



Wealth Management  
Dominion Securities

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## What to expect in 2019: A balanced environment with high volatility

- We believe equities will continue to drive portfolio returns in the year ahead as global growth continues (albeit at a slower rate) and equity valuations have come down.
- The key risks to our outlook surround China, Europe and the possibility of a misstep in U.S. interest rate policy.
- These risks mean that investors should expect increased volatility in 2019. We aim to smooth out this process for our clients by focusing on quality, defensiveness, and income.

Markets just went through one of the toughest market quarters since the Great Recession and the worst December since the Great Depression. If you were one of our clients, you were spared from committing the cardinal investing mistake: overreacting. The first few weeks of January rewarded your resolve, returning between 4-7% on the major stock indexes. This was a welcome way to say hello to 2019.

Our focus now is on making sure our clients are well positioned for the year ahead. Below, we discuss why we believe the current market is even-keeled with a balanced set of risks and opportunities.

### The good news is that equities have room to run ...

We believe equities will continue to drive portfolios in the year ahead. As our seasoned readers know, the fate of markets is largely tied to the fate of the U.S. economy. This is good news as the latter is still in solid shape: GDP and earnings are growing (albeit at a slower rate than last year), employment numbers are among the best they've been since the Great Depression, and corporate balance sheets are strong. As long as the U.S. is not in recession, we believe global equities will continue to provide clients the opportunity to capture meaningful long-term returns.

The recent downturn strengthened this argument. Valuations (measured by price-to-earnings ratios, i.e. the stock price paid for each dollar of earnings) have gone down to a level our analysts believe is within the sweet spot for profitable equity investing. We have already begun using cash built up over the last quarter to capitalize on the opportunities the selloff has created. We are doing this defensively by focusing on quality large-cap names that pay dividends. We have also created customized structured notes that trade off growth for superior income and downside protection. This reflects our conservative nature – we are comfortable giving up some upside in order to

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better protect clients when markets go down. Clients can expect us to continue building defensive and income-oriented positions moving forward.

### ... but China, Europe and interest rates all pose risks moving forward.

The good news is balanced by the significant risks we face in 2019. The first of these concerns is China, the world's second most important economy. Data coming out of the country has weakened at a faster pace than markets originally anticipated. This is bad news for global growth, particularly for the countries in the region that make up part of China's supply chain or rely on the increasingly important Chinese consumer. However, we are encouraged by the fact that both Chinese and U.S. leaders have significant incentive to ease trade tensions. This may be obvious for Trump, who has backed himself into a corner domestically and is facing an election in 2020. But it may not be so obvious for Xi Jinping, who is afforded a tremendous amount of leeway in the Chinese political system. We remind our readers that China's social stability is largely predicated on economic growth and prosperity. As President Xi warned Communist Party leaders this month, "serious dangers" could present themselves if that growth was to sputter. We therefore believe it prudent to align investments with the goals of the Chinese government,

which has recently redoubled efforts to stimulate their economy. This will no doubt add to the country's burdensome level of debt, but we see this problem being pushed back as growth is spurred in the short term. We will continue to monitor the situation as we seek opportunities.

We are less optimistic about the prospects for Europe. On the one hand, European stocks are attractively cheap. But sometimes things are cheap for a reason. Political friction within and between members of the union seems never ending and has left the continent as the perennial slouch of the modern global economy. Its fortunes have recently been made worse by slowdowns in the U.K. (due to Brexit), Germany (auto emissions), France (street protests) and Italy (high borrowing costs amidst a deficit battle). We see mixed evidence that these pressures will ease in 2019. We therefore are modestly lowering our exposure to the region. At the same time, we are stressing an active approach, utilizing on-the-ground managers to select high quality names that can deliver despite macroeconomic headwinds. This remains consistent with our overall equity strategy.

The last risk on our radar concerns interest rates. Specifically, we think the possibility of a misstep by central bankers is elevated at this late stage of the cycle. This has been captured by recent media focus on the "yield curve," which refers to the spread

between long- and short-dated bonds. When the curve inverts, it means the market believes all is not well in the financial system; that the economy cannot support the short-term rates set by the central bank. Over the long run, the market has proven to be quite adept in its assessment. This has made yield curve inversions one of the more reliable indicators of oncoming recessions. Although it is currently not yet inverted, it is awfully close. Once this happens, we can expect a recession to occur just over a year after. The good news is that the Federal Reserve has taken this into account and softened some of its language about further interest rate hikes. Still, the consequences of a misstep are substantial. We are thus comfortable maintaining a defensive stance, conscious of the fact that we may give up some upside in exchange for greater downside protection.

### More instability underscores the need for planning.

The opportunities and risks above entail more volatility in the year ahead. It is all the more important to remain conscious of your investment plan in environments like these as it is the best way of ensuring you achieve your long term goals. We encourage you to reach out to us about your personal situation and make sure everything is up to date. In the meantime, you can expect us to remain vigilant on your behalf.



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