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INVESTMENTS

Investment Letter, Q1 2019

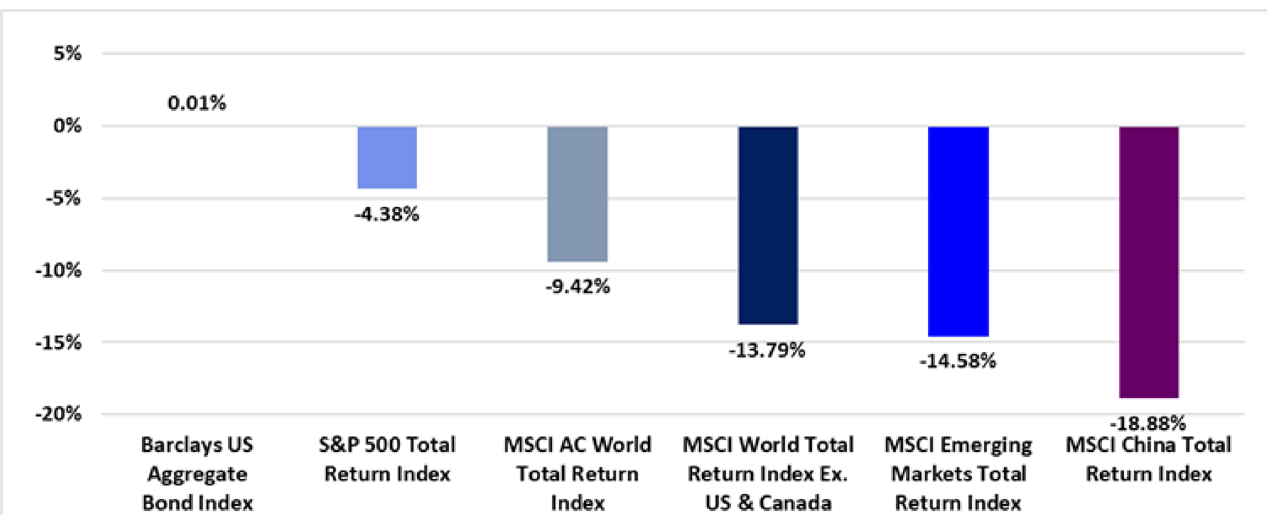
January 8, 2019

Fed Policy and Market Volatility

The major indexes ended 2018 with the worst December since the Great Depression and the biggest yearly decline since the financial crisis in 2009. Unlike these previous two periods, however, the general outlook for business is favorable, aside from a few industries. While most of the rest of the world appears to be faltering, the United States remains a bright spot in the global economy, and our current U.S.-focused strategy has and should continue to help us weather the potential turmoil ahead.

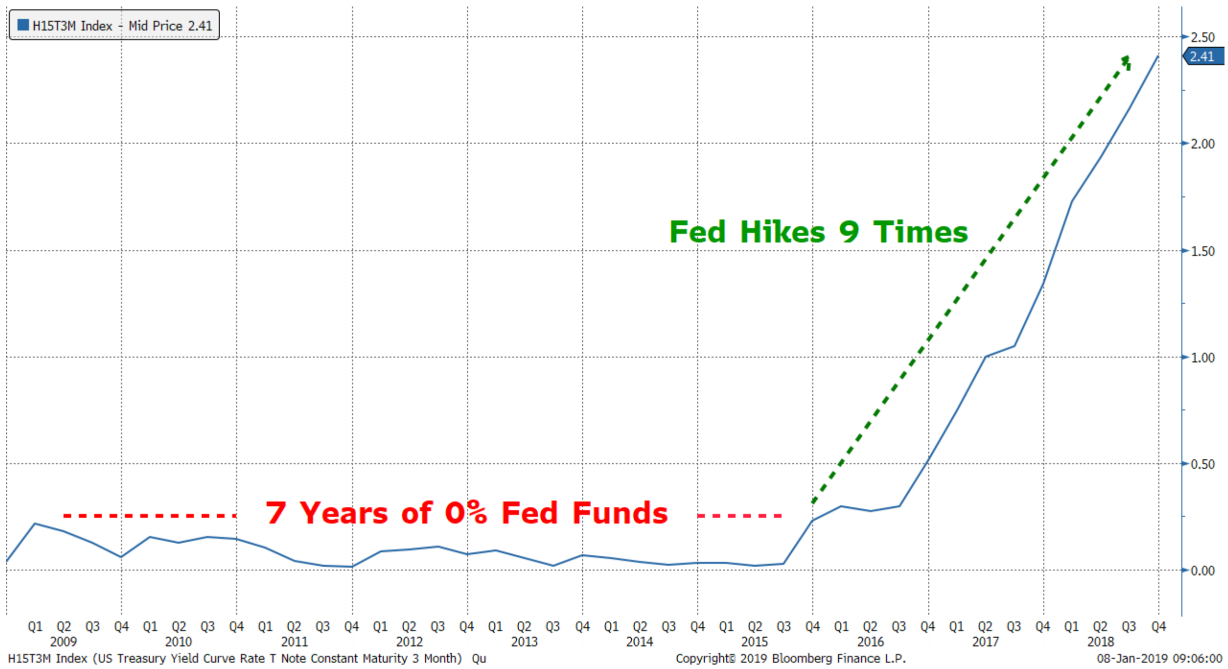
We anticipated this increased volatility in the market. In our previous letter, we noted that a change was likely brewing with a combination of factors piling up in the system, including continued Fed interest rate hikes, the possibility of sustained and increased tariffs, and generally slowing corporate earnings growth. All of these factors came together dramatically last quarter, giving us one of the most volatile markets we have seen in a decade. Let's look at what happened during 2018 and then review the fundamental outlook for the coming year.

2018 Index Returns



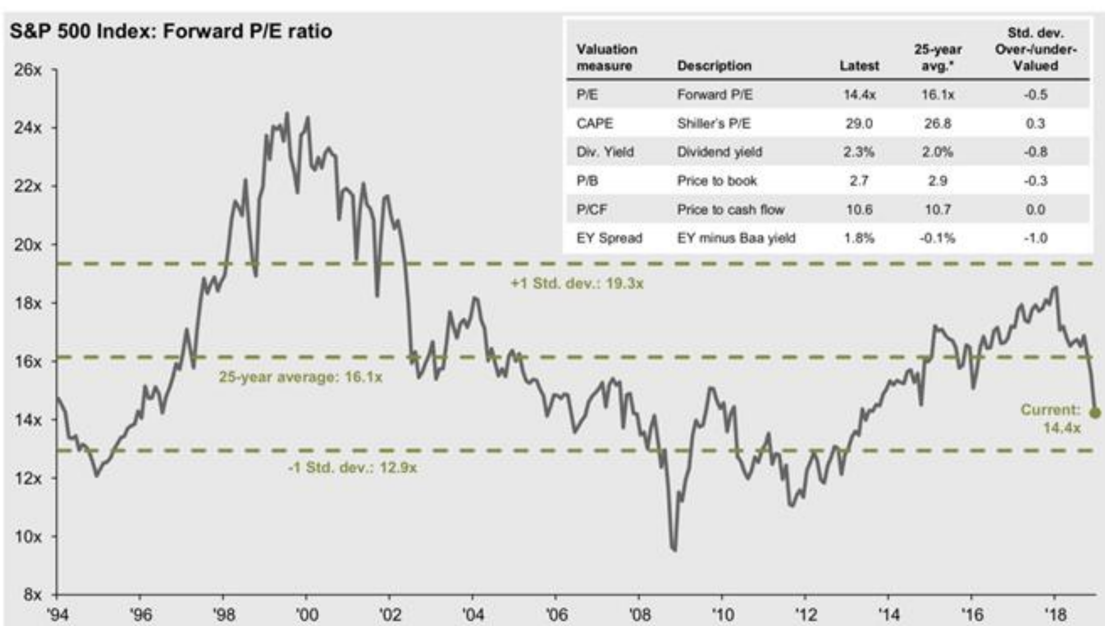
We have been highlighting the actions of the Federal Reserve for a few years in these quarterly update letters. Historically, in periods of monetary tightening, the Fed has raised rates until the economy and the markets begin to suffer, and whether or not this time will be different is the question on investors' minds. As expected, the Fed raised rates to a target range of 2.25 - 2.5% at their December meeting, but they did it in the face of slowing global economic activity and relatively extreme volatility in the U.S. stock markets. The markets did not react well. This was the 9th increase in the Fed Funds rate since December 17, 2015. When you combine that with the cumulative tapering activities by the Fed, generally tighter global central bank liquidity conditions, slowing domestic and global earnings growth rates, and increased fear of economic damage coming from the ongoing trade wars, the recent market volatility begins to make sense. The chart below illustrates the relatively dramatic trajectory with which the Fed has tightened its monetary policy into the beginning of 2019.

U.S. 3-Month Treasury Bill Yield Curve Rate



Corporate earnings estimates for 2019 continue to be a moving target with the current consensus projecting approximately 6% growth this year. This number has been coming down in the face of a possible global slowdown and an increase in fears surrounding the trade war with China. There has, however, been some good news that may have been missed because of all of the commotion in the headlines: valuations are lower than they have been in years. The estimated 22% increase in corporate earnings over the last year, coupled with the general decrease in stock prices, has brought the forward P/E ratio on the S&P 500 down to approximately 14.4. This is now substantially below the average of 16.1 for the last 25 years (see chart below).

S&P 500 Forward P/E Ratio



Source: JPM Asset Management 12/31/18

Valuations alone are not enough to stave off more short-term volatility and potential downside risk. We need clarity around the major issues driving the uncertainty, and technically, market lows like we saw in December tend to get retested. The future direction of interest rate policy from the Federal Reserve will be critical in the coming weeks and months (i.e. they need to dramatically slow or even stop raising rates). The Fed has become a bit more "dovish" lately, signaling that the pace of rate hikes going forward is not set in stone and that they will be "patient" if necessary with all of their tools, including their balance sheet unwinding, which they had previously described as being on "autopilot." In other words, they are suggesting that they will only raise rates if the economy and/or inflation starts to heat up. That should help stabilize things, and we will have a lot more data for the Fed to digest with the release of fourth quarter corporate earnings coming up in mid-January. Additionally, we need an end to, or at least some positive clarity around, the trade war with China. The cumulative effect on the global economy is starting to take a toll on the markets, and we may see that expressed in lower reported fourth quarter corporate earnings or forward guidance (or both). This may force the Fed to stop raising rates going forward or even to reverse course if things deteriorate further.

We have advocated for the last few years about the importance of being prepared for volatility prior to it arriving. When the markets drop, you can, of course, never be prepared enough; it would be nice to sell at the top and have everything in cash when this kind of thing happens—but that is not realistic. We like to think of investments like a portfolio of apartment buildings: when the market is high, you don't sell everything, pay taxes, and hope you can buy things back lower. You create some cash, so that, when the market comes down, you are in a position to add to your portfolio at better prices. We think that is the right mindset now. We are looking for opportunities to thoughtfully add to companies while they are cheaper. Since nobody ever knows the absolute bottom, it makes sense to add to your portfolio in a measured way over time while acquisition costs are lower. This period of volatility may last weeks or months, depending on the data we see coming out, and we can certainly expect more headline risk around the political discord going forward. There will likely be a lot of talk about impeachment of the president, but it is important to remember that the Constitution requires a two-thirds vote of the Senate to convict, which seems like quite a longshot given that Republicans hold a 51/100 majority. Historically, the most successful investors have used difficult markets to make more long-term investments, and we believe that this period will be no different. For many years, we have advocated for a portfolio of higher-quality, U.S.-based companies, along with a margin of safety in cash and bonds (or income securities), depending on client-specific mandates. We also generally believe higher-dividend-paying companies will make sense going forward for total return and income. We will continue to analyze the fundamental and technical data and look for opportunities to take advantage of the current environment when we think the time is right. Of course, every client has different goals and risk tolerance so please consult with your ACI advisor to make sure you are comfortable with your allocations. We look forward to helping you successfully manage these challenging markets.

Sincerely,

Todd R. Walsh
Chief Executive Officer
Portfolio Manager

Glendon C. Trullinger
Director of Trading
Portfolio Manager

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Data presented herein was sourced 1/7/2019 from Bloomberg.