THE BOSTON FAMILY OFFICE

Investment Update

Fourth Quarter 2018

Investors of all stripes will be happy to move on from 2018, and the fourth quarter in particular. As a friend of the Boston Family Office said recently, "we've had a hell of a year, in the last month…" The past year produced the first negative total return since 2008 for the S&P 500 and it barely missed the 20% decline unscientifically defined as a bear market at its worst levels on Christmas Eve and Boxing Day. The NASDAQ, emerging markets, and small company stocks all eclipsed the mark earlier in December. The pullback was quite broad and eventually included even the most defensive companies in the second half of December.

The fourth quarter started with most stock indices not far removed from recently reached all-time highs, but the S&P 500 price dropped almost 7% in October, and another 9% in December. The overarching concern was how soon we will see the next recession, and whether trade policies and Fed policy are pushing the US economy towards one sooner than might otherwise occur naturally.

Equity Markets (Total Return)	4Q18	1-Year
Dow Jones Industrials	-11.3%	-3.5%
S&P 500	-13.5%	-4.4%
S&P Mid-Cap	-17.3%	-11.1%
S&P Small-Cap	-20.1%	-8.5%
MSCI All-Country World	-12.7%	-8.9%
MSCI Foreign Developed Markets	-12.5%	-13.8%
MSCI Foreign Emerging Markets	-7.4%	-14.2%
US Bond Markets (Total Return)	**4Q18**	**1-Year**
Barclays US Govt/Credit Intermediate	1.7%	0.9%
Barclays US Govt/Credit Long	0.8%	-4.7%
BAML Municipal Intermediate	1.6%	1.6%

Recessions are generally caused when the Fed responds to inflation and overinvestment by tightening lending conditions to the point where economic activity slows. To be sure, theirs is a challenging balancing act as the transmission mechanism of higher rates can be almost instantaneous, while the available data on which to base decisions are often backward looking. Despite some evidence that more interest rate sensitive parts of the economy such as autos and housing were already slowing, and that growth outside the US was faltering, October's losses were widely attributed to comments the Fed chair Jerome Powell made on the 3rd of the month suggesting the Fed was going to raise rates four more times in 2019 just as in 2018.

The question of when the next recession will arrive is a fundamental one, and a reasonable subject of debate, but our feeling is that December's losses and volatility were mostly attributable to several technical factors. There is anecdotal evidence to suggest that hedge funds and other active managers pulled back on risk exposures after seeing their relative performance lag with few catalysts remaining in December. This diminished the "buy the dip" bid that has supported markets in the past and exacerbated what is already a thin part of the calendar in terms of market participation (late August being another notable one), when less than full attendance can lead to large price movements that may or may not reflect collective investor sentiment. Finally, tax-loss selling and margin calls added further downward pressure as losses grew

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through the month, and of course computer-driven trading also ignores fundamentals and will typically push prices in the direction in which they are already headed, in this case down.

Where, then, from here? We remain cautiously optimistic about a positive 2019 for stocks given the reasons mentioned below, particularly given what seemed to be an overshoot to the downside in December driven by technical factors. It is likely to continue being a volatile ride, but, as we have said in the past, it is the action (or inaction) chosen in these moments of stock market stress that define long-term investing success. The S&P 500 has essentially quadrupled since 2009 and such gains cannot be achieved without the occasional experience like last quarter.

Current estimates for 2019 S&P 500 earnings growth have come down in to the high single-digits from where they were earlier in 2018, but it is not atypical for that adjustment to happen. Even assuming no growth in earnings the forward price/earnings multiple at year-end was reasonable at just under 16x, suggesting that the market was already pricing in such a scenario as possible. We think some amount of earnings growth is much more likely and that such undemanding valuations suggest more upside than downside risk.

Broad measures of the US economy are slowing from earlier in 2018 but continue to be generally strong, and not signaling a recession on the horizon. However, the global economy, particularly China, is showing signs of deceleration. Though not technically part of its mandate, it is our hope that the Fed will factor ex-US trends into its policy making decisions, as they will inevitably affect US businesses.

Investor sentiment has changed after an unsettling month of market volatility, and very rapidly. The Investor's Intelligence Sentiment Bull/Bear Ratio (a survey of institutional investors) went from over 2 in mid-December to .86 on January 1st,. Given that this figure historically has not spent much time below 1, such extreme positioning could actually be a precursor to a sharp move upwards based on the assumption that anyone who could be swayed to become pessimistic already has (source: Yardeni Research).

On a more cautious note, one factor to keep an eye on over the longer term is our national debt. At 78% of US gross domestic product (GDP), it is the highest it has been since the decade following World War II. Reaching levels over 100% has historically proven to have deleterious effects on an economy because a government's borrowing starts to crowd out private borrowing, and government spending is increasingly tilted towards the unproductive cost of servicing the debt. The Congressional Budget Office's estimate for this figure in 2028 is 96% under current laws. While mindful of this, we continue to believe that staying the course with a reasonable asset allocation for your circumstances will be rewarding over time.

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