

SIGNATURE **FD****MARKET SENSE: THE FUTURE IS ABOUT PROBABILITIES:
WHAT CAN WE EXPECT IN 2019**

At the beginning of 2018, we wrote that, “The overall mood has turned dramatically from a year ago [early 2017]. Expectations were reasonable, and now seem closer to exuberant. We recognize that these conditions can last for a while longer, and we retain our optimistic outlook for early 2018.” We also provided several data points to highlight the unusual nature of the markets in 2017, including a record streak of days without a 5% correction, a minimal number of days with greater than 1% daily moves, and record low volatility readings. The point of these observations was that a long economic cycle, supportive fiscal policies (the tax cuts were passed in late 2017), and ongoing accommodative global central bank policies had ushered in a near perfect situation for equity investors, and this led to expectations that the calm conditions were set to continue.



As markets are prone to do, a turn from this widespread belief was just a matter of time. The first hint of these changes occurred during the first quarter when the global markets dropped by 10% over just a two-week period. Because of the strong start to 2018 – markets rose 8% in the first few weeks of January – and a snap-back rally, the major indices closed the first quarter with modest gains. But, the shifts seemed to indicate something more fundamental had occurred. At that point, the exuberance that we wrote about to start 2018 hit maximum levels and investors started to worry about the future, less sanguine that the goldilocks era could continue. As the year progressed international markets failed to return to their old highs and diverged strongly from those in the U.S. This was especially true of emerging markets, which declined an additional 10% by the end of the summer. With the U.S. economy running at better than 3% GDP growth and the impact of strong corporate cash flows, the S&P 500 rebounded by 15%, hitting new highs as the fourth quarter started.

In a global economy, such divergences aren't usually sustainable, yet it wasn't clear if the fears about global slowing would fade, or if the U.S. would succumb to the changes underway. By the end of the year, we knew the answer, the U.S. can hardly remain an island of growth in an increasingly turbulent global landscape. The fourth quarter saw all major markets decline and give way to losses for the year. The U.S. suffered the most during the final quarter, as it was starting from a higher level, but all major markets fell by double-digits, generally between 10% and 15%. A robust, yet late starting Santa Claus rally helped trim the final 2018 losses, but the S&P 500 was still down mid-single digits and international markets closed the year with double-digit losses. As can be seen from the table below, all major benchmarks registered losses for the year. In fact, it was one of the few years where almost all asset classes – broadly including equities, bonds, and commodities fell together. The only assets we could find that rose were Qatari stocks, U.S. healthcare and utility stocks, natural gas, and short-term U.S. treasuries.

NAME	4th Quarter	52 weeks
S&P 500	-13.52	-4.38
Dow Jones Industrial Average	-11.31	-3.48
MSCI EAFE (Developed International)	-12.54	-13.79
MSCI EM (Emerging Markets)	-7.47	-14.58
Bloomberg Commodity Index	-9.41	-11.25
Barclays Global Aggregate Bond Index (Global Bonds)	1.20	-1.20
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	1.64	0.01
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	1.58	1.69
HFRI Fund of Funds Composite Index	-4.42	-3.48

So, was 2018 abnormally bad for markets? Year-end news reports claimed, “Worst year since 2008,” and “Worst December since the depression year of 1931.” These are factual statements, but we would broaden out the scope of the review and claim that 2018 was relatively normal and certainly within the range of what long-term investors should anticipate periodically. We started the letter with a review of the abnormal conditions that existed in 2017 and the years prior because it builds a condition for disappointment due to recency bias. Recency bias is the normal human behavior of overweighting events that have occurred most recently and placing less importance on those that have happened over longer periods of time. When reviewing a history of U.S. equity returns going back to 1926, returns between +5% and -10% should be expected approximately 25% of the time, while returns worse than -10% occur about 1 in 10 periods. Moreover, when looking at other statistics for 2018, it was actually a relatively normal year:

- Equities had intra-day moves of 1%, 2%, and 5% in-line or slightly less than normal since 1962.
- The average daily equity market move was double what occurred in 2017, but still slightly below the average since 1962.
- On average, the market declines 14% from peak to trough during any given year, and comparable or worse intra-year losses have occurred in 13 of the last 39 years. Moreover, the average intra-year decline in mid-term election years is -20%, nearly identical to 2018.
- Though it had two relatively large spikes during the year, on average, the Volatility Index averaged less than its historic norm around 20.

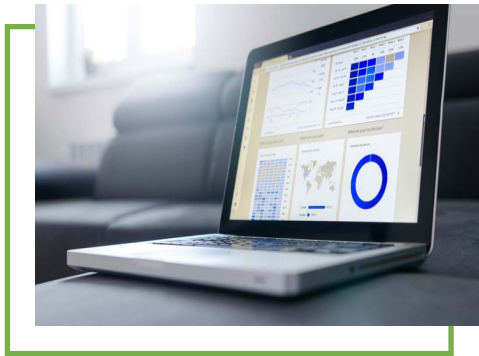
Of course, none of the above data takes away from the fact that markets and investors lost ground in 2018. It is certainly true that long-term financial planning requires growth in capital. But, it is equally true that a long-term plan must accept and account for volatility, and the type we experienced in 2018 is not abnormal. We are actively engaged in attempting to help our clients leverage upturns and navigate challenging environments. In the remaining sections of this letter, we will outline our views of the potential outcomes in 2019 and review our current and anticipated portfolio shifts within the current environment.

A PROBABILISTIC VIEW OF 2019

During the fourth quarter the SignatureFD investment committee read the book *Thinking in Bets* by Annie Duke. The premise of the book is that there are two things that determine outcomes – the quality of decisions and luck. Obviously one of these is outside our control (luck) and thus the other should capture all our attention. How do we make decisions and how do we strive to always improve on the process of decision making? We would propose that within investing, there is always some amount of risk. However, risk should not

be solely thought of as a negative, but rather the uncertainty of the future. Successful investor Howard Marks simplifies this concept to its core: “Risk means more things can happen than will happen.”

In her book, Duke goes on to highlight the difference between chess and poker. Decision-making in investing (and life) is much more like poker than chess – we are confronted with amounts of hidden information and are subject to more influence from luck. Investors often make mistakes thinking in terms of binary outcomes – something is either 100% right or 100% wrong. It’s more appropriate to think in terms of probabilities. When thinking of the future as a set of scenarios’ one recognizes that the future is about probabilities. George Soros, one of the greatest investors of all time, guides us here: “there are as many expectations as there are participants, but there is only one outcome.” Outcomes become reality and are easy to explain, but they don’t remove the fact that decision making over time must also account for all the potential realities that didn’t transpire. Simply, investing is about the future, and to be persistently successful, an investor’s risk management process is key and must always account for the many things that can happen, but don’t. With this as a backdrop, let’s review the probabilities that could occur in 2019.



SIMPLY, INVESTING IS ABOUT THE FUTURE, AND TO BE PERSISTENTLY SUCCESSFUL, AN INVESTOR’S RISK MANAGEMENT PROCESS IS KEY AND MUST ALWAYS ACCOUNT FOR THE MANY THINGS THAT CAN HAPPEN, BUT DON’T.

PROBABILITY #1 - THE PAUSE THAT REFRESHES (45-55% LIKELY)*

As the calendar shifts to 2019, this is the scenario we believe has the highest possibility of occurring. This probability aligns with the idea that markets encountered an inflection point in 2018, and the changes are too significant to reverse on their own accord. Thus, a reversal would only occur with a substantial enough change in policymaker action to reverse the negative trends. For this to occur, additional evidence of weakening trends and worsening market conditions will be required. In the end, if policymakers provide clarity around the key issues – slowing China growth, Federal Reserve tightening, and the trade disagreement, then attractive valuations and renewed growth could provide the catalyst for an upside move.

In our opinion, the only two economies that truly matter for global markets are China and the U.S., and in that order. Chinese growth is anticipated to stabilize around 6.5%. Currently, the country accounts for more than 25% of global growth, according to the International Monetary Fund (IMF). The other emerging economies – largely influenced by China – account for more than 35%. The U.S. itself accounts for a significant 16% of global growth. Thus, the twin drivers of China and the U.S., directly or indirectly, account for over three-quarters of global growth. With these two heavyweights now entangled in a protracted trade dispute, it is not a surprise that global anxieties are building.

This scenario forecasts that incoming information could get worse in early 2019 potentially causing important changes on U.S./China trade, economic stimulus in China, and the Federal Reserve is forced to pause. Chinese data has been weak, and at year-end is showing a manufacturing industry that is in contraction. Policy moves

thus far have not been significant enough to cause a turn. In the U.S. fiscal stimulus could peak in early 2019, and corporate earnings expectations are likely still too high, as evidenced by the recent announcement from Apple regarding their fourth quarter revenues and profits.

With the Federal Reserve and more than half of global central banks in tightening mode, global liquidity seems to be declining. The pressures of rising rates and a strengthening dollar can prove problematic for the \$2 trillion of emerging market debt that must be refinanced in 2019. The announced tariffs are set to move to 25% on March 1st, without a trade agreement. Though glimmers of hope were apparent on New Year's Day, the path to get an agreement is likely to still trigger bouts of brinkmanship between President's Trump and Xi. The Federal Reserve concluded its December meeting with a view that things have softened slightly, but that they still foresaw two rate hikes in 2019, and the balance sheet adjustments are unlikely to change. The Federal Funds interest rate market is now forecasting zero likelihood of rate increases in 2019. In fact, for the first time since 2008, markets show a slight bias toward expecting a rate-cut in the next 12 months. The Fed is unlikely to adjust its communication as fast as the market desires, causing the potential for investor disappointment before the Fed fully recognizes the possibility of a slowdown.

But policy makers usually react to markets when they are forced to. The slowing in China is likely to cause President Xi to bend but not break, and with the U.S. Presidential campaign of 2020 getting underway, President Trump needs to pave the way for continuing economic growth over the next six quarters. The Federal Reserve may eventually back-off its more hawkish tone and work to support the longest expansion in U.S. history. If a trade war is at least temporarily averted, China would be free to provide stimulus to their economy, weakening their currency and thus potentially creating a bottom for emerging markets. Other parts of the world could get in on the fiscal stimulus as well. With stagnating growth in Europe and political challenges for both Angela Merkel and Emmanuel Macron, the solution of fiscal stimulus would look attractive. If the first few months of 2019 resemble the challenging end of 2018, risk markets could find a durable bottom and rally strongly over the second half.

PROBABILITY #2 - ECONOMIC COLD WAR (25-35% LIKELY)*

In the first scenario, we assumed that policymakers act in a politically opportune way and change tactics before a U.S. recession is triggered and before China growth further deteriorates. In this second, more problematic, scenario we would assume that the current trade skirmishes turn into an all-out principles-based trade war, and recent volatility morphs into a negative feedback loop, especially within the fragile global debt markets.

There have certainly been hints that the disagreements between the U.S. and China are of such fundamental consequence that they may be difficult to resolve before the economy moves past the tipping point. It should not be forgotten that the U.S. market declines started almost coincidentally with a major U.S. speech by Vice President Mike Pence on October 4th, which outlined a litany of grievances the U.S. has with China, not only on trade matters but also about industrial policy, military objectives, and their expanding sphere of influence. For their part, a recent speech by President Xi continued this rhetoric and stated that, "No one is in a position to dictate to the Chinese people what should and should not be done."

China finds itself at a critical juncture on many fronts. For the global economy, China and emerging markets are the key linchpin for trade. The emerging market countries in aggregate import more than those of the U.S. and EU combined. From an economic standpoint the country has made tremendous strides over the past 20-years primarily based on three key pillars: shifting from agriculture to manufacturing employment; relocating citizens from rural to urban locations; and, building out tremendous amounts of infrastructure. But, these have largely

run their course. At the present, China must move its economy up the value chain within manufacturing and shift its economy from dependence on infrastructure investment to consumer spending. The core of the “Made in China 2025” program is to continue this transition. The last 20 years have come with the cost of a potentially dangerous debt burden that could have global ramifications if the transition doesn’t proceed. With extremely high levels of debt in China and across other emerging markets, declining global liquidity, a shortage of U.S. dollar funding, and rising interest rates, the ingredients for a credit crisis could be set.

What no one can know is whether President Trump is likely to be transactional in attempting to get a deal done and claim a victory. Or if, as the tone of Vice President Pence’s speech implied, current struggles are more akin to the Cold-war with Russia. In the latter case, it seems that the U.S. won’t be satisfied until serious harm is done to the ascension of China on the global stage.

The Chinese economy has been slowing for most of the past year, but it is only the past few months that have seen significant deterioration in some of the U.S. shorter term data. But, U.S. credit conditions, consumer spending, and corporate profitability remain solid and don’t portend an immediate recession. However, the market reaction to a full trade-war between economies that represent 75%+ of global growth expectations would be enough to push confidence and economic data to recessionary levels by the middle of 2019, in our opinion. In this case, the recent rate increases, and balance sheet shrinkage would be viewed as mistakes, but any reversal of policy would be ‘too-little, too-late’ regarding a recession.

For much of 2018, investors isolated the trade skirmish issues as being impactful mostly to China and the emerging markets. By year-end, the realization that a more negative outcome is possible began to be priced into markets but is still nowhere near a consensus view. This is not our base case scenario, but given the probability of this scenario, prudent risk management dictates moderate portfolio shifts, which we will address at the end of this letter.

PROBABILITY #3 - GOLDBLOCKS IMMINENT RETURN (15-25% LIKELY)*

We view the final scenario as the least likely but still a strong enough possibility that it must be accounted for. The market concerns of the past few months could be misplaced, and current volatility may just be an ordinary pull-back in a continuing long-term economic cycle and bull market. With China and U.S. trade negotiators meeting in early January, it may be necessary to see settlement of enough key issues that the relationship with China is fully addressed for at least the medium term. If the resolution of that uncertainty is enough to allow global economies to resynchronize, then easing fears about a U.S. recession would be put aside, and confidence may return. If the easing of concerns is simultaneous with some level of fiscal stimulus out of China and Europe, then a return to above trend growth in the majority of global economies could transpire.



THE MARKET CONCERNS OF THE PAST FEW MONTHS COULD BE MISPLACED, AND CURRENT VOLATILITY MAY JUST BE AN ORDINARY PULL-BACK IN A CONTINUING LONG-TERM ECONOMIC CYCLE AND BULL MARKET.

This scenario does come with the downside that it could cause fears of inflationary pressures to return once again. This, along with accelerating wage growth, would prompt the Federal Reserve to raise rates more than twice next year. And, this could eventually lead to a more typical end of cycle environment, with rising commodity prices and inflation pushing the Fed to raise rates to the point of causing a slowdown. This would contrast with the first scenario that could cause a more gradual and elongated end of cycle that could go into 2021-22.

CURRENT POSITIONING AND POTENTIAL CHANGES

In recent communications we highlighted portfolio positioning and shifts based on the incoming economic and market data. To briefly recap, we entered 2018 with positioning that aligned with an ongoing global synchronized growth cycle. That portfolio positioning had allowed most client portfolios to achieve solid double-digit returns in 2017 and it helped in early 2018. However, by the second quarter, while topline performance remained positive, the U.S. market became the sole engine of performance, and we saw a progression of negative changes in our model and in the outlook from our research providers. Because of these shifting views, portfolio changes were made in August to reduce some of the bias toward economic growth in our portfolios. We reduced emerging market exposure, which had served well since 2016, and we reduced energy exposure. Markets in the U.S. remained solid amidst expanding global concern through the third quarter, but October changed that with a substantial pull-back. Our indicators and research provider outlook decreased again, and we reduced risk further in early November.

At year end, portfolios had a slight defensive bias. We previously removed or reduced investments that are more sensitive to economic growth, but overall equity positions were basically neutral, and our indicators were largely non-committed on a bias toward or away from developed international and emerging markets. With the declines in December, the deterioration in economic outlook, and the rising risks that it would take more forceful action from policymakers, our indicators highlighted further weakness. Moreover, the outlook from our core research providers became more cautious. As a result, effective in early January, we are making a further reduction of equity exposure across portfolios with the cash raised going to core bonds.

This shift from equities into bonds recognizes a rising risk that the current correction could become the first -20% or greater decline since the Global Financial Crisis. The highest probability (#1 above) implies that market performance will get worse before policymakers are forced to act and this risk reduction helps in this case. If our indicators show improvement in early 2019 (probability #3) or after a policy action driven bottom in mid-2019 (probability #1), we will be prepared to return to market or even overweight equity exposure. And, we have considered this possibility with this pending portfolio shift. The proportion of funds deployed to JPST, the JPMorgan Ultra-Short Income ETF, in client portfolios will match our equity underweight. That fund is quite liquid allowing us to close the position and roll it into the equity markets efficiently, with minimal tax implications.

The cumulative effect of the portfolio shifts, to date, would help protect capital in the case of the more negative probability #2, but we are not out of ammunition following this model change. Recessionary bear markets have tended to last well over a year and taken the S&P 500 down by greater than -40%

on eight separate occasions since 1900. While a U.S. recession is not our base case, we'll be paying attention to leading indicators to determine whether the probabilities of economic contraction are increasing. If so, we would be likely to take a full underweight position in equities, pulling from a variety of growth-oriented investments, including real assets. That capital would likely again be rotated into core bonds.

It is normal that the volatility like we saw in the fourth quarter raises anxiety levels, but we are also comfortable that these types of events are anticipated in all our client financial plans. We will continue to communicate with you as our thoughts evolve. As 2019 gets underway, we wish you and your families the best for health and well-being in the New Year, and we thank you for your ongoing confidence in our entire team.

* The probability percentages are the opinions of SignatureFD based on our research and experience.

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