Proactive Investment Management & Financial Planning

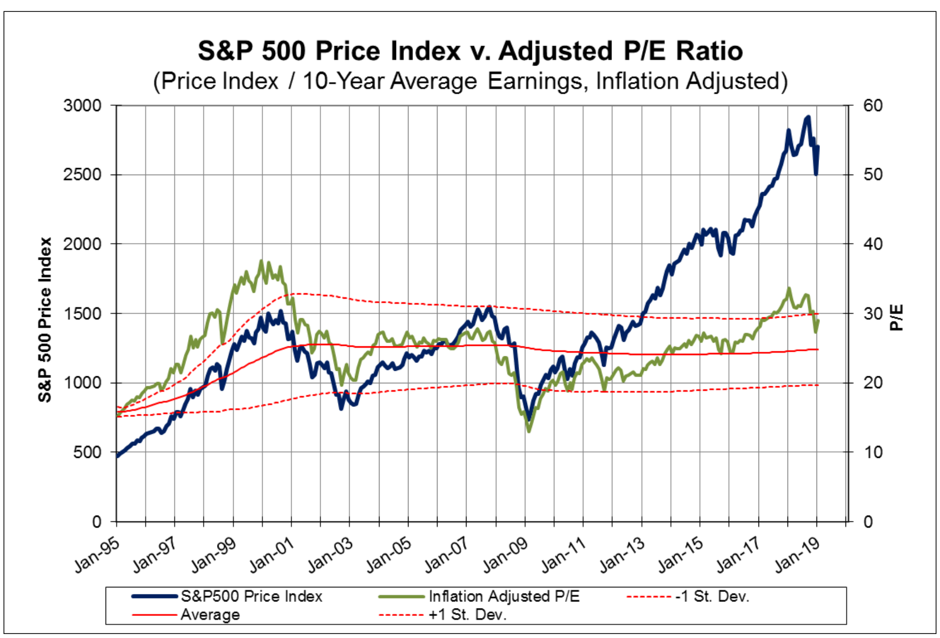
Monthly Market Comment
February 1, 2019

After a vicious stock market correction during the final quarter of 2018, January provided a nice rebound. Stock prices jumped, though not enough to make up for the declines in late 2018. Bonds and alternative assets also appreciated. In fact, for the first time in almost two years, all major asset classes provided positive total returns during the month.

Stocks

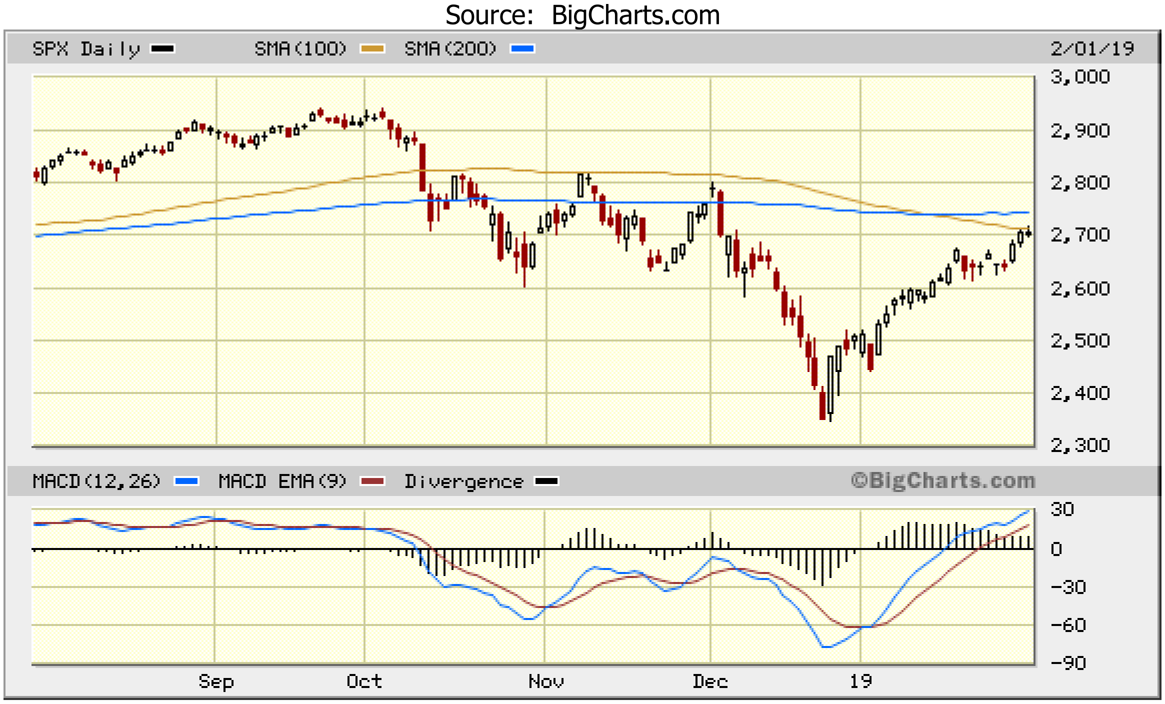
The recovery in the stock market actually started on the day after Christmas, helped by investors' realization that the fourth-quarter correction was out of sync with the continuing good economic fundamentals in the United States, and by the Federal Reserve's signaling that it would back off its long, slow campaign of interest-rate hikes. The rebound continued with nary a pause throughout January. The S&P 500 price index ended the month 7.9% higher than at the end of December, though it was still down 4.2% from the end of January 2018. Taking into account dividends, the total return on the S&P 500 was 8.0% in January and a negative 2.3% over the last year.

Looking forward, it's possible that the Fed's stand-down on further rate hikes may have come just in the nick of time. The interest-rate hikes to date have apparently helped bring inflation back down to target, and if rates now remain stable or nearly so, the good momentum in the economy could keep corporate earnings and stock prices on the upswing. That's especially true now that stock valuations have been brought back down to more reasonable levels. However, the Fed has rarely timed things so perfectly. We think there is a substantial risk that inflation could accelerate again and force further rate hikes, or that the rate hikes to date have already done their damage and push down economic growth, profits, and stocks. Just as important, slowing economic growth in China and Europe could be a problem, not so much because U.S. exports might fall, but because foreign production and sales are so important to large U.S. companies. Continued or worsening trade tensions are also a risk.



Technical indicators also suggest the stock market could keep recovering. By January's end, the S&P 500 index had risen above both its 20-day simple moving average (SMA) and its 50-day SMA, although it had not yet reached its key 200-day SMA. In addition, the key short-term momentum indicators (such as the "moving average convergence/divergence," or MACD) suggested stocks remain in a healthy recovery mode after being massively over-sold. Finally, the Dow Jones Transportation Index has recently been performing in line with the overall market, which has historically been a positive sign for stocks. It's true that the share of S&P 500 stocks trading above their 200-day SMA is only about 50%, but we think the recent price action has been much more positive than it was in the last few months. If the S&P 500 continues to rise from here, we think its next significant resistance levels will come at approximately 2,742 and 2,813. If stock prices instead start to fall again, we think the next significant support levels would be at approximately 2,632 and 2,582.

S&P 500 Stock Price Index + "MACD" Momentum Indicator
Source: BigCharts.com



Bonds

In the fourth quarter, strong safe-haven buying buoyed bond prices and drove yields downward. Those trends only slightly reversed themselves in January, in spite of the strong recovery in the stock market. The yield on the benchmark 10-Year Treasury Note stood at 2.63% at the end of the month, compared with its recent low of 2.55% at the very beginning of January and its nearly one-year low of 2.69% at the end of December. As measured by the S&P U.S. Aggregate Bond Index, the total return on investment-grade bonds was 0.9% in January and 1.9% over the last year.

As noted above, we think the jury is still out on whether the Federal Reserve has stopped hiking rates too early, too late, or just at the right time. If the policymakers had already hiked rates too far, or if the headwinds from slowing growth overseas and trade frictions become too great, the economy is likely to slow further and the current rich pricing for bonds would seem justified. However, we see some risk that the economy or inflation could re-accelerate, so we fear investors could abandon bonds abruptly and drive yields higher again. In addition, the surge in government borrowing since the 2017 tax cuts were implemented could become an ever more serious headwind for bonds. For now, we think it's wise to take a wait-and-see approach to bonds. The only significant change that we feel confident about is that if inflation re-accelerates or the Fed starts to hike rates again, yields probably would not go up quickly, so we think there is less advantage to owning inflation-adjusted obligations and shorter-term bonds than there was in recent months.

Real Estate and Commodities

Publicly-traded real estate investment trusts (REITs) enjoyed good conditions in January, as investors focused once again on the strong U.S. economic fundamentals that are likely to keep real estate properties pulling in the rents, while bond yields remained low in spite of the recovery in the stock market. At the end of January, the FTSE NAREIT Price Index stood 11.4% above its level at the end of December and 5.8% above its level at the end of January 2018. Reflecting their relatively high dividends, the total return on publicly-traded REITs was 11.6% in January and 10.3% over the last year. Looking ahead, we believe the continued economic expansion should keep REITs' operational dynamics healthy, while stable or only modestly rising bond yields will continue to help their price performance.

Physical commodities also rallied in January. In fact, prices rose for virtually all major types of commodities. The S&P GSCI Total Return Index edged up 0.9% during the month, although it was still down 9.2% from the end of January 2018. Looking forward, we see a fairly high risk that the commodity rally will be limited if it turns out the Fed has already hiked interest rates too far or the U.S. economy starts to suffer more seriously from the slowdown in foreign economic growth and the current trade disputes. We think energy prices are especially vulnerable to a pullback because of rising U.S. production and increasing oil inventories.

Patrick Fearon, CFA
Lead Portfolio Manager

Asset Class	Index	Ending Reading, Latest Month	1-Month Change	3-Month Change	12-Month Change
U.S. Stocks	S&P 500 Price Index	2,704.10	7.9%	-0.3%	-4.2%
Non-U.S. Stocks	MSCI All-Cap World Ex-U.S. Price Index	274.46	7.5%	3.2%	-14.9%
REITs	FTSE NAREIT All-Equity Price Index	700.60	11.4%	6.5%	5.8%
Commodities	S&P GSCI Total Return Index	2,401.54	9.0%	-10.8%	-9.2%
Bonds	S&P U.S. Aggregate Bond Index	195.38	0.9%	2.9%	1.9%