LPL RESEARCH

MARKET INSIGHT QUARTERLY

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FOURTH QUARTER 2018 IN REVIEW

STOCKS SLIDE MOST SINCE 2011, EVEN AMID SOLID ECONOMIC DATA

- **U.S. economy posts robust third-quarter growth.** Gross domestic product (GDP) increased 3.4% in the third quarter on an annualized basis, capping its strongest two quarters of growth in four years. The increase in GDP was fueled by a pickup in consumer spending and an unusually large contribution from build in private inventories.

  Fourth quarter data reflected a strengthening domestic economy and manageable inflation, even as uncertainty over trade tensions, slowing global demand, and geopolitical issues dominated headlines. Nonfarm payrolls grew solidly through the end of the year, and the unemployment rate fell to a 48-year low, while wage growth accelerated slightly to its fastest pace of the cycle. Contained inflationary pressures also reinforced the Federal Reserve's (Fed) gradual path of tightening, which continued in December as the Fed announced its fourth 25 basis point (bps; 0.25%) rate hike of 2018.

  Data on the U.S. consumer strengthened in the fourth quarter. The Conference Board's gauge of consumer confidence reached an 18-year high in October, and personal spending grew year over year at the fastest pace in four years. While the U.S. consumer flourished, business spending slowed in the fourth quarter,

1 Q4 2018 AT A GLANCE

	Q4 2018	2018
GDP*	2.6%	2.9%
S&P 500 Index	-13.5%	-4.4%
Bloomberg Barclays Aggregate Bond Index	1.6%	0.0%
Bloomberg Commodity Index	-9.4%	-11.2%

Source: LPL Research, Bloomberg, FactSet 12/31/18

*Bloomberg consensus as of December 31, 2018.

Figures for S&P 500 Index, Bloomberg Barclays Aggregate Bond Index, and Bloomberg Commodity Index are total returns from 09/30/18 – 12/31/18 (Q4).

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment.

Please note: All return figures are as of December 31, 2018, unless otherwise stated.

Past performance is not indicative of future results.

The economic forecasts set forth in the presentation may not develop as predicted.

and the Institute for Supply Management's (ISM) gauge of manufacturing activity fell from a 14-year high. We see the ongoing trade dispute as the primary obstacle to corporate sentiment, as many businesses have opted to put future expansions on hold until there is more clarity on the tangible and intangible effects of tariffs on demand and profits.

Overall, leading indicators pointed to low odds of a recession over the next 12 months.

- **The S&P 500 Index tumbled 13.5% during the quarter, its worst quarter since the third quarter of 2011.** Fears of a significant slowdown in global economic growth, an overly aggressive Fed, and a full-blown trade war with China all contributed to a sharp stock market sell-off in the quarter, capped off by the worst December for stocks since 1931. On an intraday trading basis, the S&P 500 entered into a bear market (20% or more decline from previous highs) December 24, and was just shy of entering a bear market based on closing prices.

  As tends to be the case during down markets, large cap stocks held up best during the quarter. The large cap Russell 1000 Index lost 13.8%, better than the 15.4% and 20.2% declines for the mid and small indexes. Value stocks held up slightly better than growth, as weakness in communication services, consumer discretionary, and technology weighed on the growth style. Value garnered support from utilities, the only S&P 500 sector that finished higher in the quarter. International equities, both developed and emerging markets (EM), fell less than the S&P 500 during the quarter as the MSCI EAFE and MSCI EM indexes lost 12.5% and 7.6%, respectively.

- **Yields slid the most in years amid stock market volatility.** Rates across the yield curve slid in the fourth quarter as fears of a marked slowdown in global economic growth and stock market volatility spurred a rush into safer assets. The 10-year Treasury yield dropped 38 bps (0.38%) in the quarter, its biggest quarterly slide since the first quarter of 2016, while the 2-year Treasury yield fell 33 bps (0.33%), its biggest quarterly drop since June 2011. The yield curve flattened further, as the spread between the 2-year and 10-year yields fell as low as 11 bps (0.11%).

  Investors' risk-off appetite boosted returns in higher-quality fixed income. Treasury prices climbed 2.6% in the quarter, while mortgage-backed securities increased 2.1%. The Bloomberg Barclays Aggregate Bond Index rose 1.6% in the quarter. Investment-grade corporate debt ended the quarter unchanged. High-yield debt lost the most among fixed income groups we track, falling 4.5% for its biggest quarterly drop since the third quarter of 2015. Bank loans decreased 4.4% during the quarter. EM debt slid 0.2%, while unhedged currency bonds rose 1.3%.

- **Merger arbitrage provides downside stock market protection.** The HFRX Merger Arbitrage Index declined during the quarter (-0.1%) but still provided tremendous downside protection during an extremely volatile time frame. The strategy's low-beta profile and the approval of several large transactions by Chinese regulators supported performance and led to tighter deal spreads. The HFRX Systematic Diversified Index also declined during the quarter (-2.7%), but outperformed the S&P 500 by an impressive 10.2% during December due to short equity and long fixed income exposure. Long/short equity strategies continued to underperform and the HFRX Equity Hedge declined 9% during the quarter, as the industry's overweight to information technology and consumer discretionary sectors detracted from performance. For the year, the index fell 9.4%, its worst year since 2011.

U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. They are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

See page 4 for list of indexes used to represent the referenced asset classes.

- **Historic oil plunge weighs on commodities.** The Bloomberg Commodity Index fell 9.4% during the quarter as a historic plunge in crude prices overshadowed other commodities. Trade tensions between the United States and China continued to dominate commodities' performance, as deteriorating economic data began to call into question China's future demand for input goods. Consequently, crude prices fell 38% during the quarter, while copper dropped 5.7%. These moves more than offset respectable gains in gold and silver prices, which rose 7.3% and 8.6% respectively during the flight-to-safety environment. Natural gas prices fell slightly during the fourth quarter, while agriculture prices were relatively stable. The Bloomberg Commodity Index lost 11.3% in 2018. ■

A LOOK FORWARD

We are looking for U.S. GDP growth of 2.5–2.75% in 2019, supported by consumer spending, business investment, and government spending, as discussed in our *2019 Outlook: FUNDAMENTAL: How to Focus on What Really Matters In the Markets*. We do not anticipate a recession in 2019, thanks to the fundamentally driven economic momentum, combined with fiscal incentives and government spending programs on tap this year. But given the length of the current expansion and where we are in the economic cycle, it is natural that investors are looking for signs of a recession on the horizon.

Considering our views on economic growth, monetary policy, and the fiscal tailwinds of government spending, reduced regulation, and lower taxes, we expect a good year for stocks in 2019. We do believe the pace of earnings gains will moderate to 6–7%, essentially in line with historical averages. Those earnings gains and steady economic growth support our forecast of 8–10% returns for the S&P 500 Index for the year.

We anticipate gradually increasing interest rates as U.S. economic growth moderates from the strong pace of 2018, making 2019 potentially challenging for bonds. We expect flat returns for the Bloomberg Barclays U.S. Aggregate Bond Index in 2019 and a 10-year Treasury yield range of 3.25–3.75%. ■

Please see our *2019 Outlook: FUNDAMENTAL: How to Focus on What Really Matters In the Markets* publication for additional descriptions and disclosures.

2 UTILITIES THE ONLY SECTOR HIGHER

S&P 500 Sector Performance, Ranked by Fourth Quarter Returns

Sector	Q4 2018
Utilities	1.4
Real Estate	-3.8
Consumer Staples	-5.2
Healthcare	-8.7
Materials	-12.3
Financials	-13.1
Communication Services	-13.2
S&P 500	-13.5
Consumer Discretionary	-16.4
Industrials	-17.3
Technology	-17.3
Energy	-23.8

3 EMERGING MARKETS BEST STOCK PERFORMER

Domestic and International Asset Class Performance, Ranked by Fourth Quarter Returns

Asset Class	Q4 2018
Emerging Markets	-7.6
Large Value	-11.7
Large Foreign	-12.5
S&P 500	-13.5
Russell 3000	-14.3
Mid Value	-15.0
Large Growth	-15.9
Mid Growth	-16.0
Small Value	-18.7
Small Growth	-21.7

4 HIGH-QUALITY BONDS OUTPERFORMED

Bond Market Performance, Ranked by Fourth Quarter Returns

Sector	Q4 2018
U.S. Treasuries	2.57
Foreign Bonds (Hedged)	2.29
MBS	2.08
Munis	1.69
Bloomberg Barclays U.S. Agg	1.64
Foreign Bonds (Unhedged)	1.31
High-Yield Munis	0.30
Investment-Grade Corporates	0.01
TIPS	-0.42
EM Debt	-1.19
Preferred Stocks	-3.72
Bank Loans	-4.41
High-Yield Corporates	-4.53

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Bond Market Asset Class Indexes: Foreign Bonds (hedged) – Citigroup Non-U.S. World Government Bond Index Hedged for Currency; Preferred Securities – Merrill Lynch Preferred Stock Hybrid Securities Index; Treasury – Bloomberg Barclays U.S. Treasury Index; Mortgage-Backed Securities – Bloomberg Barclays U.S. MBS Index; Investment-Grade Corporate – Bloomberg Barclays U.S. Corporate Bond Index; Municipal – Bloomberg Barclays Municipal Bond Index; Municipal High-Yield – Bloomberg Barclays Municipal High Yield Index; TIPS – Bloomberg Barclays Treasury Inflation-Protected Securities Index; Bank Loans – Bloomberg Barclays U.S. High Yield Loan Index; High-Yield – Bloomberg Barclays U.S. Corporate High Yield Index; Emerging Market Debt – JP Morgan Emerging Markets Global Index; Foreign Bonds (unhedged) – Citigroup Non-U.S. World Government Bond Index (unhedged)

Sources: LPL Research, FactSet 12/31/18

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

The sectors are represented by the 10 S&P 500 Global Industry Classification Standard (GICS) indexes.

Asset classes based on Russell 1000, Russell 3000 Growth and Value Indexes, Russell 2000, Russell Midcap Index, MSCI EAFE, and MSCI Emerging Markets Index.

IMPORTANT DISCLOSURES

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual security. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. The economic forecasts set forth in this material may not develop as predicted. All performance referenced is historical and is no guarantee of future results.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

For a list of descriptions of the indexes referenced in this publication, please visit our website at lplresearch.com/definitions.

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