

Take a Look Ahead

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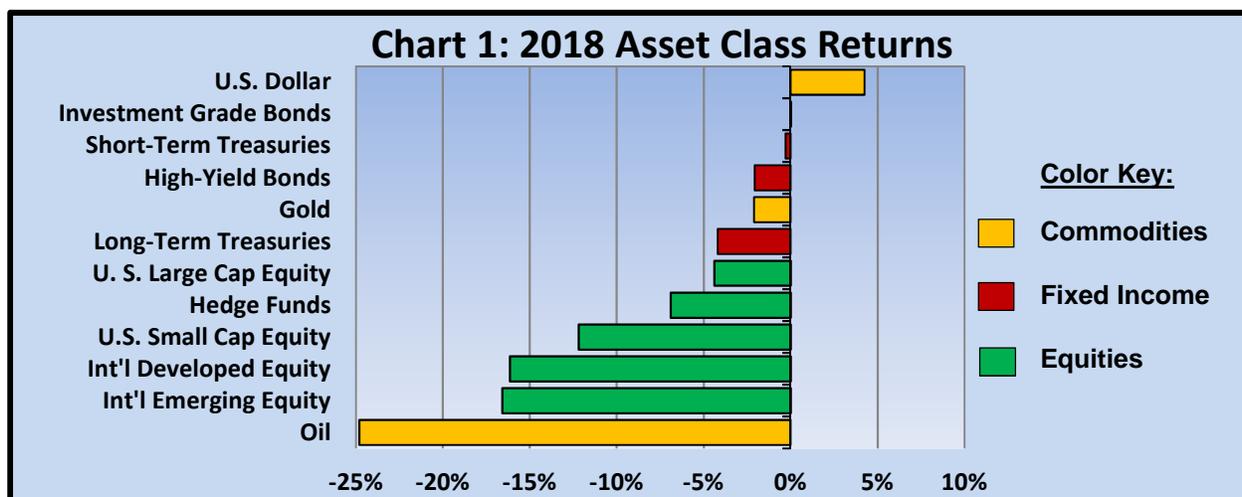
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What comes after the year in which nothing worked? For American investors, 2018 was a washout, in which not a single asset class produced at least a 5% return – the first time that has happened since at least 1972. Chart 1 shows the annual returns for a variety of asset classes in 2018; the U.S. dollar gained against other currencies, but just about everything else lost value.

The paradox of last year is that despite ugly investment markets, our clients' portfolios held their value remarkably well. Indeed, taking 2017 (the year everything worked) and 2018 (the year nothing worked) together, most investors saw very good overall returns. But with the sour taste of last month's collapse still fresh, will 2019 give us peace of mind?

Markets are forward-looking by nature, so it's tempting to heed the eternal wisdom of the baseball Hall of Famer Satchel Paige¹: "Don't look back. Something might be gaining on you." On the other hand, security prices reflect both expectations and history. It is in this context that we undertake our annual review of the economy, markets, and our investment performance. We can then construct our investment strategy for the coming year.



Source: FactSet

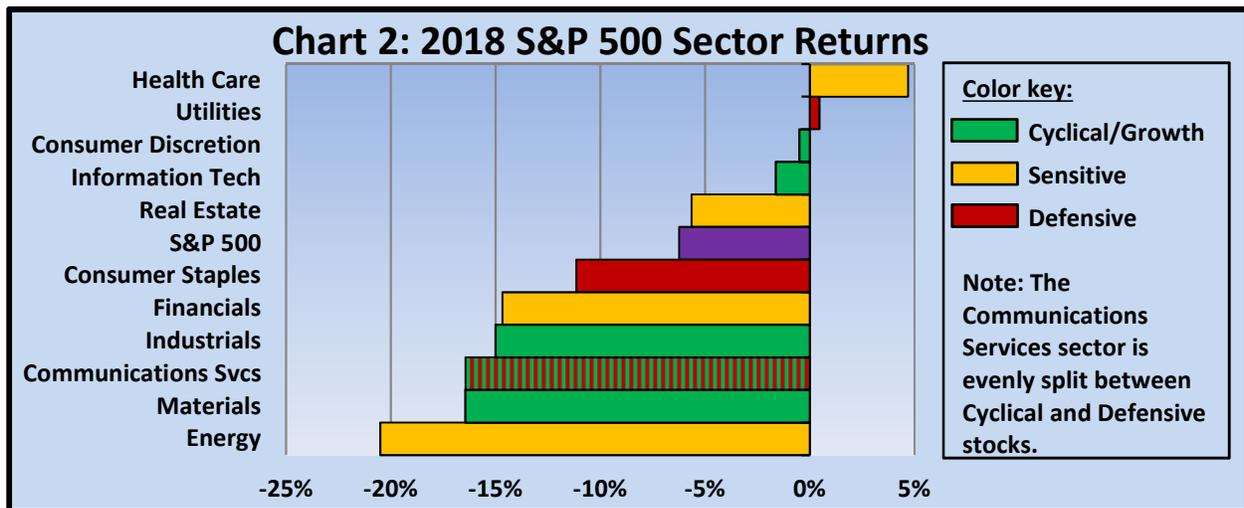
¹ The peripatetic Paige never played for Boston; the Braves weren't interested, the Red Sox didn't integrate before he retired, and the eponymous rock-n-roll band wasn't formed until 20 years after his playing days had ended.

2018 Markets Review

Domestic equities. The 2018 U.S. stock market roller-coaster included two smoking rallies and two flame-out dives; when the dust settled, stock prices had dropped by 6% for the year. Including dividends, the total return on the large-cap S&P 500 index was -4.4%. Yet corporate earnings and dividends – what investors are buying when they buy stocks – soared by more than 20%. Faced with growing political and economic uncertainty, investors sharply cut the price they were willing to pay for a dollar of earnings; the market’s P/E ratio shrank from 19x to 14x.

Not only was the overall stock market volatile, but individual sectors and companies showed marked divergence through the year; good stock-pickers could hitch a ride on the right sectors to beat the market.² Chart 2 shows the dramatic difference in performance from the best sectors to the worst; within some sectors, similar disparities appeared between the best and worst stocks. A further paradox is that performance wasn’t neatly split between “risk-on” and “risk-off” groups: Defensive stocks like utilities weren’t much better than cyclical areas like technology.

It was a year in which individual stock selection could largely offset the market’s overall decline – yet hedge funds, which theoretically should shine in such environments, fared even worse than the overall markets. Equity hedge funds as a group in the last decade have lagged rising markets, they have exacerbated falling markets, and they have charged high fees throughout.



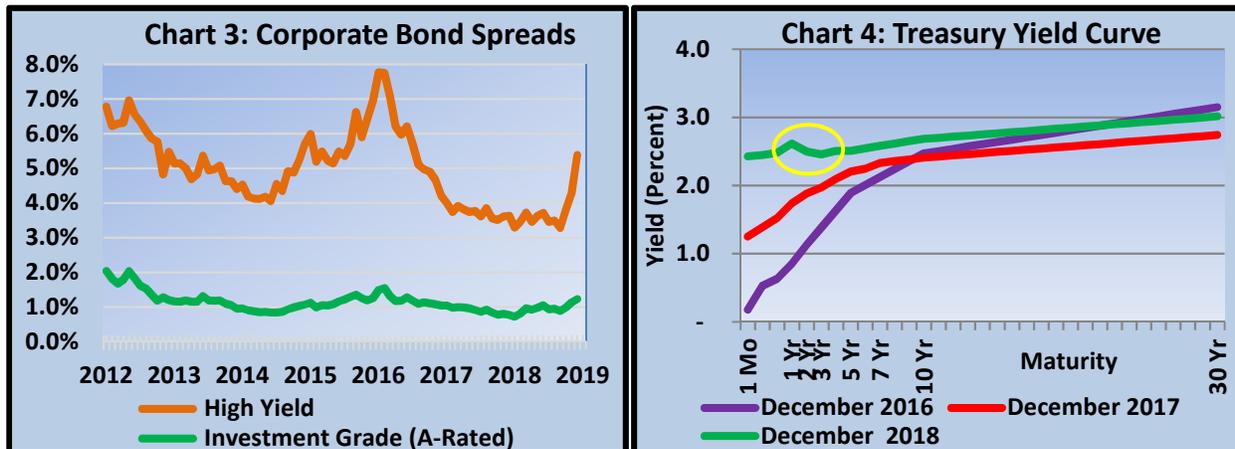
Source: FactSet

Global equities. Reverting to the 2009-2016 pattern, international stocks badly lagged domestic equity markets last year, as foreign economies stumbled due to monetary policy missteps and political upheaval. That was especially true in Europe, but emerging markets worldwide also tumbled. China’s economic slowdown created ripple effects on demand across all emerging markets, and the dollar’s rebound made dollar-denominated sovereign debt more expensive to service. Falling commodity prices crushed many producers. The incipient Sino-American trade war cast a pall over global markets.

² Contrast this to years like 2016, which had low dispersion of returns and offered investors few opportunities to outperform through stock selection.

Fixed income. The Federal Reserve raised its benchmark Fed Funds rate four times last year, and accelerated the roll-off of its long-term balance sheet holdings. In doing so, the Fed tightened financial conditions markedly and raised the possibility that central bank overreach might tip the U.S. economy into recession; investors fled corporate bonds for the safety of Treasury debt. The flight to safety caused a spike in credit spreads, as investors required higher premiums to own corporate debt (Chart 3).

Concurrently, bond investors still feared that a historically tight labor market might cause an uptick in inflation; that fear nudged long-term interest rates higher. In a tumultuous year for bond investors, interest rates rose across all maturities, as shown by the green (2018) and red (2017) lines on Chart 4; still, the Fed’s aggressive policy dominated other factors, and the yield curve flattened sharply by year-end. Indeed, the slight kink in the curve between 1- and 5-year maturities (circled in yellow on Chart 3) represents what could become a full yield curve inversion, in which long-term rates are lower than short-term rates. Bond investors share more than a feeling that such a yield curve inversion could lead to recession; they have history to validate that fear. Every sustained yield curve inversion since WWII has preceded a recession.

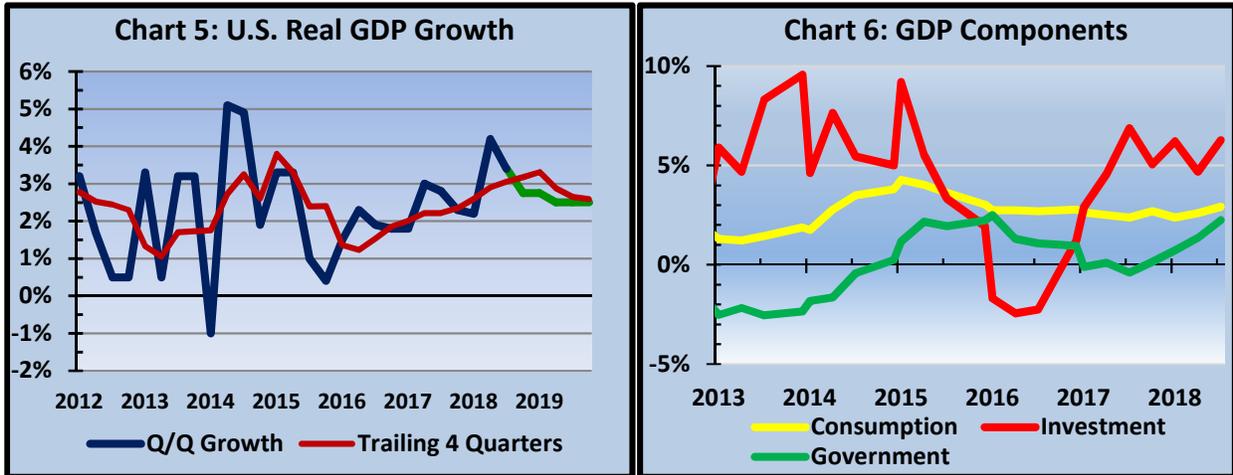


Source (both charts): FactSet

Domestic Economy

The contrast between jittery markets and a solid economy was stark. Perhaps investors were wondering whether the proverbial glass wasn’t half-full or half-empty, but entirely full: Perhaps economic conditions were so good that the only possible change would be downward. Chart 5 shows that the U.S. gross domestic product (GDP) grew by nearly 3% last year, and Chart 6 shows that all major sectors of the economy contributed nicely. But with scarcely 1% population growth and 1% productivity growth (though this is notoriously difficult to measure), the 3% GDP growth was higher than our demographic profile can sustain for long periods of time.

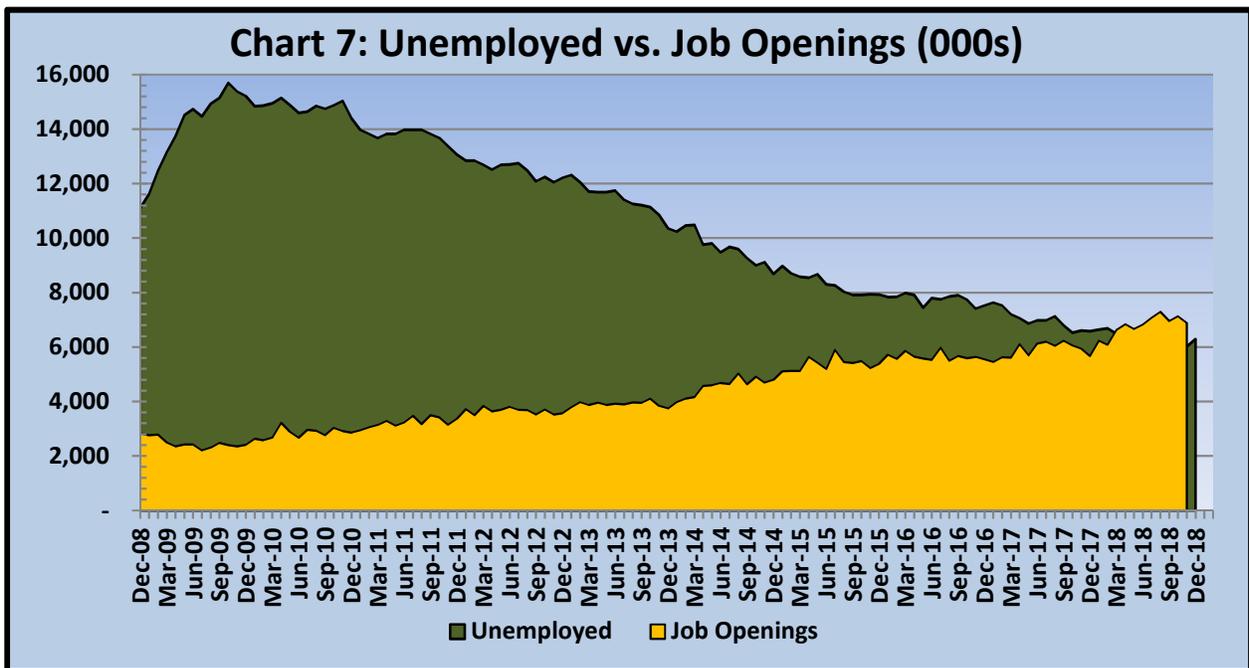
The fuel that drove 2018 economic growth unsustainably was debt; we borrowed our way to faster growth. Unlike the debt-fueled growth of the early 2000s, however, the principal borrower today is the U.S. government. Uncle Sam is running deficits of more than a trillion dollars a year to finance safety-net entitlements and tax cuts. Private individuals and corporations still have much healthier balance sheets than they did a decade ago.



Source (both charts): Commerce Department, Bureau of Economic Analysis

The biggest conundrum in the U.S. economy is the labor market. Unemployment remains at fifty-year lows, and monthly job creation numbers have remained positive for a very long time. Chart 7 shows that the U.S. currently has about a million more job openings than unemployed workers, hinting that skilled workers should be able to command higher wages; the conundrum is that hourly wages are actually growing only very slowly.

What's not shown in Chart 7, however, is that there are still about a million *more* potential workers who don't have jobs but whom the government doesn't consider unemployed because they have not been actively seeking work; these people have indicated that they would take a good job if it became available, and in fact we have seen labor force participation beginning to tick up again, as shown in Chart 8.



Source: Labor Department, Bureau of Labor Statistics



Source: Labor Department, Bureau of Labor Statistics

2019 Economic Outlook

U.S. GDP Growth. The economy last year was turbocharged by the Tax Cuts and Jobs Act, so a slowdown is almost inevitable. We anticipate GDP growth of about 2.3% this year, driven by rising employment, sustained business investment (thanks to lower corporate taxes and robust cash flows), and financially healthy consumer balance sheets.³

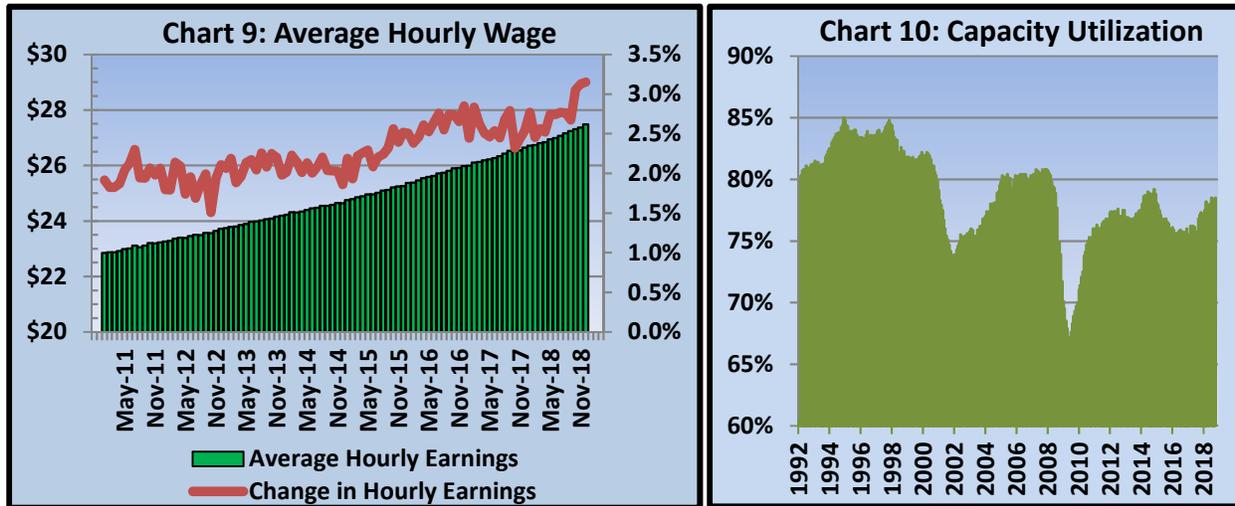
Two big uncertainties hang over our forecast like a sword of Damocles. One is how the ongoing trade negotiations with China will be resolved: If the U.S. and China can agree on a package of intellectual property protections, market access rules, free flow of capital, and reduced tariffs, then the economies of both countries could accelerate due to an increase in trade; on the other hand, an impasse (or worse) could impede global trade and cut deeply into GDP growth.⁴

The second important uncertainty is how the Federal Reserve develops its monetary policy through the year. The Fed's most recent "dot plot" of expected fed funds rates, released last month, shows that at that time the central bank still expected to raise rates twice this year. Yet investors apparently think that the Fed should stand still; Treasury futures contracts imply that the probability of any hike this year is nearly zero, and there is even about a 20% chance the Fed may cut rates by next December. This divergence suggests that the Fed is running a substantial risk of spooking the market with overly hawkish policy. The fear is simply that excessive rate hikes could deter borrowing and thereby choke off economic growth.

³ The ongoing federal government shutdown hasn't yet had any measurable impact, but it's reasonable to expect that 800,000 federal workers may change their spending habits during the shutdown and possibly even beyond its eventual resolution, which could also have ripple effects through the private sector. We do not incorporate a lengthy shutdown into our modeling.

⁴ Here's the arithmetic: The U.S. currently imports about \$500 billion annually from China, less than 3% of our GDP. The threatened 25% tariff would therefore represent a tax of about 0.7% of GDP; the ripple effects from this could expand the negative impact to more than 1% of GDP, cutting the year's growth rate nearly in half. It's not at all trivial!

Inflation. Ever since the current recovery and expansion began in 2009, inflation has been notably subdued, kept down by excess slack in the system – most notably in employment and production capacity. These factors are getting tighter; we saw hourly wage gains pick up modestly in 2018, from 2.5% growth a year ago to 3.2% today (Chart 9). Capacity utilization came closer to the 80% threshold that typically signals a need for major new investments (Chart 10). Although higher mortgage rates and the imposition of tax penalties for high-end homeowners⁵ dented demand for new homes, prices nonetheless still rose more than 5% through the year. Health care costs continued to rise at mid-single-digit rates as well.



Source: Commerce Department

Source: Federal Reserve

Still, we think inflation will remain modest through the coming year. Most notably, oil prices have plunged in recent weeks from over \$75/barrel to about \$45 and are likely to remain in a \$45-\$60 trading range. The strong dollar (up 4% last year against a basket of other currencies) has kept import prices down and offset the sting of initial tariffs imposed on China and Europe. We think the dollar has hit a plateau now that the Fed is close to the end of its rate-hike cycle, which may lead to a slight uptick in inflation from 2018 levels. The bigger risk, however, is that the U.S. and China may not be able to conclude a trade agreement, leading to the imposition of 25% tariffs on nearly all imports from China; that could drive inflation higher.

Corporate Profits. While not the same thing as GDP, corporate profits do reflect economic growth and are in some ways a better measure of the stock market’s earnings power. Two years after bursting out of a profits recession, EPS growth rates have almost certainly peaked; the 25% growth posted in the September 2018 quarter will likely be seen as the high-water mark. Heading into 2019, the one-time benefit of the corporate tax cut is now in the rear-view mirror, knocking perhaps 10 percentage points off the EPS growth rate for this year. Revenue growth has been outstanding at nearly 10% but is likely to slow this year. Profit margins may come under some pressure from tariffs and capacity constraints. All told, we think EPS growth for 2019 will be between 5% and 10%, and we have even seen some forecasts for barely 2% profit growth.

⁵ The new tax law caps deductibility of state and local taxes at \$10,000 and cuts the ceiling for deductibility of mortgage interest from \$1 million principal to \$750,000 for new mortgages. These changes have mostly affected high-end homes in high-tax states, deterring many homeowners from “trading up.”

Interest Rates. More than three years after the Fed finally began lifting short-term interest rates, the fed funds rate has hit about 2.5% – only about one percentage point below where it has been at comparable points in previous economic cycles. The Fed’s Open Market Committee “dot plot” anticipates two hikes this year, while financial markets anticipate none. With a flat yield curve, *any* rate hike could invert the yield curve, driving short-term rates higher than long-term yields – a scenario the Fed would like to avoid. We think markets are right: Unless the stock market rockets forward and the yield curve steepens considerably, we expect no change in the fed funds rate this year. We do think the Fed will continue reducing its long-term bond holdings, which has shrunk the growth in money supply and thereby tightened financial conditions more quickly than many investors (and Fed governors) had expected.

International Economies. After showing considerable promise in 2017, many foreign economies stumbled badly last year, and their problems show no signs of abating. China’s growth rate is slowing, as a mountain of debt weighs on the corporate sector (especially state-owned enterprises); the government is trying to shift from an investment-driven focus on infrastructure to a consumer-driven economy, with limited success. China’s economy has already felt the pain of initial U.S. import tariffs, as weaker export levels have led to slower demand growth within China.

Europe, too, has felt the pain of slowing global trade. The spat between the U.S. and China has caused collateral damage to other trade-oriented economies, including Germany and Japan. The Brexit saga has chilled Anglo-European trade, which severely hurts the U.K. but only mildly dents the European Union economies. Resolution of these twin trade challenges could lead to a rapid acceleration of global trade (benefiting all economies), but we think it’s still premature to forecast successful outcomes for Brexit or for a Sino-U.S. trade deal.

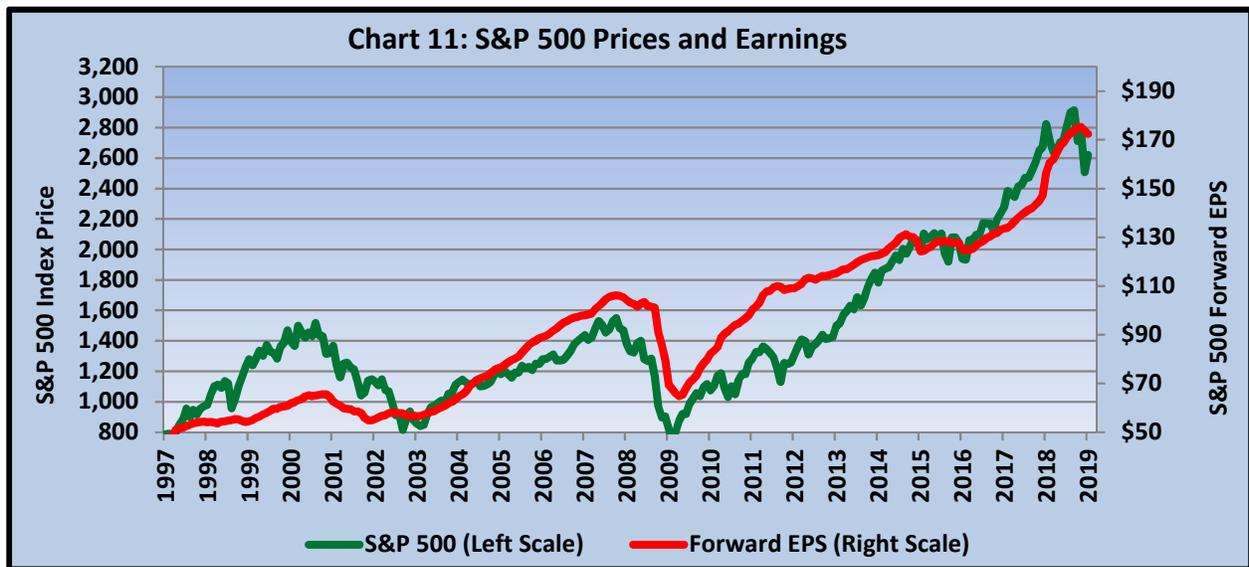
Tactical Asset Allocation. From late 2012 through year-end 2017, we had positioned client portfolios with a significant overweight toward equities. By year-end 2017, however, stocks had risen to a +13.5% overweight, which we judged to be too much exposure to a more expensive asset class. We opted early last year to pare back that overweight position, but we didn’t go far enough. For 2019, we have come full circle to a neutral stock allocation. In the following sections, we discuss our allocations within each asset class.

2019 Portfolio Construction

Bonds. The fixed income market environment is substantially different from a year ago, and we are changing our allocations to adapt to current conditions. The Fed is likely to slow or stop its rate-hike cycle, so we think short-term yields should stabilize after rising for two straight years. The more challenging question is the outlook for long-term yields. Many investors are clamoring for the Fed to reduce the pace at which it is “rolling off” long-term bonds from its balance sheet; if the central bank does slow that process, more money would remain in the financial system and a “risk-on” attitude might prevail. Meanwhile, the European Central Bank is likely to slow or stop its purchases of long-term bonds, which would cause European yields to drift upward. For these reasons, we anticipate that the yield curve will get a little steeper this year (an admittedly contrarian view), suggesting that we should keep our duration slightly shorter than neutral.

Within the context of this slightly short duration (relative to the benchmark index), we are gradually reducing our exposure to credit risk. Although a recession isn't imminent, we can imagine many scenarios that can hasten an economic downturn: A failed China trade deal; a prolonged government shutdown; an overly aggressive Fed hiking rates too far; a strong dollar depressing our exports; and more. Credit spreads remain tight (though no longer at their absolute lowest levels), and investors are simply not being paid enough to absorb these risks. With these possibilities in mind, we have upgraded our credit quality to eliminate high-yield bond funds and replaced them with funds holding corporate debt rated A or better. With less concern about inflation, we have also eliminated TIPS from our model portfolios.

Equities. Although our fixed income strategy is defensive, we are not bearish about the stock market; we think the current equity valuations reflect a deterioration in corporate profits that is unlikely to occur. Chart 11 shows S&P 500 prices contrasted with year-ahead earnings. Market watchers have trimmed their estimates slightly, as indicated by the slight downtick in the red EPS line, but the index's price has dropped by a much greater degree – even after January's rebound. Whenever the green price line is below the red earnings line on this chart, stocks are cheaper than their historical valuation levels; after plunging from September's peak, that's certainly true today.



Source: FactSet

Yet we are not bullish, either. We think that earnings estimates may dip further in the next few weeks, as corporations report their fourth-quarter results and discuss their expectations for 2019. That may lead stock investors to revisit the Christmas Eve lows, and maybe even push prices down a bit further.⁶ For now, then, we are comfortable holding a neutral position in stocks but with an eye to increase our allocation when we sense the market has established a solid foundation.

⁶ The stock market is also vulnerable to the same adverse possibilities that could upset bond investors: China trade, the Fed, strong dollar, etc.

Most of our U.S. equity participation is in individual large-cap companies. We have purchased a biotech sector fund, recognizing that the industry's fundamentals are excellent but that company-specific risk is quite high; by owning a sector fund, we diversify away the company-specific risk but retain exposure to the industry's rapid growth. We are also currently holding the broad S&P 500 index fund pending more targeted investment opportunities as the year unfolds. We maintain our participation in smaller companies through ETFs, in part because they trade at a discount to large-cap stocks, giving us an attractive valuation point. We have redirected some of our international equity participation, retaining our focus on emerging markets and reducing our holdings in Europe. We remain absent from Japan, where economic problems stem from its negative population growth rate.

To summarize, we are positioning our model portfolios and client accounts as shown in Chart 12:

Chart 12: Asset Allocation	New	Jan. 2018	Change
Tactical Equity Weighting	0.0%	+4.5%	-2.0%; slight pullback
Equities:			
U.S. Large-Cap Stocks	75.5%	73.0%	+2.5%; more defensive
U.S. Mid/Small-Cap	3.0%	3.0%	0.0%; no change
SPDR S&P 500 Trust	6.0%	0.0%	+6.0%; tactical opportunity
Energy ETF	0.0%	2.0%	-2.0%; sold during 2018
Financial ETF	0.0%	2.0%	-2.0%; sold during 2018
Industrial ETF	0.0%	2.0%	-2.0%; sold during 2018
Biotech ETF	2.0%	0.0%	+2.0%; tactical opportunity
Total U.S.	86.5%	82.0%	+4.5%
Benchmark	~82.0%	~82.0%	
International:			
MSCI ACWI Ex-US ETF	6.0%	4.5%	+1.5%; global diversifier
Developed Europe ETFs	0.0%	6.0%	-6.0%; weaker prospects
Asia / Japan ETFs	0.0%	0.0%	0.0%; no change
Emerging Markets ETFs	5.0%	5.0%	0.0%; no change
Global Small-Cap ETF	2.5%	2.5%	+0.5%; global GDP growth
Total International	13.5%	18.0%	-4.5%
Benchmark	~18.0%	~18.0%	
Fixed Income:			
U.S. Investment Grade	75.0%	75.0%	-1.2%; six-year ladder
Inflation-Protected ETF	0.0%	7.0%	-7.0%; stable CPI expected
Floating-Rate Notes ETF	0.0%	2.0%	-2.0%; duration risk mgmt.
Short-Term Corp. ETF	3.0%	0.0%	+3.0%; duration risk mgmt.
Intermed. Credit ETF	14.0%	8.0%	+6.0%; quality upgrade
Intermed. Gov't ETF	8.0%	3.0%	+5.0%; curve steepener
High-Yield ETF	0.0%	5.0%	0.0%; quality upgrade

Chart 12 shows targeted allocations for our Multi-Asset model using actively selected individual stocks and corporate bonds. We have developed comparable models for client portfolios that use mutual funds and ETFs instead of individual securities (our “Funds-Based” or “Wealth Accumulation” portfolios), and for variants of the Multi-Asset style including Core (which excludes international assets), ESG Sustainability, and Catholic styles. All of our model portfolios are derived from the same economic analysis and market interpretation, and therefore have analogous asset allocation targets. Individual client portfolios often differ from these models because of factors unique to each client, so these targeted allocations should be read as guidelines rather than as reflections of actual accounts.

2018 Report Card

Finally, we think it is appropriate to evaluate our investment decisions in the year just ended. This evaluation necessarily must cover only hypothetical guideline models; since each client’s portfolio is unique, it would be impossible to judge any individual client accounts here. Instead, we look back to our *On Our Minds* 2018 preview, “Turn the Page,” published January 18, 2018, to review our predictions and judge how well we did.

- U.S. economy. We projected that the U.S. was on track for a second straight year of 2.5% growth, but the actual number appears to be closer to 3%.⁷ We got the basics right: Steady consumer demand, a tighter jobs market, and rising capital spending. We underestimated the favorable impact of tax reform, and consequently also underestimated the power of U.S. corporate earnings growth. We correctly anticipated that inflation would remain a non-issue and that the Fed would nonetheless continue raising rates.
- Asset allocation – by asset classes. For the first time in seven years, our asset allocation decisions failed to add value to client portfolios. Last January, we pared our equity positions from 13.5% overweight to 4.5% overweight. This was the correct direction, but we didn’t go far enough: Bonds outperformed stocks by losing less value. Within equities, our preference for large-cap U.S. over small stocks was vindicated as the small-cap Russell 2000 dropped more than 12%. Cash was the best asset class, returning 2%. Overall, our asset allocation decisions detracted very slightly from investment returns.
- Asset allocation – by geography. We had positioned our portfolios near the benchmark’s 80% U.S. / 20% international blend last year, and the international allocation hurt us. The U.S. outperformed both developed and emerging markets by more than 12 percentage points last year. China’s major market indexes plunged into bear territory, as investors grappled with excessive debt, slowing infrastructure projects, weak exports (in part due to U.S. tariffs), and soft consumer spending growth. European markets fell as it became increasingly clear that the ECB’s ultra-low interest rate regime wasn’t helping spur demand growth. The twin problems of Italy’s fiscal deficit and Brexit also weighed heavily on investors’ minds.

⁷ Final numbers for 2018 GDP won’t be released until early March, but based on the first three quarters and on recent estimates of 4Q activity, we think the final number for 2018 was about 2.8%.

- Fixed income. In client fixed income portfolios, we aim to produce stable and predictable cash flows with limited reinvestment risk; most accounts use a multi-year individual bond ladder. This results in portfolios with shorter duration than most bond benchmarks. Since our objective (cash flow and capital preservation) differs from that of the benchmark (total return), performance assessment is of only limited utility. We do use ETFs and some mutual funds to sculpt overall credit and duration risk, so it is still a mostly fair comparison. Through 2018, we kept our duration close to the market index, and took on some credit risk through our high-yield ETF; we also used TIPS to hedge against inflation risk, and floating-rate loans to hedge against rising interest rates. In retrospect, the duration and floating-rate decisions were correct, as interest rates rose during the year, but the TIPS position lost value because inflation didn't materialize. Our high-yield holdings outperformed the index for most of the year and held their value surprisingly well through December's selloff.
- Equity stock selection. Our client portfolios handily beat their benchmark indexes and were well ahead of our competitive peer group as well. We won't always do as well as we did in 2018, but last year was superb. Our Core equity portfolio models were nearly 200 basis points ahead of the S&P 500 (losing 2.39% vs. the index's 4.38% loss), and more than 300 basis points ahead of the median peer group loss of 5.60%. Similarly, although our Dividend Plus model lost 3.24%, that was more than 400 basis points better than the 6.28% decline in the Morningstar Dividend Composite Index.
- Equity fund selection. While our individual stock selection was outstanding, our mutual funds and exchange-traded funds (ETFs) came up short. In particular, our holdings in energy, financial, and industrial sector funds hurt performance through the year. In global portfolios, our emerging markets and small-company funds were most painful.

All in all, 2018 was a tough year for all investors; nothing (except cash) worked. Yet our equity stock selection and our focus on cash flows in fixed income portfolios helped our clients weather the storm successfully. It's often said that anyone can make money in a rising market; the test of a good money manager is in the response to difficult times; in this respect, we are gratified that our significant equity outperformance enabled us to protect our clients through the turbulence. We approach 2019 with hope for what can go right, but also keen awareness of what can go wrong. This will be a challenging year in many ways. Things have changed and will continue to change; we begin anew each January at zero. We thank all of our clients for placing their trust in our stewardship of their financial assets, and we hope to see you all in the new year.

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