Like a perfectly normal teenager, markets experienced exhilarating highs and devastating lows in 2018. The year started with a bang but ended with a sickening thud. From an all-time high of 2940.91 on September 21st, the S&P 500 dropped 13.96%. For the year, the most widely followed index of U.S. stocks declined 4.38%. For most investors, actual results were worse, as the average U.S. stock declined more than twice as much.[1] Those who sought opportunity abroad found even more pain instead. When measured in dollar terms, most developed markets fell about 20%. Chinese stocks fared worse. Most commodities fell into negative territory, led by a 40% decline in the price of oil over just the last three months of the year.

Unlike the placid and profitable markets of 2017, 2018 was marked by petulance and volatility. The number of days in which stocks fluctuated more than 1% (in either direction) skyrocketed. A year ago, there were a total of eight days in which stocks were either up or down more than 1%. In 2018, there were 64 (about one every four trading days). On six separate occasions, the S&P moved more than 3%. Unfortunately, five of those moves were negative. The two obvious questions are: What changed, and what does it mean for the future?

In our view, the most significant culprit has been the combination of rising interest rates and the early signs that the U.S. economy may finally be slowing down.

The Federal Reserve has raised interest rates five times over the past 13 months, increasing the Fed Funds rate by 125 bps. The lagged effect of tighter monetary conditions on the economy is starting to become visible in the form of a decline in new home sales and construction, a slight softening of auto sales, and a pullback in consumer confidence from record highs. Whether the Fed's actions are meant to soften a potentially overly exuberant economy, or they are using a strong economy as cover to "normalize" interest rates and policy is irrelevant. The impact has been the same and not helpful for short-term asset prices.

Lurking just beneath the surface is the fear that we might be in the process of reliving the market debacle of 2007/2008. We strongly believe that concern to be unfounded.

We have commented before that the gradual nature of this economic recovery has also contributed to its duration. The pain of the 2008 collapse was lasting, and the excesses that have historically been associated with an overheating economy have been slow to form. New home starts at their peak in early 2018 were running at 1,334,000, only 2% above the 30-year average and 41% below the 2006 peak. Despite an unemployment rate of 3.7%, wage growth is barely in excess of 2%. And stock market valuations after a nearly ten year bull run are nowhere near the nosebleed levels observed in 2000. This does not mean that there are not pockets of "irrational exuberance" but it is difficult to identify large bubbles waiting to pop.

[1] Russell 1000 Equal Weighted Index

There is also no denying that our banking system stands better prepared to weather a storm than it did a decade ago. This is vividly illustrated by the below balance sheet which aggregates the balance sheets of Bank of America, JP Morgan, and Citigroup and compares the 2007 figures to today. Equity has risen by almost 50%, from 7% to 10.5% of assets. Conservative measures, such as cash held and deposit funding, have increased significantly, while indicators of risk (debt and trading assets) have been meaningfully reduced. In short, Fed supervision and annual stress tests have accomplished the intended goal.

	2007	Q3 2018
Cash	211,617	815,958
Loans	2,285,543	2,602,293
Trading Assets	1,197,356	951,966
Securities, Fed Funds Sold and Other Assets	1,775,950	2,509,044
Total Assets	**5,470,466**	**6,879,261**
Deposits	2,373,303	3,809,785
Trading and Other Liabilities	1,453,964	1,414,193
Debt	1,250,954	936,073
Total Liabilities	**5,078,221**	**6,160,051**
Equity	**392,245**	**719,210**
Cash % of Assets	4%	12%
Deposits as a % of Loans	104%	146%
Debt as a % of Equity	319%	130%
Trading Assets % of Assets	22%	14%

Our Approach

Throughout this bull market, we have avoided the siren song of asset class diversification. Making an active decision to concentrate portfolios almost exclusively on large U.S. equities, cash and high-quality bonds (where client appropriate) has been a significant benefit, especially in 2018. As we noted earlier, international markets, both developed and emerging, have lagged the U.S. by more than 10% during 2018. Since 2009, they have provided less than half the return. Advocates for global equity diversification promised a reduction of risk but delivered only a reduction of returns. We believe that one should venture abroad only in search of superior returns, not in response to an academic theory on reducing volatility.

We have and will continue to be bystanders to the fad of momentum investing (buying last year's best performers on the theory that they will continue to find favor in the market). According to a recent study, "quantitative hedge funds, or those that rely on computer models rather than research and intuition, account for 28.7% of trading in the stock market…a share that's more than doubled since 2013. They now trade more than retail investors, and everyone else."[2] Momentum is a primary tool of quantitative investors, and they are pushing yesterday's winners to valuations we find unappealing and unsustainable. We prefer to hunt for bargains.

Looking Forward

As noted earlier, the U.S. economy shows signs of at least a marginal slow down. The rest of the world looks worse. Despite extraordinary monetary stimulus, neither Europe nor Japan have managed to escape their malaise. China, always a wild card because of the opaque nature of its economic reporting, has the most at stake in an environment of escalating tariffs. It is possible that an easier than expected Brexit, a constructive trade agreement between the U.S. and China and/or a more stable and predictable U.S. policy provide an upside surprise. However, the more likely outcome is reduced global growth.

We think we may be on the cusp of an important shift in market dynamics. If we are right on our call that 2019 will be characterized by slow growth or even a mild recession, we believe that currently cheap stocks will handily outperform the market for two powerful reasons: The next recession will prove that fears of another financial crisis are vastly exaggerated, and a more difficult economic condition will highlight the significant operational improvements many cyclical companies have made. Certain businesses that historically hemorrhaged cash during a slowdown appear to be positioned to remain profitable throughout the cycle. When this becomes apparent to other investors, we strongly believe valuations will rise.

With almost half of the companies that we hold trading at single digit P/E multiples on our estimates of 2019 earnings, we believe that our portfolio is extremely well-positioned to withstand and profit from a more challenging environment.

[2] Zuckerman, Levy, Timiraos and Bannerji. "Behind the Market Swoon: The Herdlike Behavior of Computerized Trading." *The Wall Street Journal*, 25 December 2018.

Important Note About SA Investor Commentaries

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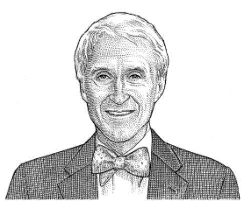

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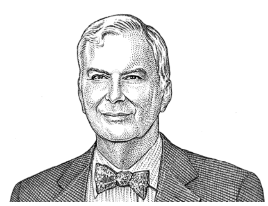

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