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The contrast between earnings growth and equity market performance in 2018 reminds us, should we need reminding, that financial markets inherently look forward. With corporate tax cuts largely priced into the stock market by late January, the earnings growth reported throughout the year generally failed to impress. Instead, markets gradually turned their focus to 2019, riding increasing waves of concern regarding the ongoing trade war, the Federal Reserve's comments on interest rates, and the government shutdown during the last weeks of total Republican control. Meanwhile, our outlook has remained relatively steady, focusing on long-term, leading economic indicators rather than the volatile news cycle. While economic and geopolitical risks remain elevated, a broad set of data continues to forecast positive, though slower, growth in 2019, for both the U.S. and the global economy. We have clearly turned the page from the blind optimism of 2017 to a more aware – and nervous – investor ecosystem, but lower valuations have helped to balance forward risks and returns thus far in 2019.

The Changing Tide of Investor Sentiment. Our quarterly outlooks during 2018 tracked the changing tide of investor sentiment, from an exuberant short-term focus on the 2017 tax bill and its effects on corporate earnings, to widespread angst about whether 2019 will bring the start of the next recession. For much of the year, more defensive, large-capitalization, and growth-oriented stocks led the market. We felt that this appropriately reflected both the strength of economic data and the likelihood of softening economic growth ahead. At this point, we suspect that sentiment may now be swinging too far towards pessimism.

In this new, more volatile market environment, anxious investors have rapidly rotated through subjects of concern. The Federal Reserve has continued its gradual and data-dependent process of raising interest rates, but clumsy comments by Chairman Jerome Powell led to agitation and speculation. Meanwhile, as the collateral damage of the ongoing trade war extends to high-profile products such as iPhones, investors are reconsidering how to price geopolitical risks with highly uncertain magnitudes and timeframes.

While prior government shutdowns have had limited effects on economic growth, Trump's threats to indefinitely extend the current Federal agency closure have raised more investor concerns and speculation. By the end of the year, the market seemed to agree with our data-driven late-cycle outlook, yet day to day sentiment remains uncertain.

Data Trends and Long-Term Projections. We have consistently argued that the 2017 tax bill's effects on earnings and economic growth would only be short-term in nature, and that consumer and investor optimism was misplaced. Our call now appears to be priced into the market. Forecasts for 2019 earnings growth are lower than for 2018, and the Conference Board's Consumer Expectations Index is at its lowest level since Trump's inauguration. However, in spite of both stock and bond market volatility and recent economic data softness, neither markets nor data are indicating a near-term recession. The consensus estimate of real GDP growth is 2.6% in 2019, down only slightly from 2.9% in 2018, and still above average for the current cycle. Other data, though also coming off of cycle highs, remain relatively strong as well. Employment continues to grow, with wages incrementally improving and bringing new entrants into the labor market. Consumer balance sheets appear very healthy, with household debt service coverage at a 40-year low. Other leading economic indicators including Purchasing Managers Indices are still well above contraction or recession levels.

Key Risks. As always, there are many sources of risk and uncertainty to our economic outlook, some of which manifest more directly and rapidly than others. Employers report difficulty hiring at this low unemployment rate, and it is unclear how much additional labor force elasticity remains, even though increasing wages have brought new, "undiscouraged" workers into the labor market. The Federal Reserve has also continued to press interest rates higher, affecting sectors such as housing and autos. These are common late-cycle headwinds, and while their effects tend to emerge slowly, they will make it increasingly difficult for economic growth to remain strong.

Furthermore, as growth slows, minor errors will have greater potential to tip the economy into recession.

Other types of risks are less predictable, and can develop much more rapidly. While we note that trade wars are neither good nor easy to win, our capacity for anticipating President Trump's negotiations is limited. Trump has acknowledged that the trade war is affecting financial markets, and it is possible that market volatility will impact his motivation to make a deal with China. Changing sentiment is itself a risk. Spending and, particularly, investments by both companies and consumers depend on confident expectations of future growth. Emerging recession fears are potentially self-fulfilling if enough companies and consumers respond to their concerns by delaying or avoiding hiring, investing, and spending, even though we do not now see the type of excesses that led to past market collapses.

Fourth Quarter Performance. Global equity markets declined aggressively during the fourth quarter, reversing the prior gains of the year. The S&P 500 lost -13.52% during the quarter and ended the year down -4.39%. The small capitalization S&P 600 fell -20.12% for the quarter and -8.52% for the year. Growth stocks underperformed value stocks in the fourth quarter, but remained the leader for full-year performance. The Russell 1000 Growth Index lost -15.98% during the quarter, ending the year down just -1.52%, while the Russell 1000 Value Index lost -11.73% for the quarter and -8.28% for the year. The MSCI All Capitalization World Index, excluding the U.S., declined by -11.45% for the quarter and -13.82% for the year, with emerging markets partially recovering from their earlier underperformance. The largest declines occurred in cyclical sectors, including Energy, Industrials, and Information Technology. Only the Utilities sector generated positive returns in the S&P 500 during the fourth quarter, while other defensive sectors including Healthcare, Real Estate, and Consumer Staples notched mild declines. After declining for the first nine months of 2018, bond prices increased as yields declined. The Bloomberg Barclays US Government/Credit Intermediate Index returned +1.65% for the quarter and +0.88% for the year, while the Bloomberg Barclays Intermediate 1-10Y Municipal Bond Index gained +1.69% and +1.28% for the quarter and year, respectively.

Valuation and Positioning. Equity valuations retreated during the fourth quarter, with the price-to-earnings ratio of the S&P 500 ending December at 14.4 times next twelve month earnings. The cyclically-adjusted P/E ratio also declined, to 29.0, near its 25-year average. The earnings yield of the S&P 500 increased to 6.9% during the quarter, while 10-year TIPS yields increased to 0.97%, suggesting that stocks will return approximately 5.9% more than bonds in the next year. Valuation-based indicators do not consistently predict near-term returns, but we note that lower price-to-earnings ratios are well-correlated with five-year forward returns. We expect continuing volatility in financial markets, but consider the long-term risk-to-reward ratio of the equity market to be reasonably balanced. As such, we continue to maintain a neutral asset positioning, and a neutral style within our equity strategies.

We continue to feel that our emphasis on companies with sustainable models for growth is both appropriate and wise, especially in an unsettled market environment. In many ways, 2018 is likely to mark the beginning of the real transition of our energy system from fossil to renewable fuels. This transition is occurring, not because of the hard work in Paris, the details slogged out in Katowice, or the physical devastation suffered by many due to the changing climate, but because of economics. In 2018, utilities voluntarily pledged to give up carbon electricity in fossil fuel-rich states Colorado and Indiana. Cities and states including New York, Washington D.C., Oregon and Hawaii pledged to decarbonize. Corporate purchases of wind and solar generated electricity skyrocketed. In 2018, building new wind and solar became cheaper than running existing coal or gas generation assets. We are now in a full-fledged transition to a renewable energy-based economy.

We are addressing the energy transition in multiple ways across our different equity strategies. In all of our strategies, we seek to invest in companies that create the infrastructure and conditions necessary for the energy transition, including wind turbines, batteries, smart-grid meters, and transmission lines linking far-flung renewable energy generators with urban areas. In our Fossil-Fuel Free, Sustainable Opportunities, and Global Equity strategies, we avoid traditional energy companies and seek companies producing renewable energy. In our Large Cap, All Cap, and Small/Mid Cap Core strategies, we encourage the traditional energy companies that meet our rigorous environmental criteria to address the energy transition and challenge them to continually reduce their environmental footprint. Across all of our strategies, we invest in sustainable leaders that share our collective urgency to transition to a renewable energy-fueled future. We are optimistic about the opportunities becoming available to support the transition.