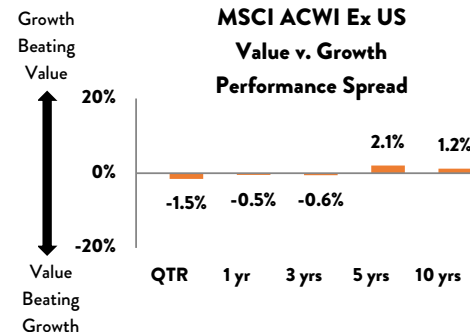


Exchange Rates	QTR	3Q18	2Q18	1Q18	4Q17	3Q17
Japanese Yen	109.70	113.48	110.71	106.20	112.69	112.64
Euro	0.87	0.86	0.86	0.81	0.83	0.85
British Pound	0.78	0.77	0.76	0.71	0.74	0.75
Swiss Franc	0.98	0.98	0.99	0.95	0.97	0.97
Chinese Yuan	6.88	6.87	6.62	6.27	6.51	6.65

## MSCI ACWI Ex US Large v. Small Cap Performance Spread



## MSCI ACWI Ex US Value v. Growth Performance Spread



## Historical Market Returns

Ranked by Performance

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	4Q18
Emerging Markets 25.55%	Emerging Markets 34.00%	Emerging Markets 32.14%	Emerging Markets 39.42%	US Bonds 5.24%	Emerging Markets 78.51%	Small Cap 26.85%	Core Real Estate 14.96%	Emerging Markets 18.22%	Small Cap 38.82%	Large Cap 13.68%	Core Real Estate 13.95%	Small Cap 21.30%	Emerging Markets 37.28%	Core Real Estate 7.38%	US Bonds 1.64%
Intl 20.91%	Commod. 21.36%	Intl 26.65%	Intl 16.65%	Global Bonds 4.79%	High Yield 58.21%	Mid Cap 25.48%	TIPS 13.56%	Mid Cap 17.28%	Mid Cap 34.76%	Mid Cap 13.21%	Large Cap 1.38%	High Yield 17.12%	Intl 27.19%	Cash 1.69%	Core Real Estate 1.52%
Mid Cap 20.22%	Core Real Estate 20.15%	Small Cap 18.37%	Commod. 16.23%	Cash 1.39%	Intl 41.45%	Emerging Markets 18.88%	US Bonds 7.84%	Intl 16.83%	Large Cap 32.39%	Core Real Estate 11.44%	US Bonds 0.55%	Mid Cap 13.79%	Large Cap 21.83%	US Bonds 0.01%	Global Bonds 1.20%
Small Cap 18.33%	Intl 16.62%	Large Cap 15.79%	Core Real Estate 14.84%	TIPS -2.35%	Mid Cap 40.48%	Commod. 16.83%	Global Bonds 5.64%	Small Cap 16.35%	Intl 15.29%	US Bonds 5.97%	Cash 0.03%	Large Cap 11.95%	Mid Cap 18.52%	Global Bonds -1.20%	Cash 0.50%
Global Balanced 12.18%	Mid Cap 12.65%	Core Real Estate 15.27%	TIPS 11.64%	Core Real Estate -10.70%	Small Cap 27.17%	Core Real Estate 15.26%	High Yield 4.98%	Large Cap 16.00%	Global Balanced 14.46%	Small Cap 4.89%	TIPS -1.43%	Commod. 11.76	Global Balanced 15.87%	TIPS -1.26%	TIPS -0.42%
Core Real Estate 12.00%	Large Cap 4.91%	Mid Cap 15.26%	Global Bonds 9.48%	Global Balanced -24.51%	Large Cap 26.46%	High Yield 15.12%	Large Cap 2.11%	High Yield 15.81%	Core Real Estate 12.95%	TIPS 3.64%	Global Balanced -1.45%	Emerging Markets 11.18%	Small Cap 14.65%	High Yield -2.08%	High Yield -4.53%
High Yield 11.13%	Small Cap 4.55%	Global Balanced 14.53%	Global Balanced 9.07%	High Yield -26.16%	Global Balanced 20.49%	Large Cap 15.06%	Cash 0.06%	Global Balanced 11.06%	High Yield 7.44%	Global Balanced 3.17%	Mid Cap -2.43%	Core Real Estate 7.76%	High Yield 7.50%	Large Cap -4.38%	Emerging Markets -7.47%
Large Cap 10.88%	Global Balanced 4.16%	High Yield 11.85%	US Bonds 6.97%	Small Cap -33.79%	Commod. 18.91%	Intl 11.15%	Global Balanced -0.97%	Core Real Estate 9.76%	Cash 0.07%	High Yield 2.45%	Global Bonds -3.15%	Global Balanced 5.38%	Global Bonds 7.39%	Global Balanced -5.30%	Global Balanced -7.61%
Global Bonds 9.27%	Cash 3.25%	Global Bonds 6.64%	Mid Cap 5.60%	Commod. -35.65%	TIPS 11.41%	Global Balanced 9.40%	Mid Cap -1.55%	TIPS 6.98%	US Bonds -2.02%	Global Bonds 0.59%	Small Cap -4.41%	TIPS 4.68%	Core Real Estate 6.66%	Mid Cap -9.06%	Commod. -9.41%
Commod. 9.15%	TIPS 2.84%	Cash 4.85%	Large Cap 5.49%	Large Cap -37.00%	Global Bonds 6.93%	US Bonds 6.54%	Small Cap -4.18%	Global Bonds 4.32%	Global Bonds -2.60%	Cash 0.04%	High Yield -4.46%	Intl 4.50%	US Bonds 3.54%	Small Cap -11.01%	Intl -11.46%
TIPS 8.46%	High Yield 2.74%	US Bonds 4.33%	Cash 4.44%	Mid Cap -41.46%	US Bonds 5.93%	TIPS 6.31%	Commod. -13.32%	US Bonds 4.21%	Emerging Markets -2.60%	Emerging Markets -2.18%	Intl -5.66%	US Bonds 2.65%	TIPS 3.01%	Commod. -11.25%	Large Cap -13.52%
US Bonds 4.34%	US Bonds 2.43%	Commod. 2.07%	High Yield 1.87%	Intl -45.53%	Cash 0.16%	Global Bonds 5.54%	Intl -13.71%	Cash 0.08%	TIPS -8.61%	Intl -3.86%	Emerging Markets -14.90%	Global Bonds 2.09%	Commod. 1.70%	Intl -14.20%	Mid Cap -15.37%
Cash 1.44%	Global Bonds -4.49%	TIPS 0.41%	Small Cap -1.57%	Emerging Markets -53.33%	Core Real Estate -30.40%	Cash 0.15%	Emerging Markets -18.42%	Commod. -1.06%	Commod. -9.52%	Commod. -17.00%	Commod. -24.60%	Cash 0.25%	Cash 0.71%	Emerging Markets -14.58%	Small Cap -20.20%

Global Balanced is composed of 60% MSCI World Stock Index, 35% Barclays Global Aggregate Bond Index, and 5% US 90-Day T-Bills.