



Quarterly Economic Update

First Quarter 2019



Cher Munoz, CFA, MBA
President, Chief Investment Strategist

A Registered Investment Advisor

After a long period of respectable returns, many investors in equities during the fourth quarter of 2018 experienced losses. This fourth quarter was filled with a great deal of uncertainty, which is the equity markets least favorite scenario. Major concerns included interest rate hikes and trade wars. A high percentage of this quarter's losses came during a disappointing December, when all three major U.S. indexes dropped at least 8.7% for the month. The Dow Jones Industrial Average (DJIA or Dow) and S&P 500 also recorded their biggest monthly loss since February 2009.

For the quarter, the S&P 500 and NASDAQ dropped 14% and 17.5%, respectively, their worst quarterly performances since the fourth quarter of 2008. The Dow recorded its worst period since the first quarter of 2009, falling nearly 12%. As bad as they were, the final numbers do not fully explain just how wild a ride December really was for investors. Based on the lowest levels of the S&P 500 on Christmas Eve, the index was down over 20% from its record high on an intraday basis, briefly meeting the requirement for a bear market. The stock market would then come rising back in the next session, with the Dow over 1,000 points on December 26th, its biggest ever point gain.

The continuing concern over ongoing trade negotiations between China and the U.S. also pressured equities this quarter.

While a correction (defined as a drop of over 10%) in equity markets is not uncommon, there was one interesting characteristic of the fourth-quarter market: intraday volatility. During the fourth quarter the Dow had a record number of sessions with intraday 500+ point swings. That is roughly 2% of the current level of the Dow. The Dow had five consecutive sessions with 500+ point swings from December 4 to December 11. This unusually high intraday volatility attracted a lot of media attention and it seemed as if the stock market was one of the main discussion topics every night on the news. (Source: Seeking Alpha 12/2018)



MONEY RATES

(as posted in Barron's 12/31/2018)

| | LATEST WEEK | YR AGO |
|---|--------------|--------------|
| Fed Funds Rate (avg. weekly auction -c) | 2.36% | 1.42% |
| Bank Money Market -z | 0.22% | 0.14% |
| 12-month Cert -z | 0.88% | 0.42% |

c: Annualized yields, adjusted for constant maturity, reported by the Fed Reserve on a weekly average basis. z - Bankrate.com (Source: Barron's; bankrate.com)

| | MONTH | QUARTER | 2018 |
|---------|-------|---------|-------|
| Dow | -8.7% | -11.8% | -5.6% |
| S&P 500 | -9.2% | -14% | -6.2% |
| Nasdaq | -9.5% | -17.5% | -3.9% |

(Source: Barron's 12/31/18)

A Review of 2018

After 2017 featured strong equity returns and an environment of very low volatility, 2018 tested the commitment of long-term investors. 2018 was characterized by the return of volatility, record highs and sharp reversals. It also resulted in the first time ever the S&P 500 posted a decline after rising in the first three quarters and the first time since 1978 that the Dow finished out the year in the red after rising in the first three quarters.

According to Morningstar Research, results for 2018 “were even worse for those invested in markets outside the United States.” The MSCI EAFE Index (an equity index which captures international large and mid-cap representation) plunged about 14% in U.S. dollar terms. Morningstar noted that a variety of concerns hurt international markets. These included local political issues and troublesome economic data. Many other stock markets abroad also posted deeper losses than those in the U.S. For example, China’s Shanghai Composite entered a bear market in June and declined nearly 25% in 2018.

Economic growth in the U.S. was much stronger than that of Europe, where the trends that finally had moved in a positive direction reversed course, with growth rates down to near zero or even dipping into negative territory in some countries. Europe’s biggest market, the United Kingdom, has been stressed by uncertainty over the details of its path to exit the European Union. Political difficulties in Italy and other European countries didn’t help matters.

2019 Outlook

Stocks may be coming off their worst year since the financial crisis, but for 2019, many analysts feel that equity markets will head higher. Over 65% of 29 respondents to



CNBC’s exclusive “Halftime Report Stock Survey” said their overall stock market outlook is positive. Over 58% feel that equities look cheap at current valuations. CNBC noted that no one responded that he or she believes equities are overvalued at current levels. About 41% believe stocks are correctly valued, and nearly 60% felt current valuations look cheap, which indicates an overall bullish sentiment. (Source: CNBC 1/7/2019)

Interest Rates are Still Critical

Three years ago, the Fed moved away from the near-zero rate that had been in place since the days of the global financial crisis. In December, the Fed raised interest rates for the fourth time in 2018 to move the target range for its benchmark fund to 2.25% to 2.5%. As of that session, Fed officials forecasted two more hikes in 2019, down from three rate raises previously projected.

While investors wanted certainty about rate hikes ending, the Fed included in its statement that further “gradual” rate hikes would be appropriate. Besides potential rate hikes, further trade wars with China can keep markets very volatile in 2019. Trade wars and signs China’s economy is slowing have added to the global uncertainty. Interest rates, trade wars and worldwide growth rates should all be on an investor’s watch list for 2019.

The Business Cycle: It’s a Correction, not a Recession

There is no question we are in the late growth stages of the business cycle. The question remains as to when the economy will stall (i.e. enter a recession). The indicators do not signal a recession in 2019. Year-over-year growth in leading economic indicators remains well above the zero line that has reliably preceded past recessions, monetary policy remains accommodative, and fiscal stimulus will continue to support growth in 2019 (albeit to a lesser degree). While the Fed still plans to raise rates in 2019, the US economy is operating at full employment and continues to benefit from several demand driven tailwinds (including rising wages).

Coming into the New Year, markets were sailing against a headwind because of rising interest rates, inflation fears and international trade worries (particularly those involving China and tariffs). These are generally – with the possible exception of the tariff talk – normal aspects of the business cycle, and that **in order for the market to remain healthy for the long term, it must go through periods of downward repricing.**

We are checking and re-checking the incoming data for signs that something worse than a soft patch is underway. The soft-patch debate is keenly relevant for investors, because bear markets typically do not emerge absent clear evidence that

the global economy is headed for a significant slowdown. It is hard to put precise timing on when the U.S. economy will peak and, thus, when asset prices will be at maximum risk. Nevertheless, we do not see the good times ending for risk assets or the expansion until the Fed intervenes to bring the curtain down.

Conclusion: What should an investor consider?

While many analysts remain optimistic, investors should not expect a straight-line uptrend. Corrections and bear markets will always be a part of the investment sequence. Although the old Wall Street joke can remind us that 10 out of 9 analysts can correctly predict the next recession, predicting exactly when equity markets will start back upward is near impossible. Investors with very long-time horizons of 10 to 20 years or longer can often accept more risk than those with shorter horizons.

CNBC reported on January 1st that some strategists are saying if the stock market's two worst fears are resolved in 2019, that it could be a good year for stocks. While strategists see volatility continuing in 2019, they felt that the biggest worries for investors are still trade wars and the Fed's interest rate movements. While many analysts remain optimistic, again, investors should still not expect a straight-line uptrend.

Knowledge is Powerful

While the nightly news and financial tabloids like to use harsh and scary language to attract viewers, oftentimes their quick views of equity market performance include media magnification, which is the act of making something look larger than it is.

| Common Market Terminology | |
|---|---------------------------|
| % Drop | Typically Referred to as: |
| Less than 5% | Dip |
| 5 to 10% | Pullback |
| 10% + | Correction |
| 20% + | Bear Market |
| Stock market crash - a sudden and significant decline in equity prices of a very short period of time. | |
| Recession - an economic term that refers to a general slowdown in economic activity; generally defined as two consecutive quarters of negative GDP growth. While the effects of a recession often cause the stock market to fall, the term itself doesn't refer to a specific type of market activity. | |

Key Points

1. Q4 finished 2018 with poor returns for equity investors.
2. After a quiet 2017, volatility returned to equity markets in a historic way in 2018.
3. The Fed raised U.S. Fed Fund rates to 2.25 - 2.50% in December and could raise interest rates again in 2019.
4. Key economic data indicators are still reasonable.
5. Analysts suggest 2019 will have positive equity returns.
6. Investors need to still be very cautious and watchful.
7. Focus on your personal goals and call us with any concerns.

Currently, equity markets are volatile and have experienced a correction (some are even in bear market territory), but not a crash. Most corrections are not market crashes. If you recall the October 19th, 1987 market drop of 508 points (a 22.6% decline), that clearly is a market crash. The same percentage decline for the Dow if it happened on January 2nd, 2019 would have been over 5,000 points (which clearly did not happen).

It's not the Wind, It's the Set of the Sails

Coming into the 4th quarter, Zephyr's portfolio positioning was oriented towards moderate-growth as the economic expansion was broad based and the economy had zero probability of entering a recession in the near term. Starting in early October, portfolio changes were made (*we use corrections to sell investments we would like to upgrade*). From a risk perspective, the goal of Zephyr's portfolios is to reduce losses. The 4th quarter's peak to trough stock market decline was quite large (*around a 20% drop in the S&P 500*) and in looking at our portfolio positioning we are confident the adjustments we made reigned risk in to an appropriate level for the given environment. If the stock market decided to enter into a second decline, the more defensive positioning would likely have been to our advantage. This is an important part of our portfolio management process – the idea is to keep the losses small enough so that a majority of your wealth remains intact if we do, in fact, enter into a protracted decline in the stock market. Alternatively, if the stock market embarks on a new uptrend, we would use that opportunity to complete the “upgrading” process in our portfolios.

The swiftness of the decline, and the apparent lateness of the cycle, unsettled some investors enough to make several of them reconsider just how long they want to stay at the bull- market party. At times when market action provokes emotional gut checks, it is essential to have a process to fall back on. Differentiating a correction (with a frequency on average of once a year) from a bear market (with a frequency on average of once every three years) can help us put things into perspective.

We don't think every market hiccup needs to cause an over- reaction, nor do we believe in reading tea leaves. We prefer to focus our work on our fundamental research of the Business Cycle, monetary policy, and the capital markets. This Business Cycle work is the fundamental driver of our research, and it relieves us from becoming overly concerned about the next Fed rate hike or the outcome of an election.

Looking forward, the next stages of the economic cycle (late expansion into stall/contraction) are when we expect to **add significant value** to our clients. Late growth stages are inherently more volatile. Our goal is to help our clients formulate a strategy for navigating the turbulence without being swept up in it. To bring market risk into a more tolerable range, we have strategies available that are geared towards reducing volatility and we will likely utilize some of those strategies in 2019. And don't forget - there are opportunities in every market including a bear market.

When we move from a growing economy to one that is stalled or contracting is not known in real time, but always known from a rear view mirror. The key to profiting from the opportunities that will follow the next bear market is in navigating the investing seas without a serious loss of capital.

During the late stages of the Business Cycle, our primary focus in Navigating through the investing seas is to emerge on the other side of any storm with most of our clients wealth intact (i.e. Capital Preservation). Of course, for our secondary focus – Wealth Creation – we will be looking for the new opportunities that present themselves. We will continue to remain stalwart. We are ready for what comes next.

For 2019, let's focus on **YOUR** personal goals and strategy.

We focus on your own personal objectives. Now is the time to make sure you are comfortable with your investments.



CAUTION is still the principal notion for investors.

Market volatility has caused concern, but panic is not a plan. This is the ideal time to ensure that you fully

review and understand your time horizons, goals and risk tolerances.

If you would like to revisit your specific holdings or risk tolerance please call our office or bring it up at our next scheduled meeting.

We pride ourselves in offering:

- ✓ consistent and strong communication,
- ✓ a schedule of regular client meetings, and
- ✓ continuing education for every member of our team on the issues that affect our clients.

Please share this report with others!

This year, our goal is to offer services to several other clients just like you! If you would like to share this report with a friend or colleague, please call Cher at Zephyr Investment Management at (805) 496-6810 and we would be happy to assist you!



We cannot direct the wind, but we can adjust the sails."

3625 E. Thousand Oaks Blvd., Suite 145, Westlake Village, CA 91362 Phone: (800) 966-3579 (805) 496-6810

Email: info@zephyrim.com www.zephyrim.com

Securities and Advisory Services offered through FSC Securities Corporation, Member FINRA/SIPC. Additional advisory services offered through Zephyr Investment Management, a registered investment advisor not affiliated with FSC Securities Corporation. Note: The views stated in this letter are not necessarily the opinion of FSC Securities Corporation, and should not be construed, directly or indirectly, as an offer to buy or sell any securities mentioned herein. Investors should be aware that there are risks inherent in all investments, such as fluctuations in investment principal. With any investment vehicle, past performance is not a guarantee of future results. Material discussed herewith is meant for general illustration and/or informational purposes only, please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice. This material contains forward looking statements and projections. There are no guarantees these results will be achieved. All indices referenced are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. Stock market. Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. Due to volatility within the markets mentioned, opinions are subject to change without notice. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The Shanghai Stock Exchange Composite Index is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. Diversification and asset allocation do not ensure a profit or protect against a loss. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. Diversification does not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. Sources: OnTrack, BCA Research, Barron's, Forbes, CNBC, Seeking Alpha, Morningstar, MarketWatch.com; Academy of Preferred Financial Advisors, Inc.