MANAGED ASSET PORTFOLIOS

MAP VIEWS

2018 Review and 2019 Preview

Stocks limped across the finish line last year, posting their worst yearly performance since the economic crisis of 2008. In 2018, the S&P 500 fell 6.2%, while markets around the world fared even worse. Stocks in Japan fell 12%, British stocks shed 13%, as did the Stoxx Europe 600.

As 2018 concluded, investors worried about a slowdown in economic growth, the U.S. government shutdown, a pending trade war with China, lack of progress on Brexit and continued turmoil in Washington. When January rolled around, stocks went into rally mode, without any real abatement in the problems that plagued investors just a couple weeks before. There does appear to be some progress on the trade front between the U.S. and China. We anticipate that a trade war will be avoided, as both countries have too much to lose in a full-blown trade war. Both countries will likely make concessions that will allow for their political leaders to declare victory.

MAP is operating under the premise that second and third quarter GDP numbers were artificially inflated by the benefits of the tax reforms passed in December 2017. Against the backdrop of high levels of governmental, corporate, and private debt, we have been cautious about domestic growth GDP for years. We have not changed our stance based on a two quarter "aberration." Given the market retreat in the fourth quarter of last year and the prospects for materially slower growth in 2019, we believe the Fed will dramatically slow their rate hikes. We would be surprised to see more than one increase this year. We also suspect the Fed's lack of rate hikes will place some downward pressure on the dollar and reverse the gains the USD Index had in 2018. In turn, this will end up providing some relief for manufacturers and the farm belt. A weaker dollar should also help Emerging Market (EM) economies and their stock markets.

Based on current interest rates and inflation expectations, we view broad stock market valuations as "fair." Some stocks have valuations that seem excessive to us; however, we are finding more names with attractive valuations. In fact, after a recent internal analysis of our portfolios, we discovered that many of our holdings are trading at valuation metrics (price/earnings, price/sales, price/book) not seen in approximately five years, implying that values can be found in today's stock market.

While we are not forecasting materially higher rates in the near to intermediate-term, we do have concerns about the bond market. Over the past few months, we have focused most of our bond holdings on short-term, high-yield issues. The thought process behind this was to take advantage of greater returns offered in the high-yield market while keeping maturities short to help mitigate interest rate risk. Over the past few years, corporations have borrowed heavily, taking advantage of record low-interest rates. These borrowings have to lead to diminished credit quality. So, while in the recent past we were most concerned about interest rate risk, we are growing increasingly worried about credit risk. Similarly, U.S. Government debt is increasing at a clip of nearly one trillion dollars per year. Such increases may be understandable during recessionary times as tax revenue trails off and spending picks up. However, we cannot help but note the age of the current economic expansion as the third quarter of 2019 will mark a decade of domestic growth. Pair this with the fact that many corporations and local and state governments are all issuing more debt to cover liabilities such as underfunded pensions, and you get a bond market that is oversupplied. Therefore, based on the laws of supply and demand, we believe interest rates will have a slight upward bias.

If there is one word that we would use to describe our strategy for 2019, it is selective. Indexing one's investments have been a popular strategy since the end of the economic crisis, and it has worked reasonably well for the past decade. However, we doubt that will be the case for the next ten years. We continue to believe that what you don't own in your portfolio may be more important than what you do own. Think back to the dot-coms in the late 1990s, financials in 2008 or energy in 2014. Investors avoided a lot of pain by avoiding these sectors of the stock market as overly enthusiastic speculators pushed their valuations to lofty levels. As investors adapt to an environment of higher interest rates and inflation, actively selecting inexpensive stocks and bonds will prove to be a valuable strategy. Investors need to realize that there is a fundamental difference between good and bad companies, as well as cheap and expensive stocks. Discrimination is wrong in every sense, except when it comes to investing.

We will continue to be selective when constructing our focused portfolios. We will continue to adhere to our value discipline and believe that our strong outperformance last year highlights the merits of value investing. We will continue to work diligently and ethically every day as we strive to generate the best risk-adjusted returns possible.

We wish all of our clients health, happiness, and prosperity in the New Year. We would also like to take this opportunity to thank you for allowing us to serve as your investment manager. We truly appreciate your support and patronage.

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Managed Asset Portfolios' Investment Team
Michael Dzialo, Karen Culver, Peter Swan, John Dalton, and Zachary Fellows

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