The U.S. stock market fell dramatically in the 4th quarter after being in positive territory for most of 2018. The Standard & Poor's 500 Index declined 19.8% from its September high to its Christmas Eve low, barely avoiding official bear market status. In all, the S&P was down 14% for the quarter and more than 6% for the year, the market's first negative year since 2016.

If ever we needed to be reminded that the stock market is forward looking, and not just a reflection of the status quo, the past year provided a valuable lesson. Stock prices fell dramatically during a year of accelerating economic growth and rising corporate earnings. When fourth quarter reports are complete, it is expected that earnings will have risen more than 20% over year earlier levels, the best earnings growth since the post-recession year of 2010.

All eleven sectors of the market posted earnings gains, led by the energy sector whose earnings more than doubled last year. Yet, in terms of price performance, energy was, by far, the *worst* performing sector of the market. The energy sector Exchange Traded Fund (ETF) was down 21%, despite the strong earnings comparisons. The earnings of financial companies were up almost 25%, but stock prices in that sector were down an average of 16%. Other economically sensitive sectors, such as materials and industrials, posted similar results, experiencing price declines of 15% or more despite strong earnings gains. The only sector that posted positive price performance for the year was health care, which was up a modest 3.1%.

The U.S. market was not alone in its pain, but was instead part of a global decline in equity prices. In fact, our market was one of the better performers globally, with a negative 4.4% total return, including dividends. Only Brazil at -2.1% experienced better (less worse?) results among the world's most significant markets. Australia and Japan were each off more than 11%, European markets were all down between 14% and 22%, and China fell almost 28%. CNBC's Jim Kramer once said that "there's always a bull market somewhere." That was definitely not true last year. For the first time since 1972, no major equity, fixed income, or commodity benchmark posted even a 5% return.

Clearly, as the year progressed, the market began to look past the positive news of the present to a more challenging environment in 2019 and beyond. The 4th quarter is the last quarter in which earnings comparisons will be aided by the enormous tax cuts that were enacted in late 2017. Beginning with next year's first quarter, earnings will be reported on an apples-to-apples basis, and the consensus expectations are that earnings growth will slow to 8% next year. There is also a general acknowledgment in more responsible quarters that those expectations may well come down further if the drag from last year's trade skirmishes turns out to be worse than forecast, or if the U.S. and China fail to finalize a new agreement by the March 31 deadline

The other major concern for next year is the future course of Federal Reserve policy, and the growing fear that the Fed may continue on its present course for too long and kill this period of economic expansion prematurely. This fear was stoked in early October by the comments of Fed Chairman Powell, who characterized the Fed Funds rate as being "a long way from normal." One could reasonably infer from this comment that short term rates were headed higher, at a time when economic growth was decelerating and the yield curve was already precariously close to inverting. An inverted yield curve, i.e. when short term rates are higher than long term rates, has been shown to be predictive of recessions in the past. In any event, Chairman Powell has become more judicious in his subsequent commentary, and has more recently characterized the Fed Funds rate as "just below normal," so concerns over the future direction of the Fed have moderated for the moment. We will stay tuned.

On a positive note, the market's decline has dragged the market's forward price/earnings ratio down to 15 times 2019 earnings, the lowest valuation level in five years. Many areas of the market are trading at even lower valuations, giving long term investors a reason to stay the course. Short term risks remain, and the volatility of 2018 is likely to continue into the New Year. In addition to the earnings and interest rate concerns noted earlier, the government remains partially shut down, trade woes persist, and a potential debt ceiling crisis looms by the second quarter. We will no doubt have more to say about those eventualities as the year goes on. But for the moment, and at current levels, we believe that most of those risks are already priced into the market, and the worst of the market decline is behind us.

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