Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

# Year-End Commentary 2018

## Market Recap

| December Benchmark Returns | MTD | QTD | YTD |
|---|---|---|---|
| **EQUITY BENCHMARKS** | | | |
| Vanguard 500 Index | -9.0% | -13.6% | -4.5% |
| iShares Russell 1000 ETF | -8.9% | -13.7% | -4.9% |
| iShares Russell 1000 Value ETF | -9.4% | -11.7% | -8.4% |
| iShares Russell 1000 Growth ETF | -8.4% | -15.8% | -1.7% |
| iShares Russell 2000 ETF | -12.0% | -20.3% | -11.1% |
| Vanguard REIT | -8.0% | -6.5% | -6.1% |
| | | | |
| iShares MSCI ACWI ETF | -7.2% | -12.7% | -9.1% |
| Vanguard FTSE Developed Markets ETF | -5.7% | -13.3% | -14.8% |
| Vanguard FTSE Europe ETF | -4.8% | -12.9% | -14.9% |
| Vanguard FTSE Emerging Markets ETF | -3.3% | -6.4% | -14.8% |
| | | | |
| **FIXED-INCOME BENCHMARKS** | | | |
| Vanguard Total Bond Market Index | 1.8% | 1.6% | -0.1% |
| Vanguard Intermediate-Term Tax-Exempt | 1.2% | 1.7% | 1.3% |
| iShares TIPS Bond ETF | 0.5% | -0.5% | -1.4% |
| ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index | -2.2% | -4.6% | -2.3% |
| S&P/LSTA Leveraged Loan Index | -2.5% | -3.5% | 0.4% |
| | | | |
| **ALTERNATIVE BENCHMARKS** | | | |
| HFRX Global Hedge Fund Index | -1.9% | -5.6% | -6.7% |
| Bloomberg Commodity Index | -6.9% | -9.4% | -11.2% |
| SG Trend Index | 1.0% | -5.1% | -8.1% |
| 3-Month LIBOR | 0.2% | 0.6% | 2.1% |

U.S. and global stocks dropped sharply during the fourth quarter, capping a year marked by turbulence and losses across most asset classes. Among investors' worries were signs of a global economic slowdown, exacerbated by ongoing Federal Reserve monetary tightening, U.S.-China trade tensions, and political uncertainties in Europe (Brexit, Italy) and the United States.

After tumbling 7% in October and then stabilizing in November, U.S. stocks fell again in December as investors reacted negatively to the Fed's language surrounding its 25-basis-point rate hike. While the Fed's updated forecast implied one fewer rate hike in 2019 than previously communicated (two instead of three), Fed chair Jerome Powell gave no indication it would ease up on its balance sheet reduction program (rolling off hundreds of billions of maturing assets purchased during quantitative easing), nor that a pause in rate hikes was imminent (although he didn't rule it out). As one commentator summed it up: "This was a more dovish Fed, but not dovish enough for the markets."

Larger-cap U.S. stocks dropped 9% in December and fell 13.6% for the quarter (its worst quarter in seven years). For the year, U.S. stocks were down a more modest 4.5%. The negative year broke the S&P 500's remarkable nine-year run of positive returns. Smaller-cap U.S. stocks fell more sharply, losing 20% in the fourth quarter and 11% for the year. Foreign stocks struggled as well, with developed international markets and emerging markets both down 14.8%. However, their underperformance versus U.S. stocks came earlier in the year. In the fourth quarter, emerging-market (EM) stocks beat U.S. stocks by seven percentage points, while developed international stocks matched the U.S. market's return.

Core bonds, which typically perform well when stocks do poorly, had losses throughout most of the year, although the category rallied during December, and basically ended the year flat.

What stands out most about 2018 is the *breadth* of negative returns across almost every type of asset class and financial market, whether bonds, equities, or commodities. A study done by Deutsche Bank noted that 90% of the 70 different asset classes they track posted negative returns for the year. This was the highest percentage of losers in the study's 100-year history.

Simply put, it was extremely difficult to make money in the financial markets last year.

## 2018 Portfolio Performance and Positioning Recap

### ASSET ALLOCATION

Although Virginia Capital Strategies can't control the stock market, we can attempt to design portfolios that are client appropriate. We have new clients complete a risk posture exercise called FinaMetrica. Results from this test, combined with other pertinent information (age, other assets, etc.) dictate an asset allocation strategy. This information is incorporated into a policy, which provides a formal level of investment discipline, as even professionals can be swayed by the two opposing emotional states of fear and greed. From time-to-time, a tactical decision will be made by Virginia Capital Strategies to modestly increase or decrease risk. In September and October, we determined the market was far overbought, and we elected to sell stocks and take some degree of risk off the table. Although we're not always right, this recent move certainly helped, as markets almost immediately declined afterwards, with some asset classes falling 20% or more.

Relative to other managers, we tend to fall on the conservative side, and certainly this helped during the turbulent 2018 environment as well. Furthermore, Performance Checker and our other analytical tools favor conservative and higher-quality investments. And finally, we put a great deal of emphasis on diversification, and by doing so we're able to eliminate some level of unsystematic risk.

The above factors certainly helped our clients preserve as much capital as possible during the very difficult conditions we witnessed in 2018. Although we obviously don't like flat or down markets, we do tend to perform relatively well under such an environment.

EQUITIES

Our equity funds have superb track records with long-tenured management. Each fund employs a disciplined process to identify high-quality and attractive investments in their respective categories. Blackrock Equity Dividend, Dodge & Cox Stock, Jensen Quality Growth, Cohen & Steers Realty, American Funds EuroPacific Growth, Dodge & Cox International and Vanguard Strategic Equity are among the best investment products available anywhere.

And as you know, our globally diversified portfolios have meaningful *strategic* allocations to developed international and EM stocks. This positioning was beneficial in 2017, when foreign markets outperformed US markets. But in 2018, it was a drag on returns as US stocks outperformed the international and EM markets. The last several investment commentaries we have written have detailed the current relative attractiveness of international investments, and we will continue to maintain exposure in this area.

FIXED-INCOME

Our balanced portfolios have a large allocation to actively managed, flexible bond funds such as Weitz Short-Intermediate Income, Templeton Global Bond and Osterweis Strategic Income (in addition to our core bond exposure). During the first three quarters, these funds contributed positively to portfolio returns and outperformed the core investment-grade bond index. We expect these products to outperform in the future, particularly if interest rates continue to rise. However, Dodge & Cox Income, our actively managed, core investment-grade bond choice outperformed during the tumultuous fourth quarter. We hold core bond funds as risk mitigators in the event of recession or some other shorter-term "risk-off" scenario, even if we believe the likelihood for higher rates is present.

OTHER

The Merger Fund, a sleepy product that is about as exciting as watching paint dry, returned 7% last year!

RELATIVE PERFORMANCE

We shy away from selling performance, but interestingly, most Morningstar Balanced Universes returned anywhere from negative 6% (Morningstar 50-70% Equity) to negative 8% (Morningstar World Universe) in 2018, far worse than what was experienced by our investors.

## 2019 Outlook

Are we at the end of a spectacular 10-year bull market for stocks or did we simply witness a long-due hiccup during 2018? Will 2019 resemble the poor environment of 2018 or the spectacular late-2016 and 2017-time frame? No one truly knows, but we will highlight two divergent short-term macro scenarios: one bullish for stocks and one bearish. Each scenario reflects the 2019 outlook of a highly respected, independent, macroeconomic investment research firm whose research we pay great attention to: BCA Research and Capital Economics. We think either of these scenarios has reasonable odds of playing out (as well as any number of variations on them). And each has a very different implication for investment returns as shown below (and we've provided our best guess as well):

BCA's BULLISH SCENARIO

In a nutshell, BCA sees slowing but still solid U.S. economic growth next year. They expect a reacceleration of global growth in the second half of the year, as the effects of more aggressive Chinese fiscal and monetary stimulus kick in and the drag from tight financial conditions dissipates. Given relatively solid but slowing U.S. growth, they expect the Fed to implement a gradual and measured path of interest rate hikes— with the possibility just one rate hike this year. They believe asset markets have already discounted the deceleration of growth they expect to see in the first half of the year. In this scenario, a U.S. recession is unlikely for a couple of years. These conditions will lead to a continuation of the current bull market and solid returns for stocks both in the U.S. and overseas this year. Core bonds will underperform in this environment, but credit-oriented bond funds should fare well.

CAPITAL ECONOMICS BEARISH SCENARIO

Capital Economics is not forecasting a U.S. recession in 2019 either, but they expect the economy to slow "sharply" due to tighter monetary policy and the fading boost from the 2018 tax cuts. They estimate the Fed will hike rates two more times in 2019 but will be forced to begin cutting rates in 2020. They expect the Chinese economy to lose momentum but then stabilize by the middle of the year due to monetary and fiscal stimulus. Overall, they expect slower global growth than the consensus expects, driven by slowing global demand and tighter financial conditions

Under this scenario, the implications for financial assets in 2019 are as follows: U.S., international, and EM stocks will all have losses. Despite their lower valuations, foreign markets will be dragged down by falling U.S. stocks, but U.S. stocks will experience the steepest declines. Core bonds should provide a modest rate of return; however, credit-oriented bond funds will decline in price due to the deterioration of economic conditions.

VCS EXPECTATION

We tend to more agree with the BCA outlook, primarily driven by the fact the Fed has clearly revealed a change of course for 2019, with an emphasis on data-dependency verses the more hostile autopilot strategy of raising rates they broadcast last year. We recently witnessed some generally positive economic reports as well as improved projections for 2019. The forward P/E ratios of the US and global stock markets have returned to a more reasonable level of around 15X due to the fourth quarter market correction. And a trade deal with China would be perceived as extremely positive for the markets. Although a recession is inevitable, we tend to agree with BCA that such an event may be years away, and a modest growth, low inflation environment could certainly be a tailwind for stock prices in 2019. We're not suggesting adding to stocks in 2019 is warranted; however, it is not our current intent to reduce stock levels further.

## Closing Thoughts

The financial markets proved extremely challenging in 2018 across the board. A historically high percentage of markets posted losses for the year. Several stock markets and asset classes fell into official "bear market" territory, dropping more than 20% from their highs.

Earlier in this commentary, we presented two possible scenarios for 2019, as well as our own. However, no one truly knows what 2019 will bring and market participants and analysts will undoubtedly be surprised with what takes place. The only certainty is the lack of certainty.

But, our confidence in the investment vehicles we use remains high, and we are optimistic about their potential for strong relative performance in the years ahead. All our recommended products are currently rated either "A" or "B" based on our proprietary model, Performance Checker. However, we continually update our due diligence on these products and will make changes when appropriate.

Successful investing is a process of consistently making sound, well-reasoned decisions over time, and across market and economic cycles. If we continue to execute our approach with discipline and remain patient during the inevitable periods when our strategies are out of favor, we have no doubt we will continue to achieve successful and rewarding long-term results for our clients.

As always, we appreciate your confidence and trust in Virginia Capital Strategies, Inc. and we wish everyone a happy and healthy New Year.

Sincerely,

Stephen J. Bowery, CFA, CFP