R Thoughts

Morgan Stanley

The Diamond Peak Group
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Winter 2019

"Volatility is the price we pay emotionally to make money over the long run."

Brian Wesbury
Chief Economist
First Trust Portfolios, LP.

The 2018 financial markets were almost an inverse image of the 2017 markets. Though investors have fond memories of 2017 for its low volatility and positive monthly returns, they would probably like to forget 2018—a disappointing year in which no major asset class provided returns that outpaced inflation.

Chart 1

Annual Total Returns of Major Asset Classes over Last 10 Years – in 2018 Cash was King while All Asset Classes Underperformed Inflation

Asset Class	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US Large Cap	28.4%	16.1%	1.5%	16.4%	33.1%	13.2%	0.9%	12.0%	21.7%	-4.8%
US Small Cap	27.1%	26.8%	-4.2%	16.4%	38.8%	4.9%	-4.4%	21.3%	14.6%	-11.0%
European Equities	36.2%	4.2%	-10.4%	20.1%	25.9%	-5.7%	-2.3%	0.1%	26.3%	-14.3%
Japan Equities	6.5%	15.5%	-14.2%	8.9%	26.9%	-3.4%	9.3%	3.0%	24.5%	-13.2%
Emerging Mkt Equities	78.9%	19.2%	-18.2%	18.6%	-2.3%	-2.0%	-14.6%	11.8%	37.8%	-14.5%
US Inv. Grade Bonds	18.7%	9.0%	8.1%	9.8%	-1.5%	7.5%	-0.7%	6.1%	6.4%	-2.5%
US High Yield Bonds	58.2%	15.1%	5.0%	15.8%	7.4%	2.5%	-4.5%	17.1%	7.5%	-2.1%
US Inf. Linked Bonds	11.4%	6.3%	13.6%	7.0%	-8.6%	3.6%	-1.4%	4.7%	3.0%	-1.3%
Commodity Index	18.7%	16.7%	-13.4%	-1.1%	-9.6%	-17.0%	-24.7%	11.4%	0.7%	-13.0%
Gold	24.4%	29.6%	10.1%	7.1%	-28.3%	-1.4%	-10.4%	8.1%	13.5%	-1.6%
10 Yr Treasuries	-9.8%	8.0%	17.2%	4.1%	-7.8%	10.7%	0.9%	-0.2%	2.1%	0.0%
2 Yr Treasuries	1.3%	2.4%	1.5%	0.3%	0.3%	0.7%	0.4%	0.6%	0.3%	1.4%
Cash	0.1%	0.1%	0.0%	0.1%	0.0%	0.0%	0.0%	0.3%	0.8%	1.8%

Source: Bloomberg, Morgan Stanley Research, as of 12/31/2018

Annual Total Returns of Major Asset Classes Over Last 10 Years [1]

Here are some notable market-performance statistics from 2018, similar, I guess, to reviewing some of the worst movies of the year . . .

- 2018's (-6.2%) price return on the S&P 500 was the worst since 2008's (-38.5%) drop at the height of the Financial Crisis. Moreover, a 60/40 stock/bond portfolio declined about 5%.
- No major asset classes generated returns above inflation in 2018. (See the chart to left). Cash and short-term Treasuries were the only asset classes with positive returns—the first time that has occurred in multiple decades.
- The (-14.0%) return for the S&P 500 in the fourth quarter was the worst quarterly performance since the third quarter of 2011.
- The December 2018 (-9.2%) pullback was the worst month since February 2009 (-11%).
- The average individual stock trading in the S&P 500 index ended the year down roughly 25% from its 52-Week high. For the NASDAQ Composite, the average stock was down 41%.
- U.S. 10-year Treasury interest rates hit a 7-year high of 3.26% in November 2018 before closing at an 11-month low of 2.68% at year end.
- The realized volatility of the S&P 500 was 17% for 2018—its highest level since 2011—and significantly higher than 2017.
- While the number of days of +/-1% market moves in 2018 was roughly average relative to history, the 20 days of +/- 2% market moves over the year represented the highest total since 2011[1]

2018 was, without a doubt, a challenging and frustrating year for investors and for us, your asset managers.

The Stock Markets

As the legendary investor Sir John Templeton often said, "The four most dangerous words in investing may be 'this time is different'." We have observed on several occasions throughout our careers many who believed that "this one time it truly is different" only to be proved disastrously wrong.

Given the market volatility and carnage associated with this year's fourth quarter, investors grew ever concerned as it invoked memories of 2008's drawdowns and the possibility of the next recession. With the Federal Reserve signaling the prospect of higher interest rates in early October, many felt that a "Fed-Induced Recession" was on the horizon. The stock market obliged—with the S&P 500 Index falling almost 20%[2] on the fears of recession caused by the combined evil forces of potential higher interest rates and a trade war with China.

With liquidity tightening and the trade negotiations ongoing, some are calling for investors to prepare for further volatility and drawdowns in equities. But is the fear of a market crash warranted?

In our mind, we consider market declines of greater than 20% AND lasting longer a year in length as severe. As we have stated many times previously market corrections—15% or more lasting less than a year—as pullbacks and they are the price of admission to longer-term potential greater returns. It's the "price we pay emotionally to make money in the long run." The added dimension of time is important as many investors are able to ride out the shorter-term turmoil of a market correction as it impacts their portfolios much less severely.

What is important is that market declines' greater than 20% and lasting longer than one year—the truly destructive market declines—are 2.5 times more likely to coincide with recessions, historically.[3]

Therefore, we believe the key question for investors in 2019 is whether the U.S. is heading into an economic downturn. With data supplied by ClearBridge Investments through their Recession Risk Dashboard it appears these recession fears may be overblown. Shown in the next column, we observe it currently features eight green indicators, four yellow, and zero red. This is not a picture that suggests a looming recession on the near-term horizon.

Chart 2

Exhibit 2: ClearBridge Recession Risk Dashboard

		Fourth Quarter 2018	Third Quarter 2018
Financial	Yield Curve	Caution	Expansion
	Credit Spreads	Caution	Expansion
	Money Supply	Caution	Caution
Inflation	Wage Growth	Expansion	Expansion
	Commodities	Caution	Expansion
Consumer	Housing Permits	Expansion	Expansion
	Jobless Claims	Expansion	Expansion
	Retail Sales	Expansion	Expansion
	Job Sentiment	Expansion	Expansion
Business Activity	ISM New Orders	Expansion	Expansion
	Profit Margins	Expansion	Expansion
	Truck Shipments	Expansion	Expansion
	Overall Signal	Expansion	Expansion

Expansion Caution Recession

Data as of Dec. 31, 2018. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

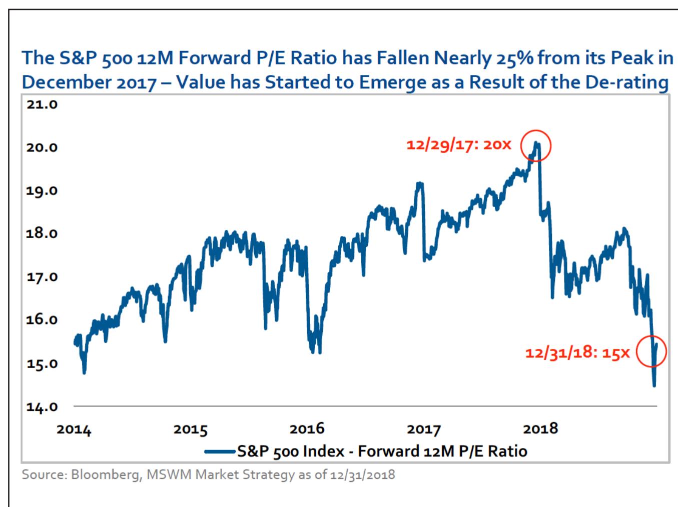
ClearBridge Recession Risk Dashboard[4]

So, in light of this we ask the question posed earlier: will this time be different and will the market experience significant drawdowns—more than 20% and lasting longer than a year—without undergoing a recession? In our view we currently find that unlikely although we will always error on the side of preparing for the worst and hoping for the best.

The earnings U.S. companies generate continue to grow impressively albeit at a rate lower than the past year and a half. The Federal Reserve has recently backed off of their previous "too arrogant" stance about the future path of policy and increasing interest rates. As stock

prices declined almost 20% in the 4th quarter, earnings have continued to increase and the Fed has committed to adjusting their policy course based on market data, values in selected areas have begun to emerge.

Chart 3



The S&P 500 12M Forward P/E Ratio[5]

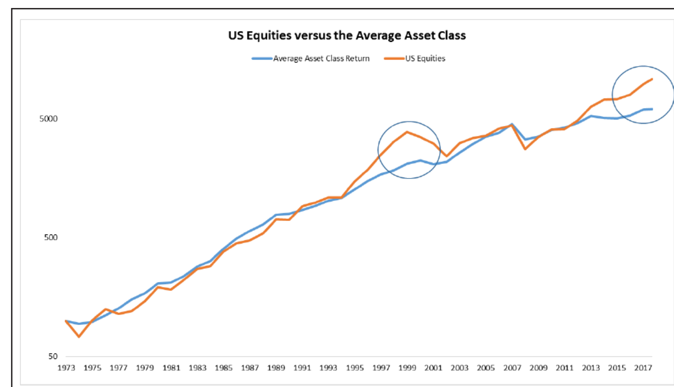
A look at Chart 3 shows stock prices are currently nearly 25% "cheaper" than they were at the end of 2017 based on the price-to-earnings ratio. This indicates much of what has concerned market participants late in 2018 is now priced into the markets. We are seeing much better valuations which potentially set up better opportunities down the road.

We do, however, continue to have some real concerns about U.S. Equities when compared to many of the other investable asset classes, which continues to give us reason for some caution as we move into 2019.

As we discussed in the fall edition of *RThoughts*, for 10 years now, the United States stock market has completely dominated all other investment classes—including commodities, real estate, international stocks, cash and currencies. As demonstrated earlier in Chart 1, diversification has had one of its worst years in history last year. Given the significant outperformance of U.S. stocks to all other options over the past decade, it is not surprising there is a significant performance gap between U.S. stocks and the other average asset classes.

As illustrated in the following chart, one can see the orange line (U.S. Equities) has clearly decoupled from the blue line (Average Asset Class). This again is visual evidence that any attempt to lower risk and diversify assets away from U.S. equities over the past several years has resulted in a performance penalty. The last time we saw a gap this pronounced was back in 1999 which resulted in a decade in which the average asset class (diversified assets) significantly outperformed those of an exclusively U.S. equity exposure.

Chart 4



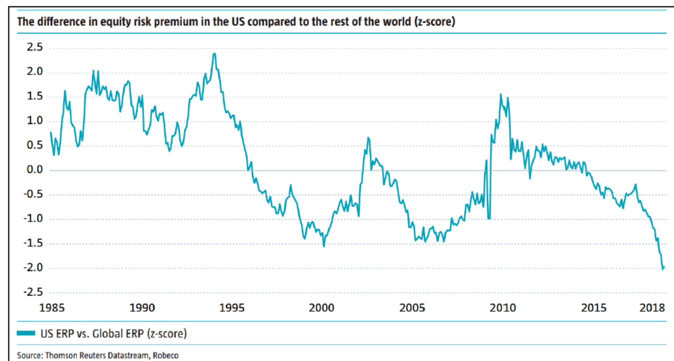
U.S. Equities versus the Average Asset Class[6]

Perhaps the "least loved" of the Average Asset Class group is currently reserved for the International Equity arena. While they were darlings back the 2000s, International stocks provided a successful foil for those who possessed the foresight to choose to diversify away from its U.S. brethren.

Today the difference in the equity-risk premium is at the same level or more pronounced than it was in early 2000. The recent major trends for International equities are negative—although with some improvement noted

in the past few months—but to say that the longer-term risk reward for International equities is favorable is an understatement.

Chart 5



U.S. Versus International Equity Risk Premiums[7]

As can be observed in Chart 5 above, International markets appear more attractive and offer better relative value compared to the U.S. stock market. Overseas stock markets are under-owned in most portfolios. Right now it is certainly not a crowded or popular trade idea, and a weak U.S. dollar would help amplify the potential in foreign market investment returns.

We see long-term opportunities in the relative values which currently are present in the International space and have begun to "dip a toe in the water" adding starter positions into the portfolios we manage. We would caution however that the foreign markets have displayed better relative value for some time now and the timing and catalysts for improved relative performance is always much more difficult to predict. Just because something is a value today doesn't mean it can't continue to be a value a year from today.

Risk management was at the forefront of most of our investment decisions as we went through the difficult 4th quarter of 2018. We sent out two "market volatility" email updates during the quarter highlighting the actions we were employing to reduce risk in the managed accounts—one in late November, the other between Christmas and New Year's. Cash levels increased significantly as we moved through the quarter in an effort to decrease risk and net equity exposure. Our cash position was there because of a process put in place to make managing adverse market events a priority.

As our friends at Policy Based Investing recently wrote, "2019 should be a binary year for policy and asset class performance. Either the Fed will stay true to the recent shift towards data-driven policy and risk assets like stocks will perform well, or the Fed will revert to the failed Philips curve arrogance and safe haven assets like bonds and gold will perform well."[8]

One of the major benefits of employing investment strategies based on the principles of supply and demand and relative strength is that these processes will ultimately lead to exposure into the best performing asset classes. If 2019 is indeed a binary year for investing, employing an unemotional and predictable process in an consistent manner will allow us to adapt and adjust to whichever asset classes are strongest—either risk assets like U.S. and/or International stocks or the safe haven assets like bonds, cash and gold.

The collective strategies employed by the Diamond Peak Group in managing assets are the result of a total of 84 years of experience in the financial markets. We employ risk management strategies and as we have all learned in the final quarter of 2018, risk will always be present in any capital market.

What we do is not buy and hold, and it's not market timing. We think it is common-sense investing and we do it based on a process which is based on our experience. It's not a perfect process—there isn't one out there—but it is objective and rational. Our goal is to make gradual shifts to an asset allocation model that will be more conservative or aggressive based upon objective and unemotional measures of market risk.

The U.S. stock markets have now experienced more than nine years of significant relative outperformance to other asset classes. That outperformance may continue into the future and then again it may not.

In that light we have a simple ask of you, the folks we have worked with and know us well. With nine years of outperformance in U.S. equities, many investors—folks

who do not work with us—do not have a process to protect the gains in their accounts. We aren't smart enough to tell anyone when the next big decline in stocks is going to happen—no one is. We just know it's going to happen again sometime in the future and very few people have a process in place to manage risk effectively.

So, if you happen to know anyone—people you love and care about—who you think might want a second set of eyes—a second opinion—to review their portfolios geared toward managing risk, the Diamond Peak Group would be happy to take a look—no strings attached.

Again, thank you for your continued trust and confidence through the years. ◗

Sources and Footnotes

1. MS Wealth Management, Market Strategy—Daily Positioning—January 3, 2019
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2. Morgan Stanley Wealth Management, Capital Market Indices—January 2, 2019
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3. ClearBridge Investments, Market Commentary—Fourth Quarter 2018
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6. Hays Advisory, Hays Market Outlook—December 28, 2018
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The Diamond Peak Group at Morgan Stanley

Jim Kniffin CPM®
Branch Manager, Senior Vice President,
Portfolio Management Director, Financial Advisor
503.588.5741
NMLS #1262143

Scott Bigham, CFP®
First Vice President, Portfolio Management Director, Financial Advisor
503.588.5726
NMLS #1274637

John Sipple, CFP®
First Vice President,
Portfolio Management Director, Financial Advisor
503.588.5705
NMLS #1261821

4582 SE Commercial St., Suite 200
Salem, OR 97302

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