



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2018

Leigh Bivings, Ph.D., CFP®



Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420



Executive Summary

- Q4 was a bloodbath in the markets. The total U.S. equity market declined by -14.3%, with smaller companies entering what's called a bear market (i.e., a total decline of over 20%). Investors did not like Fed Chairman Jerome Powell's decision to increase interest rates in light of slowing growth, political gridlock, and moderating inflation.
- Other developed markets did not escape the carnage. In addition to the above worries, Europe has Brexit, the "gilets jaunes" protests in France, a sharp slowdown in eurozone business confidence, and the poor health of Italian banks. In contrast, emerging market equities did not perform so poorly in Q4, falling by only -6.4%, in part due to U.S. dollar weakening.
- Bond yields fell sharply during the quarter, broadly reflecting increased risk aversion and hence, showed positive returns. U.S. Treasuries returned +3.7% during the quarter. In contrast, more credit-sensitive segments of the market got crushed. U.S. high-yield was very weak, falling by -4.7%.
- **2019 Outlook.** We are not as pessimistic about 2019 as some of the reports we read. The U.S. consumer is in great shape, the Federal Reserve is now promising to be more 'data dependent', inflation is moderating, and company earnings forecasts, while moderating, are still healthy. We are also hopeful that China and the U.S. will find a resolution to their brewing trade war.
- However, we recognize that a lot could go wrong in 2019. Key risks include the knock-on effects of an extended government shutdown, Fed policy over-reaction, an unexpected inflation scare, China failing in its attempts to stimulate its economy, a full-on trade war and generalized political paralysis.
- **Artemis Portfolio Strategy.** We will be taking a more defensive posture in 2019 due to the high degree of risk and uncertainty facing global markets. We are not, however, abandoning our long-term view that those companies best positioned to create or benefit from the wave of technological innovation underway will outperform in the long run.
- Finally, we plan to focus more squarely on sustainable investing. It is my personal belief that climate change is an existential threat to our existence. Importantly, I think more and more companies, governments, and investors believe it, too. Artemis will be taking this into account more deeply in our investment strategy, and we will be reporting on this activity regularly in the future.

Q4 and Year in Review

As all of us witnessed, Q4 was a bloodbath in the markets. The total U.S. equity market declined by -14.3%, with smaller companies entering what's called a bear market (i.e., a total decline of over 20%). See Figure 1.

Figure 1. Asset Class Returns in USD for 2018 (%)*

Asset Class	2018				Total Year	Index
	Q1	Q2	Q3	Q4		
Equities						
All Markets - Global*	(0.9)	0.7	3.9	(13.3)	(10.1)	MSCI ACWI IMI (net)
U.S. Large Companies	(0.8)	3.4	7.7	(13.5)	(4.4)	S&P 500
U.S. Small Companies	(0.1)	7.8	3.6	(20.2)	(11.0)	Russell 2000
Int'l Developed Markets	(2.0)	(0.8)	1.3	(12.8)	(14.1)	MSCI EAFE & Canada (net)
Emerging Markets	1.3	(8.4)	(1.9)	(6.4)	(14.8)	FTSE EM All Cap China A Inclusion (net)
Fixed Income						
All Segments - U.S.*	(1.5)	(0.2)	0.0	1.6	0.0	Barclay's U.S. Aggregate
U.S. Treasuries	(1.9)	(0.1)	(0.8)	3.7	0.9	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds	(0.9)	0.9	(0.1)	1.7	1.6	Barclay's Municipal Bonds, 1-15 Years
U.S. Corporate	(1.8)	(0.4)	1.0	0.6	(0.7)	Merrill Lynch U.S. Corporate Bond, 5-7 Years
U.S. High Yield	(0.9)	1.0	2.4	(4.7)	(2.3)	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	4.6	(4.8)	(2.5)	2.1	(0.9)	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds	(2.0)	(4.0)	2.5	(1.6)	(5.2)	J.P. Morgan USD Emerging Market Bonds
Floating Rate Bonds	1.4	0.4	2.1	(4.4)	(0.6)	S&P.LSTA U.S. Leveraged Loan 100 Index
Real Assets						
U.S. Tips	(0.8)	0.8	(0.8)	(0.4)	(1.3)	Barclays Capital U.S. TIPS
Commodities	0.4	0.4	(2.0)	(9.4)	(11.3)	iPath Bloomberg Commodity
U.S. Real Estate Income	(3.5)	2.8	0.3	(3.6)	(4.1)	Fidelity Series Real Estate Income Composite
Int'l Real Estate	(1.2)	(0.1)	(1.4)	(4.9)	(7.4)	Dow Jones Global Ex-US Select RESI

*Used to create Artemis portfolio benchmarks

Many (including yours truly) argue that the fall was especially steep due to (mis)statements made by Fed Chairman Jerome Powell. Early in the quarter, Powell said that interest rates were “a long way” from neutral, implying that the Fed foresaw many more rate increases over the next few years. By late November, he had walked back this statement, saying current rates were “just below” the range of estimates for neutral. Then, on December 19th, the Fed increased interest rates anyway.

At that point, investors revolted, and the markets reached a nadir on Christmas eve. Clearly, investors saw a different environment than the Fed – slowing earnings growth, trade tensions, slower Chinese growth, not to mention the endless political fight in Washington.



To them, the Fed was increasing interest rates faster than the economy could withstand, particularly in light of little inflationary pressure.

Other developed markets did not escape the carnage, falling in lockstep with the U.S. In addition to the above worries, Europe is dealing with Brexit, the “gilets jaunes” protests in France, a sharp slowdown in eurozone business confidence, and the poor health of Italian banks. Japan has been struggling, in part due to a succession of natural disasters (earthquake, typhoon and floods), and slowing demand from China.

In contrast, emerging market equities did not perform so poorly in Q4, falling by only -6.4%, in part due to U.S. dollar weakening. The emerging market index was also helped by news of positive supply side reforms in Brazil and a potential acceleration of growth in India.

As for fixed income, bond yields fell sharply during the quarter, broadly reflecting increased risk aversion and volatility, and hence showed positive returns. U.S. Treasuries – often a safe-haven asset – did not disappoint, returning +3.7% during the quarter, providing a nice ballast to balanced portfolio investors. In contrast, more credit-sensitive segments of the market got crushed. U.S. high-yield was particularly weak, falling by -4.7%.

Figure 1 (above) shows how markets fared over the course of the entire year. Apart from some volatility at the beginning of the year, U.S. equities were performing nicely until the start of Q4, and much better than in the rest of the world. U.S. growth stocks were particularly strong, and much was being written about the so-called FAANG (Facebook, Apple, Amazon, Netflix and Alphabet’s Google) stocks. Indeed, by September, U.S. consumer confidence had hit its highest level since 2000, while the monthly average of initial jobless claims fell to the lowest level since 1969. Wage growth rose to its highest level since 2009, supporting retail sales growth of over 7% year-over-year. Corporate earnings growth year-over-year was also stellar, turbo-charged by the Tax Cut and Jobs Act that was passed in December 2017. In short, it was a remarkably strong growth backdrop and therefore not surprising that U.S. equities were delivering attractive returns. It is also not surprising that the data was giving the Fed confidence that it should raise interest rates.

The same cannot be said for other markets. Eurozone growth had been slowing throughout the year, primarily due to the sharp slowdown in exports to China and the myriad of other issues facing the region. U.S. fixed-income returns had also been challenged as investors had bought into the story that interest rates were going to continue to rise, thereby putting downward pressure on prices. Yields did rise until Q4, with the 10-year yield topping out at 3.23%. By end year, all was reversed, with the 10-year yield dropping back down to 2.69%.



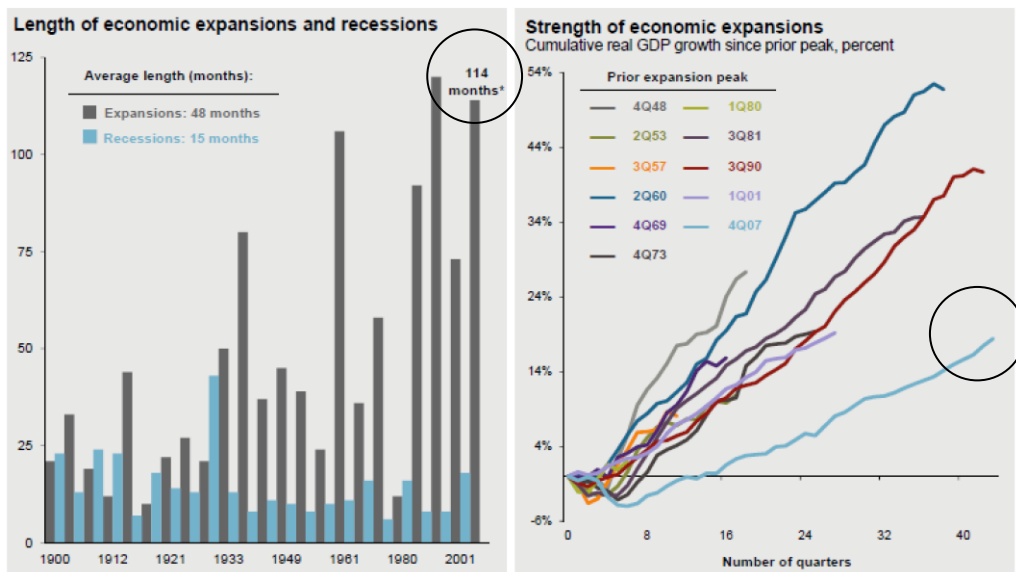
2019 Outlook

This might be an appropriate time to remind ourselves of the famous economist Paul Samuelson’s quip that the stock market has predicted exactly nine of the last five recessions. And economists and analysts themselves are not much better at it. The record indicates that while market experts are reasonably good at getting the general direction of markets correct, they, too, are pretty bad at anticipating turning points. As such, what I have to say regarding the outlook for 2019 should be taken in this context.

There is no question that as we step into 2019, global financial markets are fraught with risk and uncertainty; it’s also true that recent volatility has seriously dented investor sentiment. Yet, I confess that I am not as pessimistic as some of the reports I am reading regarding the outlook for 2019. But I am also going to talk about the risks we currently face, which could render my point-of-view overly optimistic.

First, while all good things come to an end, just because an economy is slowing, doesn’t mean it is going to stall out and land in recession. Let’s remember, as Figure 2 shows, while the current recovery may end up being one of, if not the longest on record, it is also by far the most tepid on record. This alone suggests that 2019 might simply mark a return to the U.S. economy’s underlying slow cruising speed of real GDP growth of around 2%.

Figure 2: The Length and Strength of Expansions and Contractions



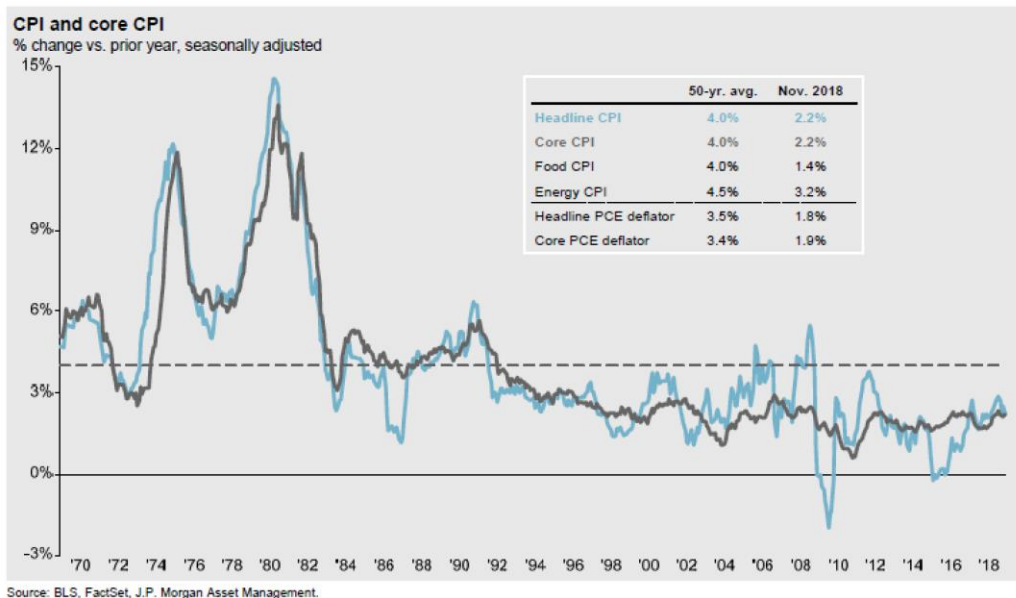
Source: BEA, JP Morgan



I don't know when the next recession is going to hit, but I don't think one is imminent. Let me start by reviewing some of the positives happening in the U.S. economy. First, the U.S. consumer, responsible for almost 70% of GDP, is in great shape. Wages are increasing, jobs are plentiful, gasoline is cheap, and many folks are slated to get tax refunds in the first half of the year. This is powerful protection for economic growth.

Second, overall inflation is low and has been moderating of late, even in the face of an extremely tight labor market. It is worth pointing out that core PCE inflation (the measure of inflation the Fed watches) has undershot the Fed's own target eight years in a row, and the central bank even projects 2019 inflation will ring in lower than its own 2% target. As shown in Figure 3, despite a technology and jobs boom in the late 1990s, and a flood of liquidity post the 2008-09 recession, the U.S. economy has not generated inflation above 3% (except for very brief periods) for almost 30 years. Most of the time, inflation has been steady at around 2-2.5%. We don't fully understand why this is so, but my point here is Fed Chairman Powell seems to finally get it. In a recent statement, he said that the Fed would be adopting a more flexible path on interest rate increases and be more "data-dependent". This is welcome news and is the key reason, in my view, as to why the market is rallying so hard this month. (Of note is that Fed policy has actually engineered every recession since WWII.)

Figure 3. U.S. Inflation by Every Measure





Note: Core CPI excludes food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

I do agree that both GDP and profit growth for U.S. companies have likely peaked, given the artificial boost they received in 2018 from the tax cut, but few believe earnings are about to contract. Current analyst projections and some emerging guidance from companies are indicating earnings will likely grow by 6-8% this year. Thus, unless profit growth is further undermined (more on this later), job growth is unlikely to snap.

Finally, there are some very early signs that China and the U.S. may resolve at least some of their trade problems soon. Already, both sides are posturing as such and indicating that harmful tariffs will be withdrawn. We will know a lot more soon given the self-imposed March 1 deadline to reach an agreement.

China is also reflating its economy (i.e., lowering interest rates, extending more credit, announcing new infrastructure projects, and so forth), to boost growth. The big question is whether they will reflate enough to help lift global growth like they did in 2008-09, and more recently in 2016, but at least it's a step in the right direction.

In contrast, I don't expect the global economy is going to get much help from Europe in 2019. Moderating global growth is only going to exacerbate the economic pain in Italy and Southern Europe. And the overall eurozone is plagued by a host of factors - aging population, slow productivity growth, resistance to reforms, and fiscal retrenchment. Current projections are that the region will only grow by 1% in real terms in 2019. And that's not even factoring in a hard Brexit, which looks ever more likely by the day.

In short, the view I am outlining here rests on the Fed being "dovish" (slowing its monetary tightening), China intensifying its policy reflation, and China and the U.S. coming to a reasonable compromise over trade. If all of this happens, this should produce a weaker dollar, lower global interest rates and, ultimately, a stronger global economy.

What Could Go Wrong?

A lot, unfortunately. My greatest worry a week ago was that the partial shutdown of the U.S. government had started to undermine business confidence and investment. The temporarily resumption of government funding is a step in the right direction, but some harm has been done already. And if the stalemate returns, then we could see job growth curtailed and consumer confidence and spending weakened.



Another big risk is that I'm wrong on inflation and it finally starts to rear its ugly head. If so, the Fed will likely jump to increase interest rates and engineer a fast slowdown of the economy. Higher interest rates typically also strengthen the U.S. dollar (putting pressure on U.S. companies' global profits) and reduce the demand for emerging market assets.

Also, we might be dead wrong on China. Chinese government officials have been flip-flopping on domestic fiscal and monetary policy over the last few years, due to worries about the country's overall debt level. It could be that they continue their piecemeal approach to stimulate the economy with little to show for it in the end. Worse still, what if growth in China slows more rapidly than anticipated (current data look bleak) and the government can't stimulate fast enough?

Finally, and perhaps most importantly, there is the risk of global political gridlock, preventing any kind of coordinated policy response in the face of a recessionary or deflationary scare. I think this is the key warning that is coming out of the World Economic Forum recently concluded in Davos, Switzerland. Larry Summers, for example, is pleading with leaders to better prepare themselves to be able to stimulate (i.e., spend money) should growth slow considerably. Christine Lagarde, head of the IMF, is saying much the same.

Artemis Portfolio Strategy

Artemis portfolios had a rough 4th quarter in 2018, largely due to three factors. First, although we had started to pare back equity exposure early in the year, most portfolios were still overweight equity when the market pulled back. That alone caused them to underperform their benchmarks. Second, until the very end of the year, we were taking more risk than normal in our fixed-income allocations due to the view that interest rate increases were going to eviscerate returns of core interest-rate sensitive fixed income. Such a strategy was working nicely until Q4, when the market turned. Finally, while I strongly believe that the global corporate landscape continues to be transformed by revolutionary technological change, our initial investments into new technology thematic investing in 2018 were ill-timed in hindsight.

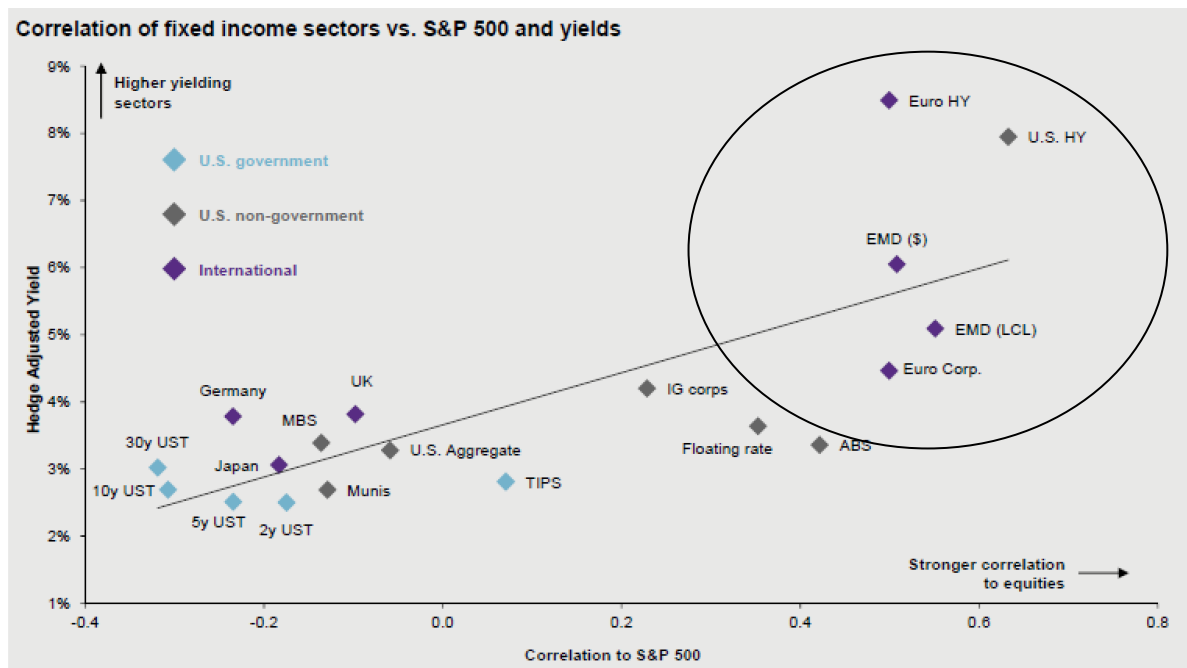
I think the key lesson here is the challenge (and perhaps folly) of trying to squeeze the last returns out of a 10-year bull market. The late-cycle combination of lower returns and higher volatility suggests that we need to take a more defensive posture overall, and that is our



goal for 2019. What follows is the positioning we are adopting for most client portfolios for 2019.

More Defensive in Fixed Income. As the data indicate in Figure 1, U.S. high yield bonds, floating rate bonds and, to some extent, emerging market bonds all got crushed in Q4. Each ended the year earning less than more defensive segments of the bond market. This is because these segments of the bond market are much more correlated with equity returns, as shown in Figure 5. We think it's time to be more defensive in our fixed-income allocation to provide more ballast to the portfolios, as markets are likely to continue to be volatile in 2019, and we face the risks outlined in the prior section of this report. This repositioning is currently underway (hence, why many of you had a higher than normal amount of cash in your portfolios until very recently).

Figure 5. Risk and Return in Bond Investing



Source: JP Morgan. Note: HY=high yield; EMD=Emerging Market \$-denominated bonds; IG=investment grade; UST=U.S. treasuries; MBS = mortgage-backed securities.

Neutral on U.S. Equity. As I discussed in the prior section of this report, I do not believe the conditions for a major bear market are in place that would warrant a move to an underweight position in U.S. equity. There's a lot of good news: valuations have become much more reasonable of late; consumer spending is solid due to low unemployment and



wage growth; and the fiscal impulse due to the elimination of spending caps last year is going to continue to be stimulative into 2019 (basically because not all of the money has been spent). However, most clients are still overweight U.S. equity relative to their strategic targets, and we will be looking to pare back during the first half of 2019.

Underweight Developed Markets. This is more of a contrarian call, as many forecasters argue that valuations in Europe and Japan are attractive, especially relative to the U.S., warranting an overweight stance. Yet we all know that valuation is not very predictive over short periods of time and, frankly, I think Europe is a bit of a 'value trap'. In brief, I still think the risk/return is better in the U.S. or invested in global new technology themes.

Neutral to Overweight on Emerging Market (EM) equity. It should be a good year for EM assets if China does really stimulate its economy, and the trade war gets resolved. In addition, EM assets will also benefit if the U.S. dollar weakens in 2019 due to the Fed being more dovish on interest rates. Of course, if we are wrong on these views, it may be another tough year for the asset class.

Continued Focus on Thematic Investing. As I discussed in several of my quarterly reports last year, Artemis initiated some positions in thematic equity (largely new technology-centric) in 2018. Our timing was unfortunate for most clients, as some of these positions were initiated just before the technology sector started to decline. Nevertheless, I am a big believer that long-term investors will benefit with some exposure. Now that prices have come down, I will be aiming to top up our exposure to this asset class.

New Focus on Sustainable Investing. "We are in deep trouble with climate change...we are still not doing enough nor moving fast enough, to prevent irreversible and catastrophic climate disruption." These are the words of United Nations Secretary General Antonio Gutierrez at the opening of the 24th annual UN climate conference in Poland in October. Additionally, the Trump administration released a huge report over Thanksgiving detailing the damage already being caused in the U.S. by climate change. As such, we have embarked upon taking a closer look at some of the index-based large-cap sustainable equity funds (DFA, Calvert, and a few others) that we have been selectively using. Absent any client expressly telling us otherwise, we plan to start using these or similar funds in place of our standard large cap index funds in 2019 in all client portfolios. Note that we do not plan to replace what clients already have in their taxable accounts, as the tax costs would be high for most, but we do plan to use these funds in tax-deferred accounts and for when we want to increase exposure. It is my personal belief that climate change is an existential threat to our existence. Importantly, I think more and more companies, governments, and investors



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believe it, too. Artemis will be taking this into account more deeply in our investment strategy, and we will be reporting on this activity regularly in the future.