GRANT STREET ASSET MANAGEMENT, INC.

QUARTERLY LETTER

4TH QUARTER 2018

12/31/18

In our first quarter 2018 letter, we wrote: "Prior to January 2018, the S&P 500 has gone 1.5 years without a single 5% or higher drawdown. For historical context, the S&P 500 on average experiences one 10% drawdown and five 5% drawdowns in a given calendar year, and yet it posts positive calendar year returns 76% of the time." 2018 represented a return to normal market volatility that investors have become less accustomed to in recent years.

There were two primary headlines that affected investor psychology throughout 2018: rising interest rates and uncertain trade tariffs. We made mention of these issues in each quarterly letter last year. While global equities continued their climb higher in the third quarter on the back of record-high economic metrics, despite those same metrics remaining in solid economic-growth territory, headline concerns dominated investor activity and market returns in the fourth quarter. Stocks pulled back, recapturing gains made throughout the year in nearly every global equity asset class, resulting in the first year of negative returns for most equity asset classes since 2015.

Index	2018 Total Return
S&P 500 (Large Companies)	-4.4%
S&P 400 (Mid-sized Cos.)	-11.1%
Russell 2000 (Small-sized Cos.)	-11.0%
MSCI EAFE (Europe, Australia & Far East)	-13.8%
MSCI Emerging Markets	-14.6%
MSCI ACWI (All Country World Index)	-9.4%

Fixed income overall was not much of a positive hedge against falling stocks due to the headline uncertainty surrounding the expectations for Federal Reserve activity in 2019. Overall, high-quality fixed income offered less than 2% positive return on average during the fourth quarter to offset falling stocks, and below-investment-grade bonds were negative for the quarter.

For the year, total returns across fixed income were mixed, depending on quality and interest rate sensitivity.

Index	2018 Total Return
Bloomberg Barclays U.S. Aggregate Bond	0.0%
Bloomberg Barclays Municipal Bond	+1.3%
Bloomberg Barclays U.S. Corporate High Yield	-2.1%

As volatility has returned to the markets, so have the hyped news headlines that the long-running stock market climb we have enjoyed since 2009 has finally come to an end. We disagree. Our investment process involves tracking fundamental data points that drive stock and bond market cycles. While there is no one measure or even set of measures that can predict the end of a rising market for stocks, the metrics collectively reflect strength or weakness in corporate health and the economy overall. Recall that in the third quarter, many of the metrics we track reached what may be peak levels for this cycle: GDP achieved 2.2% year-over-year growth and 3.4% for the quarter, and second quarter GDP was revised upwards to 4.2%, the highest since 2014. Consumer confidence posted an 18-year high, and small business optimism registered an all-time 45-year high. Admittedly, these metrics have recently pulled back from those levels, but most remain well above average and nowhere near levels that would suggest economic contraction or an oncoming recession.

For the fourth quarter, GDP is expected to be around 2.5%, and unemployment sits at lows not seen since the 1960s. For the year, employers have added 2.6 million jobs, representing the strongest job growth since 2015. Leading economic indicators, an index of 10 measures that economists use to evaluate the strength of and predict shifts in an economic cycle, continues to reflect growth, and has not yet pulled back from its highest levels. Global manufacturing surveys remain at levels indicative of continued economic growth for most countries around the world. Those countries that have only recently fallen just below the key level of 50, such as China, may have done so due to added influences from the trade negotiations. Finally, corporations continue to record impressive results. U.S. corporations (represented by the S&P 500) grew earnings per share by approximately 26% in the third quarter (reported in fourth quarter), the highest since 2010, and driven by strong sales growth. Please see the research section of our website for additional analysis of many of the data points we track.

We highlight these positive points as a stark contrast to the negative sentiment and investor psychology that dominated the fourth quarter. That is not to say that there are not legitimate concerns overhanging global markets today, but so as to remind investors of the mostly positive backdrop from which we view the global markets overall. The headlines of rising interest rates and trade tariffs took center stage in the fourth quarter. While one concern has perhaps been temporarily allayed, investors still do not have any more clarity on the other.

The Federal Reserve's messaging in the early part of the fourth quarter about its plan to raise rates through 2019 left little room for a data-dependent "pause" that investors were hoping for given the uncertainty surrounding U.S.-China trade tariffs. The December rate hike was not a surprise, but investors grew fearful of an overreaching Fed in 2019, as it became clear that a hoped-for year-end resolution to the uncertain trade policy was not going to materialize. That fearful sentiment shifted after the first of the year, when Chairman Powell stepped back from the certainty of 2019 hikes and suggested that the Fed's plans were not set in stone. Investors have taken this to mean the Fed would be more cautious and "data-dependent" before increasing rates to put the brakes on an economy that may already be decelerating. As a result, stocks seem to have found a bottom in the first weeks of 2019.

The uncertain outcome of the U.S.- China trade negotiations continues to weigh on investors. As we have commented in prior letters, the size of trade between the U.S. and China alone is not enough to have a measurable impact on global growth. However, the broader impact of the uncertainty on corporations and psychology on businesses and ultimately consumers can grow beyond the scope of an otherwise modest issue. One of our active fund managers shared with us an excellent example on a recent call: a popular retailer in their portfolio sources 80% of its goods for sale from China. Management requires clarity to know if it should spend time and staff energy on negotiating with new suppliers in different countries or if the expected increase in cost due to tariffs is something they can manage. Tariffs alone would not prevent the company from continued growth, but without clarity on basic information required to run the business, a "wait and see" strategy has taken hold and slowed if not paused growth plans for this company and certainly other companies with strong business ties to China. While this group of companies may be small compared to the broader market, these issues began to creep into quarterly earnings calls. Third quarter earnings and revenue that were reported in the fourth quarter were some of the strongest in years, but it was the common theme of management caution regarding 2019 guidance that drove stock prices in opposition to those results. The trade issue has yet to be resolved, and the biggest risk to markets today is that the psychological impact of the uncertainty continues to dampen what would otherwise be healthy levels of economic and corporate growth.

As long-term fundamental investors, we must balance the optimism and the pessimism in the markets today. Even if many fundamental data points peaked in third quarter 2018, markets historically continue their ascent higher following these peaks. Valuations on U.S. stocks now sit below 25-year averages, and corporate earnings and sales continue growing, albeit at a slower pace. This should represent a good environment for U.S. stocks. We also expect the U.S. dollar to weaken against most global currencies, as it recently hit highs not seen since 2015 and prior to that 2003. A weakening dollar is a tailwind for U.S. investors owning international investments, and we are positioned to benefit from that tailwind.

Within fixed income, cash-like money markets are now yielding rates north of 2% and can finally, after more than a decade near 0% yield, be considered as a competitive alternative or compliment to certain fixed income asset classes. Yields overall in fixed income remain historically low, although have moved higher with the Fed's increase in short-term rates. There is little opportunity for price appreciation in bonds at current prices, so as rates increase and yields rise, short-term fixed income will likely provide low- to mid-single digit returns. Long-term bonds may experience volatility in both up and down directions, as they are more sensitive to movements in interest rates, and the expected path of long-term rates is less certain at this time.

Decelerating growth is not contraction, and stock market cycles do not die of old age. The fundamental data we monitor is historically supportive of stocks climbing higher from here. We continue to monitor the environment for signs of strengthening or further weakening to best manage clients' portfolios for long-term returns.

Sincerely,

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