Pinnacle Capital Management, LLC

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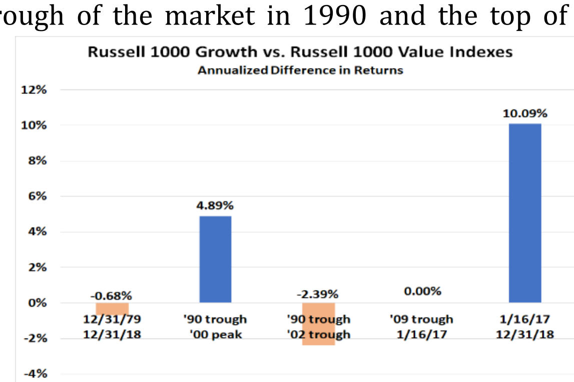
COMMENTARY

As 2018 began it looked like it was going to be a gangbuster year for the equity markets. We were coming off a strong 2017, and tax cut legislation had been enacted. Meanwhile interest rates remained low, providing a supposed ideal environment for stocks. Consequently, the S&P 500 returned 5.72% in January as optimism prevailed. But as February began, a report of strong wage gains prompted a sell off by the markets. While this may seem counterintuitive, wage gains were perceived as indicative of higher inflation which would likely lead to higher interest rates. Higher interest rates have two possible negative effects. First, the value of future earnings when discounted back to the present is reduced. Second, higher interest rates add to the overall cost of doing business. The result was a sharp downswing in the equity markets. Volatility, which had been practically nonexistent in 2017 had reared its ugly head in 2018.

This volatility was short lived as the economy continued to expand. By the second quarter GDP grew at a 4.2% rate. Still, interest rates rose. The 10 year Treasury rate, having closed 2017 at 2.41%, reached 3% by early April. Meanwhile, the Federal Reserve's Fed Fund rate was increased by a quarter point in March; and the Fed would continue to raise that rate in similar increments three more times during the year. Nonetheless, the market shook off its fears of inflation and higher interest rates and resumed its relentless march upward.

But under the surface some cracks appeared. It has been apparent to us that recent stock price gains have been driven just a bit too much by speculation. The markets were in love with growth stocks, especially high-tech ones with stories about future disruption. It was clear that not all stocks were advancing substantially. Many believe that growth stocks, especially tech stocks, are going to outperform old economy and value stocks. But this has not always been the case. As a proxy for these let's look at the Russel 1000 Growth and Russell 1000 Value Indexes. As you can see in the nearby chart, between the ends of 1979 and 2018 the Growth index has ***underperformed*** the Value index by an average of 0.68% per year. Of course, comparative returns in individual years and market cycles varied. For example, in the span between the trough of the market in 1990 and the top of the



market in 2000, a period of extended expansion, declining interest rates and great interest in technology and disruption, Growth outperformed

Value by 4.89% per year on average. However, extending the period to the trough of the market in 2002 (the end of the dot com crash), relative performance flips; Value outperformed Growth by 2.39% year. We would not be surprised by a similar reversal in this cycle. And without the gains of those growth stocks, the recent advance would not have seemed so impressive.

Another mid-year issue was that future growth appeared more questionable. Nearly full employment meant that fewer gains could be reaped by increased employment. And while the full impact of tax cuts boosted corporate earnings in 2018, a similar benefit wasn't expected going forward. Trade was problematic as well. The two big trade stories for 2018 were Britain's struggles to negotiate its exit from the European Union (Brexit) and rising trade disputes, primarily between the U.S. and China. A disorderly Brexit could greatly slowdown trade between the U.K. and the rest of the continent. Irrespective of what ultimately happens, the uncertainty alone can result in reduced investment and economic activity, and of course, slow down international trade.

Likewise, President Trump has implemented a series of tariffs primarily aimed at China. The scope of this article does not permit us to delve into the details of the President's trade policies. We do, think the objectives are worthwhile. Still, achieving these goals is not a pain free process. In the short run disruption and uncertainty can slow economic expansion. Unfortunately, this is not the only cause of economic uncertainty. We must add uncertainty caused by a change in control of the U.S. House of Representatives, a Federal Government shutdown, the ongoing Robert Mueller investigation, and the continued rise of short-term interest rates.

All of this proved too much for the markets to ignore. As if a switch had been turned, the equity markets sold off in the fourth quarter of 2018. The S&P 500 returned -13.52% in the fourth quarter resulting in a return of -4.39% for all of 2018. Ironically this sudden pessimism led to a fall in interest rates, though that pertained mostly to the long end of the curve. While the yield on 10-year U.S. Treasuries reached 3.23% in early October, it then fell to 2.69% by year end. On the other hand, 3-month U.S. Treasury bill rates rose from 2.20% on September 30th to 2.35% by year end.

In the first few days of 2019, the markets' volatility has persisted. Clearly bullish and bearish players are at odds. Additionally, there is fear that this nearly 10-year-old economic expansion can't persist. When investors think about a recession, they tend to think about the last one. Unfortunately, the 2008 recession was particularly bad. The bears project a 2008 environment and drive prices down. Having painted this picture, we need to emphasize that all is not so bad. Fuel prices are falling putting money into consumers' hands. Consumer sentiment and spending remain buoyant helped by this "tax cut". Looking at various economic sectors, we don't see significant overexpansion. In fact, in some cases it's just the opposite. For example, the auto industry has cut back to avoid the situation of massive oversupply that has gotten it into trouble in the past.

Rising interest rates, to the extent that they're still rising at the short end, should not be a significant headwind at these levels. Despite recent increases, rates are not high by historical levels. With corporate profit margins higher than in previous expansions, interest rates shouldn't harm the economy anytime soon unless they increase too rapidly. Trade disputes will continue, but some progress is likely to be made. Of course, nothing is certain when it comes to negotiation. The risk is that pessimism regarding trade and general Washington turmoil could cause the economy to slow down. However, should a recession occur, it is likely to be short lived and mild – more akin to the recession in 1990 than the 2008 recession.

While we're optimistic towards the markets in 2019, they will likely continue to remain volatile. Moods will swing from euphoria to despair and back again. In such an environment it is pointless to time the markets. If one's horizon is the next 12 months or so, then the equity markets are not the place for your money, even if your outlook is rosy. Long term the fundamentals of the markets are still solid, and valuations (except for perhaps areas of the high growth tech sector) remain reasonable, if not cheap. We feel the equity markets are the best place to place money for those with a long-term horizon. Just don't expect it to be a smooth ride.