Colorado Capital
MANAGEMENT

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Economic Review

The dramatic decline in the stock market during the 4th quarter of 2018 was accompanied by a general softening of the U.S. economy. However, most key economic indicators remain positive, resulting in an apparent disconnect between the economy and the stock market.

GDP growth dropped from a robust 3.4% in the 3rd quarter to a still healthy 2.8% (estimated) pace in the 4th quarter. The Fed increased short term interest rates by one quarter point, but longer-term Treasury rates actually declined. Unemployment increased from 3.7% (the lowest level in decades) to a still modest 3.9%. The dollar continued to strengthen, which helped drop core inflation below the Fed's 2% target. Core inflation excludes the impact of oil prices, which fell close to 40% during the quarter on fears of oversupply and slowing demand. Consumer and business confidence indicators remain well above average, although both declined sharply during the quarter. Stock market valuation multiples have dropped to much more attractive levels. Please see the chart on page 4 for current vs. historical valuations for the last 25 years.

Key Economic Indicators			
Indicator	Current (12/31/2018)	3 Months Ago (9/30/2018)	1 Year Ago (12/31/2017)
US Economy			
Quarterly GDP	2.8%	3.4%	2.3%
Unemployment Rate	3.9%	3.7%	4.1%
U.S. CPI (Core)	1.9%	2.2%	2.1%
Interest Rates			
Fed Funds Rate	2.50%	2.25%	1.50%
10-Year Treasury Rate	2.7%	2.9%	2.5%
Currency & Commodities			
Crude Oil (WTI)	$ 45.72	$ 74.45	$ 61.75
Gold Price	$ 1,278	$ 1,192	$ 1,325
Trade Weighted Dollar Index	128.1	125.5	120.0
Confidence			
Consumer Confidence Index	128.1	138.4	123.1
ISM Purchasing Managers Ind	54.1	59.8	59.1
Stock Prices			
Dow Jones Industrial Average	23,327	26,458	24,719
S&P 500 Forward P/E ratio	15.6x	18.0x	20.0x

GDP Growth: U.S. real GDP in 2018 is expected to come in at just under 3%, making it one of the strongest years of the expansion. Consumer spending, the largest component of GDP, remained hot through the year-end holiday season. Growth in real disposable income, high personal savings rates, upbeat confidence and record levels of household wealth are expected to continue to support generous consumer spending.

But some of the factors that contributed to GDP growth this year are beginning to fade. The income-lifting effects of the tax cuts will dissipate in 2019, which should lead to some deceleration in real personal consumption expenditures. Growth in real government expenditures is also set to slow. Higher interest rates appear to have weighed on the housing market recently, and the Fed is probably not done raising interest rates.

That said, the U.S. economy has strong momentum behind it at present, which should keep the expansion intact. As the boost from strong consumer spending and fiscal stimulus wears off, U.S. growth should slow to a still-healthy 2.5% in 2019.

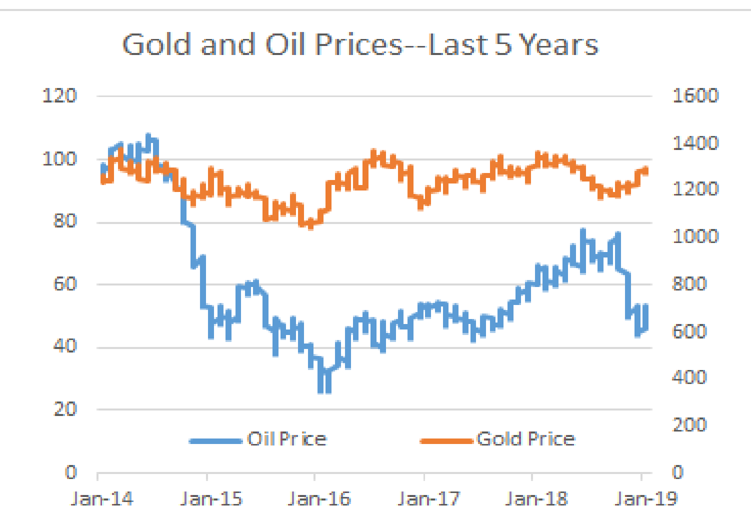
Labor Market: Employment growth showed persistent strength in the face of near record low unemployment. Business confidence has been buoyant, thereby underpinning investment spending and employment growth. At year end, there were reportedly more job openings than unemployed persons. Unemployment has receded to its lowest rate in nearly five decades, which has led to some acceleration in wages.

Colorado Capital Management contributors and editors: Steven Ellis, Monica Mielke, Lee Strongwater, and Julia Wentworth.

Inflation: The tight labor market has pushed wages and salaries higher, but productivity growth has also picked up, which helps to offset the inflationary effect of the wage increases on consumer prices. Core inflation has remained very close to the Federal Reserve's 2% target, which provides policymakers with some leeway in normalizing interest rates.

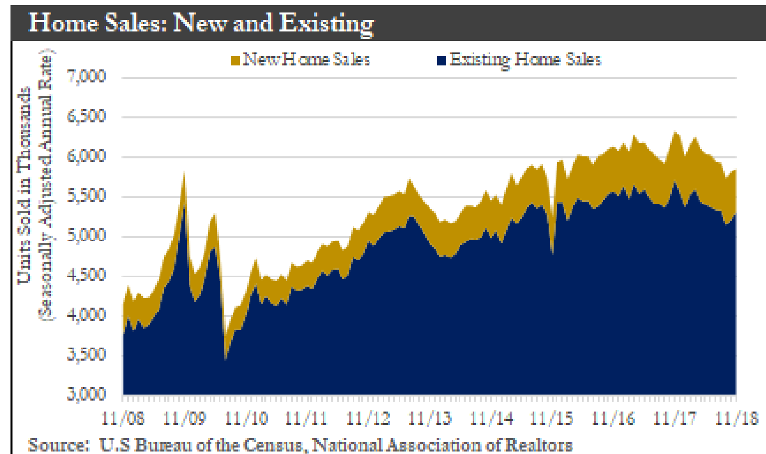
Interest Rates: The Federal Reserve has been gradually raising interest rates, including four ¼ point increases in 2018. The Fed is expected to continue to raise rates in 2019, but much will depend on the rate of inflation. If the Fed believes inflation has stabilized at 2%, it may pause the rate increases.

Oil Prices: The U.S. benchmark, West Texas Intermediate, has declined 40% since a high in October. The large decline has been largely attributed to an oversupply of oil, caused by U.S. shale production, timid production cuts by OPEC nations, and generous sanctions waivers by the U.S. for Iranian oil. Demand for oil may also be slowing, particularly in emerging economies across Asia such as China and India, which until recently were the primary source of new demand.



Global Growth: The global economic outlook has been shifting, which could lead to new turbulence in the U.S. economy and financial markets in 2019. Global growth in 2018 was less consistent than in 2017. Some of the world's major economies, including China, Germany and Japan, have seen growth contract in recent months. Trade tensions between the United States and China escalated dramatically in 2018. In addition to the potential trade war, China's economy faces growing headwinds— from weakening household spending and declining industrial output to anemic investment in factories and other big-ticket projects, but it is still expected to grow at approximately a 6% rate next year.

Europe is projected to grow at closer to a 2% rate in 2019, but is also facing its own turbulence from fading fiscal stimulus, rising short-term interest rates, Brexit, a fiscal crisis in Italy, political unrest in France, and declining bond buying by the major central banks.



Housing: Home sales have also been sputtering, hurt by high prices, rising mortgage rates and growing consumer anxiety that the market has peaked. While the latest culprit is higher interest rates, the persistent weakness in housing has likely been due to demographic shifts and the exceptionally high costs of suburban development. These hurdles are unlikely to relent in coming quarters, which means home sales and new home construction should continue to underperform the overall economy and underlying growth in households.

The Dollar: The trade-weighted value of the U.S. dollar against other major currencies has risen over 6% since the beginning of 2018. The strength of the U.S. economy relative to most other major economies has led the Fed to hike rates at a faster pace than other major central banks, thereby supporting the dollar. But many other major central banks should start to catch up to the Fed in 2019. This monetary policy convergence should lead to dollar depreciation vis-à-vis most other major currencies in 2019.

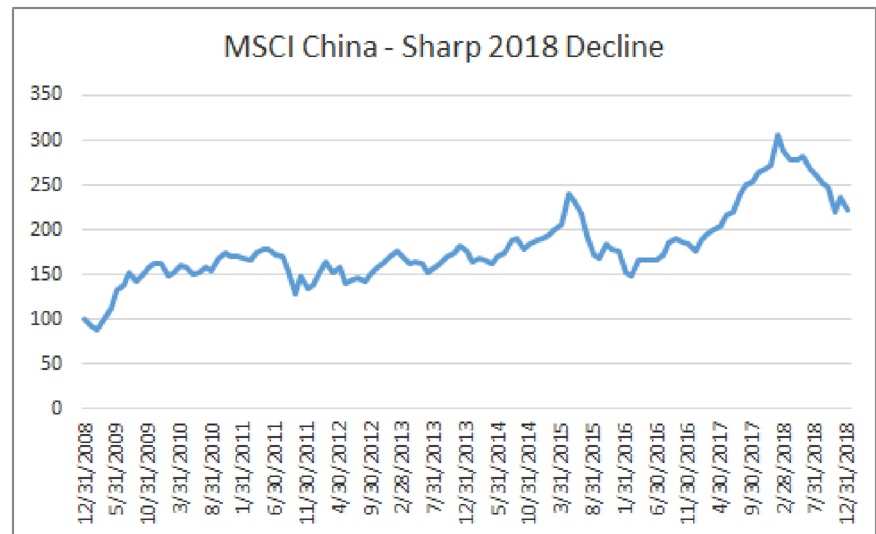
Market Commentary

The fourth quarter proved to be difficult as the S&P 500 and the Nasdaq turned in their poorest quarterly performances since 2008, dropping 13.5% and 16.8%, respectively. And the Dow Jones Industrial Average generated its worst quarterly return since 2009, falling 11.3%. A significant portion of these losses came during the month of December. The DJIA and S&P 500 recorded their weakest December performances since 1931 and their largest monthly losses since February 2009.

The slowdown in Europe can be attributed to, at least in part, a sharp decline in the manufacturing sector's new export orders amid a slowdown in demand from China. Germany, the region's largest economy, experienced its first quarter-on-quarter economic contraction since the first quarter of 2015. Weakness was also displayed in Japan, where a series of natural disasters caused this country's economic growth rate to also turn negative in Q3.

Results overseas were also negative as the MSCI EAFE index fell 12.5% during the quarter, and the MSCI Emerging Markets index dropped 7.5%. Fixed income markets benefited from a flight-to-safety dynamic. The Barclays U.S. Aggregate Bond index gained 1.6% during the quarter while its foreign bond index rose 0.91%.

Domestic Equities: The quarter began on an upbeat note as markets responded positively to a deal forged by the U.S. and Canada to salvage NAFTA as a trilateral pact with Mexico, rescuing a three-country, $1.2 trillion open-trade zone that had been about to collapse after nearly a quarter century. Volatility, however, quickly returned.



Comments by Federal Reserve chairman, Jerome Powell, implying the Fed would continue raising interest rates, contributed to volatility. Additionally, trade concerns continued to be a theme during the quarter.

International Equities: Economic concerns weighed on international markets as global growth became less synchronized. A key theme for 2018 was the strength of U.S. markets, relative to the rest of the world. For the year, the S&P 500 returned a negative 4.4% while the MSCI EAFE index dropped nearly 14%.

China, the world's second largest economy, faced headwinds from high levels of debt, slowing construction activity, weak demographics, and the ongoing trade dispute with the U.S. With expected GDP growth of about 6.5%, the Chinese economy is growing at its slowest pace since 1990. Amongst the major developing countries (Brazil, Russia, India and China), China was the weakest by a large margin with the MSCI China index down nearly 19% for the year. And weakness in China certainly had an effect on other regions.

Fixed Income: Fixed income markets generally produced positive results during the quarter as investors sought refuge from volatile equity markets. Government issues led the way with the Barclays U.S. Government Bond index up more than 2.5%. In contrast, corporate bonds lagged. Non-financial corporate debt-to-GDP has risen to its highest level in over 70 years, and the credit quality of U.S. investment grade debt has deteriorated. A wave of downgrades as the cycle matures could put further stress on credit markets.

Outlook: In the U.S., the outlook for 2019 is generally positive and reflects a constructive view on economic growth, inflation, and earnings. Furthermore, the potential for greater clarity on trade and Federal Reserve monetary policy may well emerge. Risks to this outlook include a prolonged extension of the government shutdown, the potential of a Fed mistake, slowing global growth, and declining margins as corporate America absorbs rising wages and other input costs. Signs of slowing global growth and signals from the Fed will be key to market behavior. It can be argued that these two factors have been the primary drivers of recent market weakness.

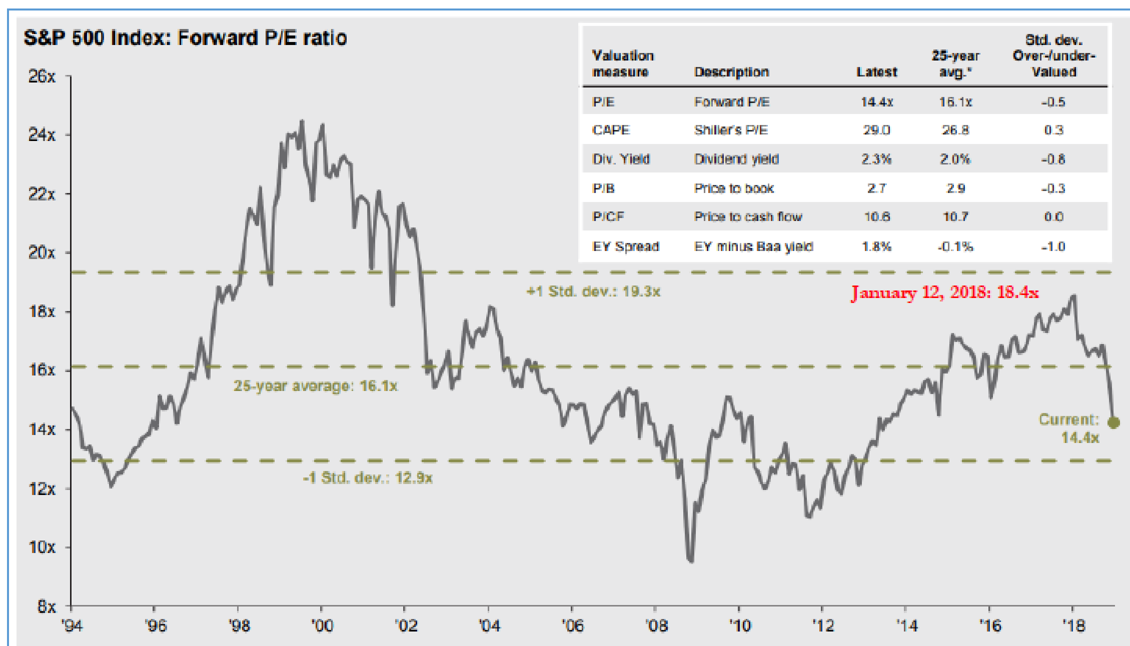
Trade related issues continue to be a risk as they have the potential to negatively impact global growth rates. In short, U.S. markets are late but not at the end of the cycle. No recession is expected in 2019, and equity bear markets typically don't begin until about six months before a recession.

In developed overseas markets, we expect Europe and Japan to rebound from recent, temporary setbacks. In Japan, rising household incomes and strong business confidence are tailwinds. And in Europe, credit is expanding and financial conditions remain supportive of growth, while issues in Italy and Brexit pose risks.

Valuations are compelling in Emerging Markets, but trade related issues, a slowing Chinese economy, and further U.S. dollar strength are concerns.

Fixed income investors should expect greater volatility as markets adjust to tightening financial conditions. This is certainly the expectation in riskier, higher leveraged parts of the market, including bank loans, high yield, and emerging market debt. Tighter global monetary policy, a strong U.S. dollar and slowing global growth are likely to limit the rise of bond yields, going forward.

Valuations are More Attractive



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.8	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

At 14.4 times forward earnings, S&P 500 valuation is well below the 25-year average of 16.1. A year ago, the S&P 500 traded at 18.4 times forward earnings. Bloomberg reports the forward P/E ratio of the S&P 500 at year end to be closer to historical norms at 15.6x.

Sources: Capital Market Consultants, Dept. of Labor, Dept. of Commerce, Bloomberg, Morningstar, JP Morgan.

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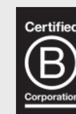

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