FINANCIAL MARKETS

Virtually all equity markets fell sharply during the final quarter of 2018. Large cap US stocks, as measured by the S&P 500, declined by 13.5% in the fourth quarter, dragging the full year return down to a loss of 4.4% – the first negative calendar year for the broad market index since 2008. Stocks of smaller US companies fared even worse, while major indices of international stocks registered double digit declines for the full year. High quality fixed income was a bright spot during the quarter as investors sought the security of long and intermediate term government bonds, pushing the Bloomberg Barclays Government Credit Index up by 1.5%; but bonds offered little protection for the full year, as the Index fell 0.4%. It is a rarity for both stocks and bonds to register negative returns in the same calendar year. This was the first such occurrence since the bond index was created in 1979.

Perhaps making the negative returns even more unsettling, the stock market's oscillations felt extraordinary following years of general market calm. Market pundits didn't hesitate to cite a plethora of triple digit Dow

INVESTMENT PERSPECTIVES

Domestic Expansion Continues

In contrast to the market's volatility, virtually all available data indicate a US economy that is still on firm footing. The labor picture is exceptionally robust, with the unemployment rate firmly below 4%; according to the latest reports, average hourly wages are increasing by over 3% – almost a full percentage point higher than inflation – providing a real increase in consumers' spending power. The recent pullback in oil (and gasoline) prices has provided an additional boost to disposable income. Confidence readings from both consumers and manufacturers remain positive, and only modestly lower than the highs reached a couple months ago. GDP expanded at an annualized rate of 3.5% during the third quarter; this pace surely reflects a short-term lift from the 2017 tax cut, but normalized growth of 2-3% is still expected for the coming year.

For its part, the Fed raised its benchmark overnight interest rate by another quarter point at its December meeting – the fourth such increase of 2018 – but cautioned that changing global economic conditions could influence their decisions regarding future rate increases. And therein lies the current paradox of strong data, yet concern regarding rising risks. As we've previously noted, the Fed controls short-term borrowing rates, but market participants set the price and yield of longer maturity bonds. With unevenness in international economies as well as pockets of political unrest, global investors have continued is set to leave office in 2021 after more than 15 years in power. Meanwhile, protests against gas taxes in France are indicative of unrest relating to economic policy. These uncertainties can provide a headwind to business investment, and in turn, economic output. And while there are no signs that the region is devolving into a recession, the political tumult raises the risk that an economic dislocation would not be met with a coordinated and sufficient policy response.