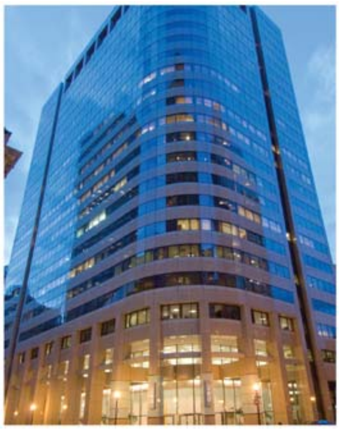
TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
January 3, 2019

OUR VIEW



The market may have overreacted to some of the latest developments in a turbulent year, and December's market slide is more likely to be a pause in the bull market rather than the start of an extended bear market.

In response to the turbulent end to 2018, we are deviating from our normal publication schedule to provide you TFC's market outlook for 2019. Later this month, we will also provide a "2018 in review" letter to accompany year-end statements.

Market Volatility

Market volatility in December tested the emotions and confidence of even the most experienced investors. The resignation of James Mattis as Secretary of Defense, rumors that President Donald Trump would fire Federal Reserve Chair Jerome Powell and the shutdown of the U.S. Government were unwanted gifts for investors hoping for a restful holiday season.

The market may have overreacted to some of the latest developments in a turbulent year, and December's market slide is more likely to be a pause in the bull market rather than the start of an extended bear market. Government shutdowns are becoming a more frequent occurrence, and we are hopeful that this shutdown will end shortly into the New Year. It is unclear whether Trump can legally fire Fed Chair Powell, and doing so would meet with opposition from both Democrats and Republicans on Capitol Hill. Fed policy wouldn't likely change if Powell were removed from office, as the remaining members of the Board of Governors would be united in defending the independence of the central bank.

2019 Outlook

TFC's outlook is heavily influenced by our expectations for economic growth, interest rates, and trade policy. We are also paying close attention to geopolitical issues that may influence market direction. For example, ongoing developments in the Brexit process will certainly be in the headlines in the coming weeks.

Economic growth is slowing from the rapid pace of the first three quarters of 2018. Global manufacturing indicators are weakening, a consequence of uncertainty about trade policy and slowing economic growth in China. Manufacturing growth continues to expand in most of the world, albeit at a slower pace. China is a notable exception, however, with the most recent data signaling a slight contraction in manufacturing activity. The housing market has also lost momentum. Although home prices have been rising, housing market indicators such as housing starts and mortgage applications are uninspiring. Rising interest rates, tax changes reducing the desirability of home ownership, and a shortage of entry level homes are among the factors contributing to the housing slowdown. Falling oil prices contributed to December's market volatility, as investors worried that oil prices were a signal of collapsing economic growth. It is our view that the fall in oil prices has more to do with an abundance of supply rather than a shortage of demand. The Trump Administration granted waivers of sanctions on Iranian oil exports to eight major importers, which effectively added more than 1 million barrels per day to the global supply of oil. The American consumer remains a strong engine for economic growth. Consumers are benefiting from a tight job market, long-overdue wage increases and healthy personal balance sheets. Solid retail sales this holiday season offsets much of the negative news elsewhere in the economy. Overall, although U.S. economic growth will slow from the rapid pace of the first nine months of the year, 4th quarter GDP growth is projected to remain above-trend for this economic expansion.

Second-guessing the Fed is a popular pastime, but we disagree with Trump's assertion that the Fed is to blame for the economic slowdown and market downturn.

The Fed raised *interest rates* four times in 2018. Second-guessing the Fed is a popular pastime, but we disagree with Trump's assertion that the Fed is to blame for the economic slowdown and market downturn. The Fed's actions are consistent with the mandate to promote maximum employment, stable prices, and moderate long term interest rates. From the Fed's perspective, tight labor markets are creating long-overdue wage growth, fiscal stimulus may contribute to inflationary pressures, and tariffs may be inflationary in the short-term. By raising rates to at least a "neutral" level and shrinking the Fed's balance sheet, Powell is trying to regain the flexibility necessary to support the financial system during the next recession. The Fed is also aware that past periods of "easy money" gave rise to excesses in commercial and residential real estate, technology, and commodities. However, the downturn in equity prices and widening of corporate credit spreads relative to government bonds seem to make that task less critical. We expect slowing growth and the flattening yield curve to cause the Fed to hit the "pause button" on rate hikes in early 2019.

Trade policy has far-reaching implications for economic growth and market sentiment. Although U.S. companies were expected to boost capital spending in response to corporate tax reform, business spending has fallen far short of expectations. Tariffs and trade tensions create uncertainty about input costs, supply chains and potential tariffs, diminishing the enthusiasm of corporate CEOs to initiate capital spending projects. The announcement of plant closures and job cuts by General Motors (GM) highlights the challenges faced by many American manufacturers, and disconnect between political promises and economic realities.

Although there is likely to be a "grand bargain" with China on trade before the 2020 election, the next year may be filled with periods of hope and despair much like that experienced in the days following the Trump/Xi dinner at the G20 Summit in December.

The disconnect between politics and economics is particularly important in the debate about trade with China. Despite some of the claims made by policymakers in Washington, China's economy is far from collapsing. China's economy did grow at its slowest rate since 2009, with reported third-quarter 2018 GDP growth of 6.5% (private sector estimates are that growth was closer to 5%). Slowing growth in China has more to do with credit tightening designed to curtail "shadow banking" activities than with tariffs imposed by the U.S. Although trade was once a significant driver of Chinese economic growth, net exports now represent only about 2% of Chinese GDP. Exports to the U.S. represent less than 20% of total Chinese exports. China is softening the impact of tariffs on exporters by allowing its currency to depreciate. China is also building ties to expand production capacity and enable more trade within Asia. Consequently, the ultimate beneficiaries of a trade war between the U.S. and China may be Southeast Asian countries such as Vietnam, Thailand and Malaysia.

Marko Papic, geopolitical strategist for BCA Research, offers a worthwhile framework for thinking about geopolitical issues. Papic believes that geopolitical decisions are shaped by constraints rather than preferences. The reduction in American soybean and iPhone sales to Chinese consumers is an early indication that trade conflicts create very real economic costs. Trump might "prefer" to escalate trade disputes with China for the remainder of his first-term as President, but he ultimately will be "constrained" by the negative impact of a protracted trade war on U.S. unemployment and economic growth. Although there is likely to be a "grand bargain" with China on trade before the 2020 election, the next year may be filled with periods of hope and despair much like that experienced in the days following the Trump/Xi dinner at the G20 Summit in December.

TFC FINANCIAL
The Financial Counselors

The most likely scenario for 2019 is a growing but slowing economic environment.

Closing Thoughts

The most likely scenario for 2019 is a growing but slowing economic environment. Compromise on trade and a pause in interest rate hikes would likely be a catalyst for a relief rally in many of the segments of the market that have struggled in 2018.

We understand that the steep downturns in 2000 and 2008 remain fresh in investor consciousness. However, we see few parallels to the major bear markets of 2000 and 2008. Going back further in time, we also fail to see many parallels to the early 1970's bear market. In comparison to 2008, there isn't a real estate bubble, bank leverage is far lower than was the case a decade ago, and regulators have considerably more visibility into derivatives usage. Equity valuations are far from the distorted levels of 1999, and capital spending has been far more muted. Unlike the 1970s, inflation remains under control, with oil prices falling and wages rising moderately despite tight labor markets.

The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the market."

We concur with thoughts from two investors we admire, Vanguard founder John Bogle and Oaktree Capital's Howard Marks. Bogle suggests creating enough liquidity to cover your near-term financial commitments. "If I had a big liability in a year, I'd get prepared for it right now," says Bogle. "You want to be able to fund it without pressure." But for a long-term goal, such as retirement? "Keep investing, no matter how frightened you are." Marks recently shared his outlook: "Move forward, but with caution. The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the market."

As always, we welcome your comments and questions. Please contact us or your TFC advisor should you have any questions or concerns. Our 2018 in review letter will be published shortly, and will include information about 2018 performance and portfolio positioning as we start 2019.

Sincerely,

Daniel S. Kern, CFA, CFP®
Chief Investment Officer

Renée Kwok, CFP®
President & CEO

TFC Financial Management, Inc.
260 Franklin Street, Suite 1888, Boston, MA 02110
p 617.210.6700 | f 617.210.6750 | tfcfinancial.com