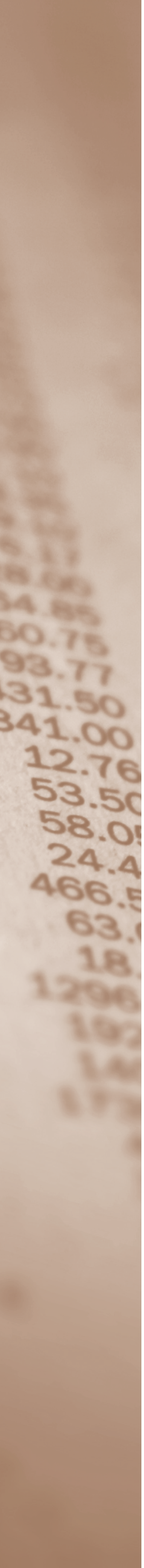

The Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

Market Update – *First Quarter, 2019*

THE END OF 2018 delivered extremely tough market conditions. Each of the 11 sectors of the S&P 500 fell in the month of December, its worst since 1931. In our last newsletter we wrote, "The bears have taken control as Q4 gets underway." Here is the proof:

Index	December (%)	Q4 2018 (%)
S&P 500	-9.18	-13.97
S&P MidCap 400	-11.48	-17.65
S&P SmallCap 600	-12.26	-20.43
Dow Jones Industrial Avg	-8.66	-11.83

Source: S&P Dow Jones Indices LLC.

Returns shown are price returns.

WHAT HAPPENED? On the year, the S&P 500 was down 6.24%, its worst year since 2008, while the MidCap 400 dropped 12.50% and the SmallCap 600 declined 9.75%. The Dow Jones Industrial Average fell 5.63%.

We entered 2018 set-up for perfection as sychronized global expansion, record corporate profts and surging GDP were able to shake off worries of trade tensions, rising interest rates and inflation. That narrative was quickly tested with a market correction of 12% in February. After a modest recovery, the market re-tested those lows as the calender turned towards April. However, in resilient fashion the bulls took control in fairly short order and produced a lengthy rally lasting well into September, climbing 16% off the low of the year.

Enter the fourth quarter and things got ugly, real quick. In the end, the market was unable to sustain a rally against the persistent headwinds and it ultimately gave way to the downside in violent fashion. In fact, the velocity (defined as speed with a direction) of the Q4 market decline mirrored what was experienced during the Great Depression and the Great Recession. Is 2019 setting up to repeat those economic and market environments?

IN OUR VIEW the answer is no. Our base case is we do not see an impending recession in 2019 and feel it is premature to de-risk away from equities. Fundamental and economic data provide evidence for a continued expansionary environment, albeit at a slower pace.

It is important to distinguish that a moderation of growth does not necessarily mean contraction or recession. In economic terms, a recession is two consecutive quarters of negative GDP growth. We do not see that on the immediate horizon nor do we see consecutive quarters of negative corporate EPS growth in 2019.

Instead, we believe heightened volatility and uncertainty favor episodes of market drawdowns that are typical in late cycle expansions. Furthermore, conversations of peak corporate profits and the aging bull may take center stage yet we caution on wholesale moves away from equities. History shows corporate profit margin expansion can continue late into the cycle all the way up to the beginning of a recession. This supports our conviction of monitoring data and signs of further economic deterioration before trying to call an end to this cycle.

WE'RE NOT BLINDLY BULLISH. There are clear and present risks that standout for 2019. Let's breakout our top 5:

5. Inflation: Currently, inflation is in check and Action Economics predicts core PCE (inflation) at 2.1% for 2019. However, signs of rising input costs, including transportation and raw materials have become apparent. Should that trend continue or accelerate, inflation will become more of a material risk.

4. Fed / Rising Rates: The Fed's dovish tone in December reduced the risk here. Most bear markets occur with excessive Fed tightening. One measure of this is the spread between the Fed Funds Rate and headline CPI inflation which currently stands at 0.37. Sam Stovall from CFRA reminds us the typical spread leading into bear markets averages 2.5 percentage points.

3. Peak Corporate Profits: Coming off several quarters of 20%+ earnings growth, there is little debate we will encounter an EPS slowdown or moderation of growth. This is normal in later stages of the cycle. A contributing factor here includes the strength of the dollar. Over 40% of revenue for S&P 500 companies comes from outside the US. Despite the dollar weakening in 2018, a return to strength is a risk point to monitor.

2. Corporate Debt: Corporations have been adding debt. In fact, as a percentage of GDP it has topped 45% and is now at previous cycle highs. The counter to this is low interest rates that allow for adequate debt service which is reflected in the declining default rate. However, should rates rise, profits decline or any other combination of risk accelerates, this becomes a pivot point for not only fundamental health but market valuation as well.

1. Trade: Here we highlight The Tax Foundations long-term estimate of the impact on GDP - which includes all announced and enforced tariffs from all countries, including China - of 0.6%. This may seem low considering the amount of attention this issue receives. However, it is difficult to predict what trade uncertainty does to global business sentiment, investment and hiring.

A WORD ON VALUATION. The market selloff at the end of 2018 has re-set valuation to a more attractive level. By the numbers, the S&P 500 trades around 15.1 times on a forward 12-month Price/Earnings basis. Historically speaking, the five-year average is 16.4 and the ten-year average is 14.6.

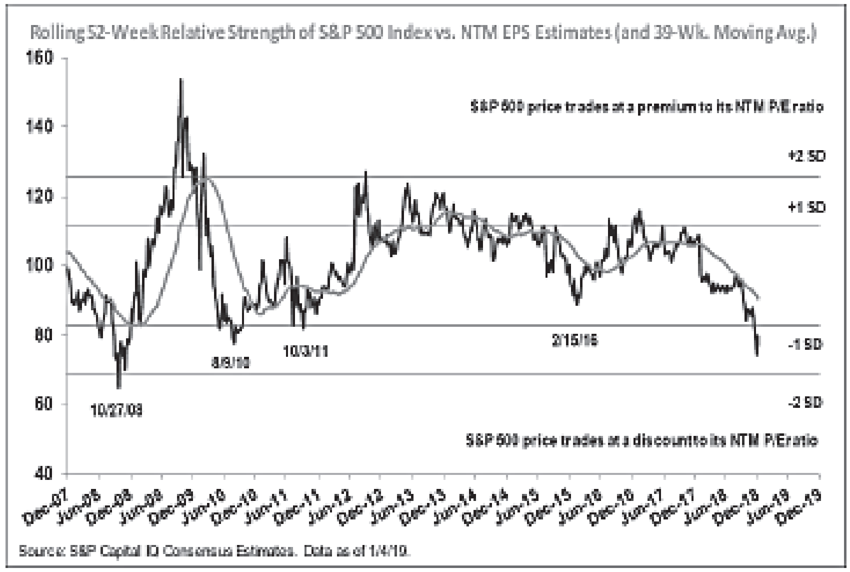

Figure 1 shows valuation in a different context by looking at the S&P 500 versus forward earnings estimates. If you take a look to the far right, you will notice the dark jagged line has fallen quite a ways below the smoothed line. This means the S&P 500 is trading at a discount to its next 12-months earnings estimates. As CFRA points out, the S&P 500 is now trading between one and two standard deviations below its mean over the last 20 years. Unless there is unforeseen reason or negative data to drive EPS estimates off a cliff, the S&P 500 is trading at an attractive valuation.

As always, thank you to our clients for the many referrals and allowing us to continue working to meet your needs. Please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, we take our role as fiduciary very seriously. If you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. We will happily provide you with an unbiased opinion based on your specific situation.

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