The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.

- Warren Buffett

Certainly, there was little "cheery consensus" in the fourth quarter as the S&P 500 declined by 14.5% which resulted in a negative total return of 4.4% for 2018. The proximate cause of the global stock market weakness in 2018 was concern about the global economy exacerbated by slowing growth in China and Europe, trade disputes and less accommodative central banks. In particular, there is also a fear that the U.S. Federal Reserve might raise interest rates too vigorously and induce a recession via policy error.

	2018
S&P 500	-4.4%
Treasury	0.9%
Muni	1.3%

S&P 500 & Bloomberg Barclays U.S. Treasury: Both Negative

Since 1973

None

S&P 500 & Bloomberg Barclays Municipal Bond: Both Negative

Since 1980

1981: S&P 500 (-4.9%), Muni (-10.2%)

2008: S&P 500 (-37.0%), Muni (-2.5%)

Source: Bloomberg, Avalon Advisors, LLC

Before we leave 2018 and begin discussing our views for 2019, returns in 2018 continued to underscore the value of asset allocation for risk management within a portfolio. Despite the negative total return from stocks, high-quality bond holdings continued to provide a strong ballast for a portfolio. This is consistent with history as the Bloomberg Barclays U.S. Treasury index since inception has never posted a negative total return in the same year as a decline in the S&P 500. While the Bloomberg Barclays Municipal Bond index since inception has only declined twice in the same calendar year as stocks.

Looking forward to our expectations for 2019, Avalon expects the U.S. economic growth to slow from its greater than 3% GDP growth rate in 2018 to roughly 2.25% in 2019. Our view remains that the probability of U.S. recession remains low in 2019. Earnings for the S&P 500 likely grew at over 20% year-over-year in 2018. It is also important to note that this growth is not just due to the recent corporate tax cut as sales at S&P 500 companies likely grew at a high single-digit rate. Corporate earnings should continue to grow in 2019 and Avalon's initial estimate is for 5% or greater year-over-year earnings growth. S&P 500 earnings for the fourth quarter of 2018 will begin being reported the week of January 14. While current results are important, future earnings guidance will be closely watched given the concern about the economic growth trajectory. Earnings and stock prices can deviate significantly over the short-term, but the growth in the value of stocks over the long-term has reflected their earnings.

While our view of the market fundamentals makes us more optimistic for stock returns in 2019, our analysis of market history should also provide some comfort for long-term investors. Since 1928, the S&P 500 has posted only a handful of consecutive calendar year losses. These past strings of losses revolved around the Great Depression, World War II, a severe oil shock and the technology bubble.

Consecutive Calendar Year S&P 500 Losses

Since 1928

1929 (-11.9%), 1930 (-28.5%), 1931 (-47.1%), 1932 (-14.8%)

1939 (-0.1%), 1940 (-9.6%), 1941 (-11.6%)

1973 (-14.7%), 1974 (-26.5%)

2000 (-9.1%), 2001 (-11.9%), 2002 (-22.1%)

Source: Bloomberg, Avalon Advisors, LLC

On December 24 the S&P 500 declined 19.8% from its September 20 peak and came very close to the 20% decline that many define as a bear market. Our analysis looked at whether it typically paid off for investors to buy when stocks were roughly 20% off their high in the post- World War II era. While there doesn't need to be a recession for stocks to decline 20%, most of the worst declines in U.S. stock market history are associated with a recession (shaded) with an average decline of 33.8%. On average, investor returns were positive over the next ninety days, one-year and three-years if one purchased after these roughly 20% declines even if the decline ended up continuing further. The recession-related scenarios were more challenging in the short-run but ended up at a similar three-year positive forward return.

Bear Beginning		Bear Ending		Calendar	%Loss	Return After Falling -20%		
Date	S&P 500	Date	S&P 500	Days		+90 days	+1 year	+3 years
5/29/1946	19	5/17/1947	14	353	-28.8%	2.1%	-0.8%	2.7%
6/15/1948	17	6/13/1949	14	363	-20.6%	14.5%	42.1%	79.4%
4/6/1956	49	10/22/1957	39	564	-20.2%	6.1%	31.0%	36.8%
12/13/1961	73	6/26/1962	52	195	-27.9%	7.3%	26.1%	58.3%
2/9/1966	94	10/7/1966	73	240	-22.2%	8.3%	24.6%	27.3%
12/3/1968	108	5/26/1970	69	539	-35.9%	-4.5%	11.9%	35.4%
1/11/1973	120	12/6/1974	65	694	-45.9%	-0.7%	-26.9%	7.8%
9/21/1976	108	2/28/1978	87	525	-19.3%	11.3%	10.6%	50.8%
4/27/1981	135	8/12/1982	102	472	-24.4%	2.6%	40.9%	67.2%
8/25/1987	337	10/19/1987	225	55	-33.2%	12.0%	24.3%	36.0%
7/16/1990	369	10/11/1990	295	87	-19.9%	5.4%	29.1%	56.0%
7/17/1998	1,187	8/31/1998	957	45	-19.3%	21.6%	37.9%	17.9%
1/14/2000	1,465	10/9/2002	777	999	-47.0%	7.6%	-1.2%	-5.3%
10/9/2007	1,565	3/9/2009	677	517	-56.8%	-20.0%	-29.1%	6.0%
4/29/2011	1,364	10/3/2011	1,099	157	-19.4%	16.2%	31.5%	77.0%
9/20/2018	2,931	12/24/2018	2,351	95	-19.8%	?	?	?
Mean (No Recession)		7		224	-24.3%	11.2%	22.0%	38.6%
Mean (All)		15		387	-29.4%	6.0%	16.8%	36.9%
Mean (Recessions)		8		529	-33.8%	1.4%	12.2%	35.4%

Source: Bloomberg, NBER, Ned Davis Research, Avalon Advisors, LLC

CONCLUSION

We believe investors should expect a more normal amount of volatility from stocks versus what we experienced post-financial crisis as economic growth slows and interest rates are above their ultra-low levels. History shows that since 1928 the S&P 500 has experienced a 5% decline on average about every 2 months and a 10% decline every 6 months. Also, to further put it into perspective, on average the S&P 500 has experienced intra-year declines of almost 14% since 1980 despite going on to post annual gains in over 75% of those years.

After the recent decline in stock prices and continued earnings growth, the valuation of U.S. stocks is near a five-year low relative to earnings estimates. While U.S. stocks are not cheap on an absolute basis since they still sell for about 15 times forward estimates, valuations are cheap relative to bond yields.

With the return to a more normal monetary policy along with a slowing global economy and trade disputes, it seems likely that volatility will persist so one should be prepared for the roller coaster ride to continue and perhaps even take us back below the recent low. Avalon forecasts that the risk of recession in 2019 remains low though U.S. growth is certainly slowing. Armed with these historical market facts along with our forecasts, Avalon believes that investors should consider at least rebalancing back toward their long-term target in stocks as this decline has likely provided an attractive entry point especially if the U.S. avoids recession as we expect.

Please work with your Avalon client advisor to ensure your asset allocation is consistent with your goals and risk tolerance if you are feeling uncomfortable. Volatility in and of itself is not a reason to change your asset allocation.

Please do not hesitate to let us know if you have any questions. Best wishes for a prosperous New Year in 2019.

DISCLOSURES

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