MALVERN CAPITAL MANAGEMENT

MCM

Fourth Quarter 2019 Market Review and Outlook

January 2019

Fourth Quarter Summary

Despite achieving 11 record closing new highs for the Dow Jones Industrial Average in 2018, the Index closed down 3.48% for the full year. The fourth quarter of 2018 was devastating to all major equity indices. In the fourth quarter, the S&P 500 Index retreated by 13.52%. Small-cap companies fared even worse by declining by 20.20%. Only investment grade bonds were able to manage a gain in the quarter as longer-term interest rates surprisingly dropped.

The equity declines in the fourth quarter were following a rather impressive third quarter. Optimism turned to pessimism very quickly and investors looked at the glass as "half empty" rather than "half full." At the end of the third quarter, 2018 was on track for recording yet another year of stellar equity gains, but then things abruptly changed. The market peaked on October 3rd and suffered many successive days of declines. No significant relief came until after Christmas. So much for a Santa Claus rally.

Still lacking confidence at the end of the year, investors were left wondering when or if the market correction would ever end. Moving into 2019, would there still be further downward pressure on the equity markets or would the markets stabilize?

Index Performance

Category	Representative index	Dec. 2018	4th Qtr	2018	3 yr*	5 Yr*	10 Yr*
Mature US Large Company	DJ Industrial Average	-8.59	-11.31	-3.48	12.94	13.16	8.19
Broad US Large Companies	S&P 500 Index	-9.03	-13.52	-4.38	9.26	13.12	7.77
US Small Cap Companies	Russell 2000 Index	-11.88	-20.20	-11.01	7.36	11.97	7.50
US Mid Cap Companies	Russell Mid Cap Index	-9.92	-15.37	-9.06	7.04	14.03	8.89
Largest 100 NASDAQ Companies	NASDAQ 100 Index	-8.83	-16.76	0.04	12.59	19.29	11.21
Developed International	MSCI EAFE Index	-4.85	-12.54	-13.79	2.87	6.32	4.74
Emerging Markets	Russell Emerging Mkts Index	-2.31	-7.19	-14.54	8.91	9.22	8.45
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	1.84	1.64	0.01	2.06	3.48	3.87
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	-2.14	-4.53	-2.08	7.23	11.12	7.00
Commodities	Bloomberg Commodity	-6.89	-9.41	-11.25	0.30	-3.78	-2.47
Total US Market (all cap stocks)	Russell 3000 Index	-9.31	-14.30	-5.24	8.97	13.18	7.89
Real Estate Investment Trusts	Wilshire US REIT Index	-8.37	-6.93	-4.84	2.06	12.19	8.21
Cash	US T-Bill 90 Day	0.20	0.57	1.94	1.06	0.38	1.26

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2018.*
All returns include the reinvestment of dividends.

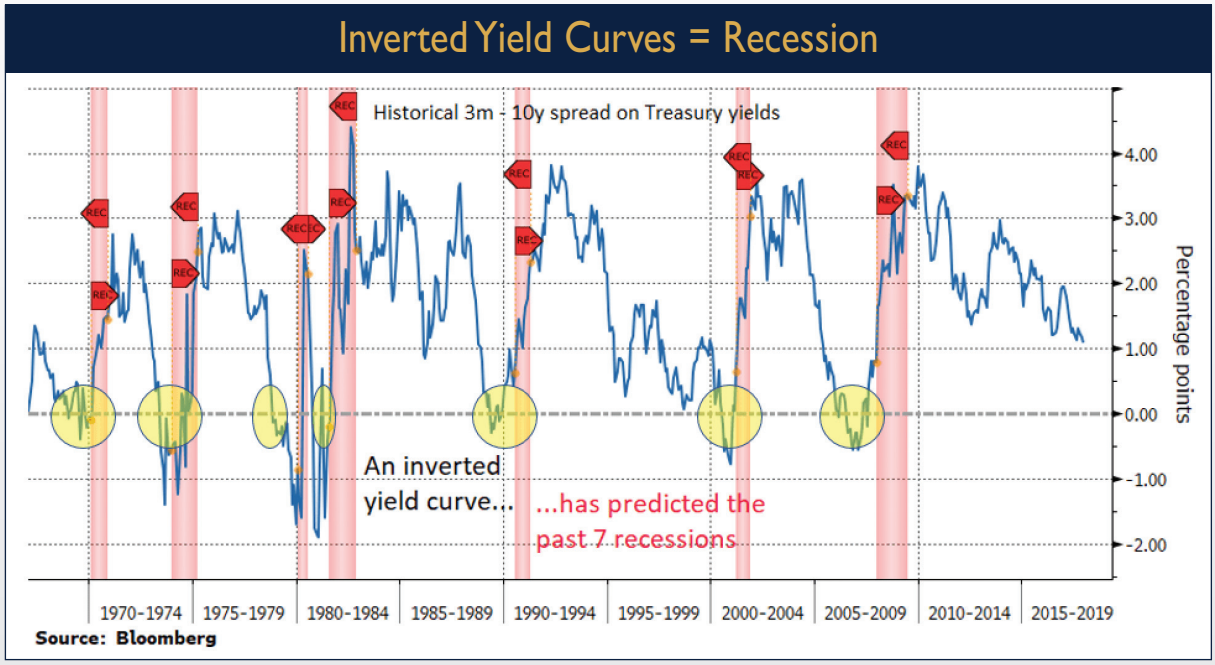
Why Did the Market Sell Off?

We believe there were a number of reasons for the market correction that began in early October. These include 1) the Fed's raising of short-term interest rates, 2) tariffs, 3) an inversion of the yield curve, 4) falling oil prices and 5) global economic slowing.

Fed's raising of short-term interest rates: The Federal Reserve ("Fed") began raising interest rates in late 2015 and has continued to incrementally raise the Fed Funds rate. It has also begun a systematic program to unwind the bond buying that occurred through four rounds of quantitative easing that was implemented following the financial crisis. Although the raising of interest rates is a signal that the Fed sees the economy as strong, the fear is that the Fed may be going too far, too quickly and higher rates will bring the economy to a screeching halt, or even send it into recession.

Tariffs: The United States has placed a 10% tariff on certain goods being imported from China. Likewise, China has placed a tariff on goods coming from the United States to China. The fear is that a trade war is brewing or even occurring and historically trade wars have been bad for global economic growth.

An inversion of the yield curve: An inverted yield curve occurs when shorter term interest rates rise higher than longer term rates. Historically when the yield curve inverts, a recession follows. In fact, every recession has been preceded by an inverted yield curve. However, not every time the yield curve inverts, do we experience a recession. Recently, the two-year U.S. Treasury note yield was slightly higher than the five-year U.S. Treasury note yield giving us an inverted yield curve. No other points on the yield curve were inverted but the spreads between the two-year U.S. Treasury note and 10-year U.S. Treasury note have become very narrow.



Falling oil prices: Seemingly falling oil prices are good for the economy as they allow consumers to have more dollars available for spending on other goods or services besides oil and gasoline. However, the recent decline in oil prices has left many investors wondering if the decline is a signal of a slowing global economy rather than an oversupply of oil.

Global economic slowing: Europe has been in a funk economically for some time now. In 2018, China's growth in GDP slowed. Although not directly supported by the economic data, investors have been fearful that slowing global growth will spill over into the United States. In the month of December, high yield corporate bond spreads widened signaling some additional credit risk due to perceived slowing in the economy. The

widening high yield spreads also make corporate borrowing more expensive at least for below investment grade rated companies.

Why the Market Will Recover — Seeing the Glass Half Full

We look at the markets and conclude that there are a lot of reasons to be positive and to see a continuation of the bull market that began in February, 2009. Those reasons include 1) attractive company valuations relative to earnings, 2) corporate insider buying at an eight-year high, 3) a likely short-lived trade war, 4) the economy is still growing, 5) the yield curve may normalize and 6) the Federal Reserve may slow or stop raising interest rates.

Attractive company valuations relative to earnings: The recent stock market decline would normally suggest that corporate earnings growth was flat or declining. That is not the case. Standard & Poor's estimate that the year-over-year growth in earnings on the S&P 500 Index companies at nearly 11%. Likewise, valuations of the market have become "cheap" based on the outlook for earnings. The market appears to be undervalued by some 9% at year-end if one would apply an average historical Price to Earnings ("P/E") ratio of 16.5 times forecasted earnings.

Corporate insider buying at an eight-year high: Who knows their business better than executives who run the companies investors invest in? There are a lot of reasons that executives may sell their company's stock, but there really is only one reason why executives buy their company's stock; they think the company is undervalued. In December, such buying reached an eight-year high.

Likely short-lived trade war: Nobody will win a trade war and it is improbable that tariffs on goods going to and from China will continue. Some sort of trade deal will likely be made similar to the deal recently agreed upon between the United States, Mexico and Canada.

The economy is still growing: Recent market activity would suggest that the U.S. economy was slowing or contracting. This is not the case. Whether it is GDP growth, jobs growth, durable goods orders or housing starts, the numbers are encouraging. Plus, lower oil prices, if sustained, should act as an economic stimulus similar to a tax cut.

The yield curve may normalize: Although an inverted yield curve can signal an impending recession, the positive economic data suggest that no such recession is on the horizon. As a result, the yield curve should normalize.

The Federal Reserve may slow or stop raising interest rates: Historical data show that the Fed's raising of interest rates usually does not cause stocks to sell off. It is only in the rare case when the Fed goes too far that stocks have declined. Although the Fed has signaled that it will raise interest rates two times in 2019, the Fed Funds futures market is pricing in zero rate increases in 2019. The Fed Funds futures market has been a fairly reliable predictive indicator historically.

What Could Go Wrong?

Although we are optimistic that the equity markets will recover and resume the bull market, there are still things that could go wrong which could derail anticipated gains which include 1) the Fed could still go too far and push the United States into a recession, 2) the impeachment of the President and 3) the trade wars are not averted.

The Fed goes too far and pushes us into a recession: Although we view the Fed going too far as a very low probability event, it is still a possibility. If interest rates rise too high, too quickly, the economy could grind to a halt.

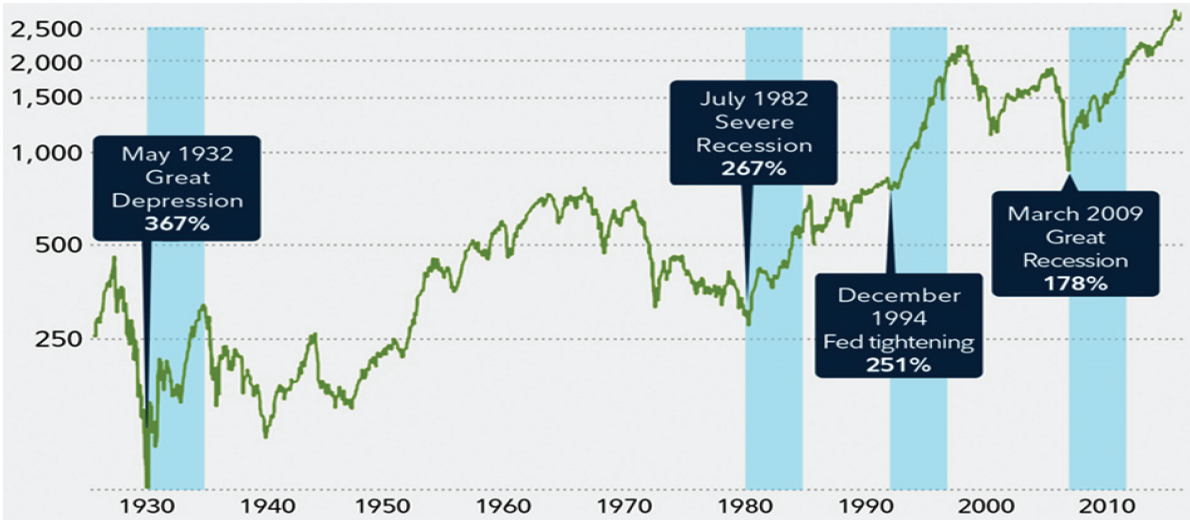
The Impeachment of the President: Congress could be bogged down and focused on impeaching the President. Some Democratic lawmakers who recently took over the House of Representatives last fall have vowed to investigate the President for various alleged infractions. The risk here is that the House spends its time with investigations and impeachment proceedings and not focused on passing meaningful legislation to advance the country. Much progress could be made in terms of infrastructure spending, health care and immigration and all of this could be placed on hold for the next two years as Congress prioritizes impeaching the President. Even if the House does vote to impeach the President, it takes two-thirds of the Senate to remove him from office which has a near zero probability of occurring.

Trade wars are not averted: Although we believe that a trade deal with China will occur and may even be imminent, if such a deal does not occur the China/U.S. markets and economies will suffer.

Long-term Investors Should Stay Invested Regardless of Volatility

To long-term investors, "short-term" downturns should not have much of an impact on one's ultimate performance. Instead of trying to judge when to buy and sell based on market conditions, investors that take a disciplined approach to investing will avoid the perils of market timing. By staying invested through downturns, there will be short-term drops in portfolio values but over the long run, those losses will likely be negligible. In fact, what has seemed like some of the worst times to get into the market turned out to be the best times. The best five-year return in the US stock market began in May 1932 – in the midst of the Great Depression. The next best 5-year period began in July 1982. It was an economy suffering through one of the worst recessions in the postwar period and featured double-digit levels of unemployment and interest rates.

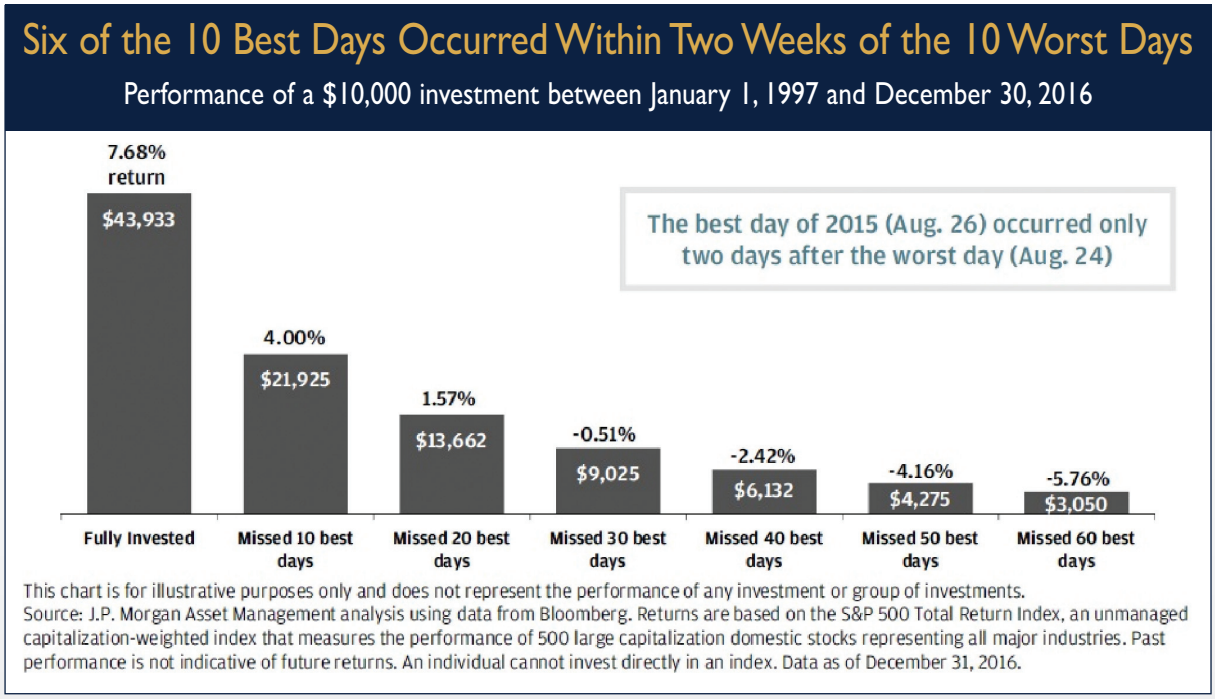
Subsequent 5-year Return



US stock market returns represented by total return of S&P 500® Index. Past performance is no guarantee of future results. It is not possible to invest in an index. First 3 dates determined by best 5-year market return subsequent to the month shown. *Sources: Ibbotson, Factset, FMRCo, Asset Allocation Research Team as of July 1, 2018.*

Attempting to move in and out of the market can be costly. Research studies from independent research firms show that "timing" decisions investors make with regard to buying and selling mutual funds causes those investors to perform worse than had they "bought and held" the same mutual funds.

It would be great to avoid the "bad" days and invest during the "good" ones. The problem is, it is impossible to consistently predict when those good and bad days will happen. And if one misses even a few of the best days, it can have a lingering effect on portfolio performance. Bottom line, investors are better served by taking a long-term approach to investing and ignoring short-term volatility.



Outlook for Longer-term Interest Rates

We have discussed short-term interest rates and the Federal Reserve above. The Fed generally only impacts short-term interest rates. Longer-term interest rates are more impacted by the fixed income markets than by the Fed. At present, the Fed has some impact on longer-term interest rates as it systematically unwinds the quantitative easing programs' bond buying.

However, for the most part the market will determine where longer-term interest rates will go. At the end of 2018, the Ten-year U.S. Treasury note yield was 2.69%. At the end of September, 2018, it stood at 3.06%. The decline in the fourth quarter 2018 was largely a result of fears that the U.S. economy was slowing or even could slip into a recession.

It is our view that we will see continued positive economic growth in the U.S. and as such, longer-term interest rates will rise. The unwinding of quantitative easing will also put some upward pressure on interest rates. As a result, the yield on the 10-year U.S. Treasury note will rise to between 3.25% to 3.50% in 2019 and settle toward the lower-end of this range by year-end.

Outlook for Inflation and the Economy

The Federal Reserve has been managing inflation expectations by raising the Fed Funds rate. Inflation is tame and under control. We are confident that inflation will hover around the Fed's inflation target of 2%. The Fed continues to monitor the economic data including wage growth and will act accordingly. Although jobs data have been very strong, we do not believe that the economy is heating up or in any danger of an inflationary spike.

As for GDP in 2019, we are coming off of some strong readings in 2018. The second quarter was 4.2% and third quarter at 3.4%. Our expectation for GDP for the fourth quarter of 2018 is 3%. We further expect that GDP growth should hover around 3% throughout 2019.

Equity Market Forecast

Currently the forward Price-to-Earnings (P/E) ratio for the S&P 500 index is 14.6 times and the current trailing P/E ratio is 16.67 times as of year-end. The average trailing P/E ratio over the past 20 years (average of quarter-end P/E ratios) is 19.4 times. With earnings projected to grow by some 10.9% over the next twelve months (according to Standard & Poor's Corporation), a 16.67 times trailing P/E ratio suggests an inexpensive market at this time. In addition to strong expected earnings growth, the U.S. economy is strong based on many measures which would help justify a higher P/E ratio. As such, we believe that the S&P 500 Index can have a P/E ratio of 17.5 times earnings (5% higher than the current trailing P/E ratio). This suggests a market return on the S&P 500 Index of 16.4% this year. However, such a return only gets us back to just under the previous record high on October 3, 2018.

U.S. small-cap stocks performance was among the worst of the major indices in 2018. However, we believe that small-cap stocks have the potential to be the best performing sector in 2019. Small-cap stocks have a projected five-year earnings growth rate of over 14% compared to large-cap stocks at 13.2%. Our analysis suggests that small-cap stocks (Russell 2000 Index) could return around 17.5% in 2019.

U.S. mid-cap stocks also performed poorly in 2018. The five-year estimated growth rate in earnings for mid-cap stocks is 12.7%, lower than both large and small-cap companies. Our analysis suggests that mid-cap companies should return around 15.7% in 2019.

We do not have high expectations for developed international stocks primarily due to the anemic growth coming out of Europe. However, we do have optimistic expectations for emerging markets stocks in 2019 based on the assumption that a trade deal will be made between the U.S. and China.

Conclusion

The fourth quarter 2018, in particular December 2018, was very ugly for equity prices. The S&P 500 Index alone was down 13.52% in the fourth quarter which classifies the drop as a "market correction." A correction is usually defined as a decline of 10% up to 20%, with a bear market label reserved for declines of 20% or more. Longer-term interest rates also fell which provided a lift to bond prices in the fourth quarter

after bonds had a rough start to the year as interest rates were rising. The Federal Reserve has been on a steady pace of raising short-term interest rates all year and it has signaled that it will continue to raise the Fed Funds rate in 2019. On the contrary the Fed Funds futures market is projecting no interest rate increases in 2019. Should the Fed not raise interest rates in 2019, equities should respond positively.

There were many reasons for the markets to sell off in the fourth quarter besides the Fed's continued monetary tightening. Tariffs with China, an inversion of the yield curve, falling oil prices and a perceived global economic slowing, all weighed heavily on the equity markets in the fourth quarter. On the other hand, we view the equity markets differently than investors did in the fourth quarter and sense that investors have over-reacted to the reasons we cite for the selloff. There are many reasons for why we remain positive. They include attractive company valuations relative to earnings, corporate insider buying at an eight-year high, the probability of a short-lived trade war, an economy that is still growing, a yield curve which will likely normalize and a Federal Reserve which may slow or stop raising interest rates. Certainly, things can go wrong or get in the way of positive equity prices, and we will monitor such issues accordingly.

At least in the short-term, volatility has revisited us. Now is the time to focus on one's long-term goals and resist the temptation to move to the sidelines. Whether the selloff is over or not, one's asset allocation strategy was developed to – balance risk in one's portfolio. We are here to listen, counsel and provide direction to all of our clients.

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