JMK Jurika · Mills & Keifer
Private Wealth Management

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To our clients and friends.

Most of us have flown many times in our lives and know that bouts of turbulence are normal. And, even though we rationally know that the plane has been engineered to withstand turbulence far in excess of what we will ever likely experience, it is still an unnerving experience, especially when the turbulence feels severe and flight attendants are asked to take their seats.

At times like this it is always reassuring to hear from the pilot, reminding us that he or she is there in the cockpit, letting us know what is going on, setting expectations and engendering a renewed sense of calm and confidence.

And so, with all the ongoing market turbulence and declines, we thought it would be good to do the same and send a quick note to you with some thoughts on the current market environment.

In November we wrote to provide some historical perspective on market corrections as well as seasonality. We pointed out that corrections are a normal and often healthy occurrence, although never pleasant. Nobody likes to see their portfolio values decline.

We also pointed out that there is typically a seasonality to markets and that in most years, November and especially December tend to be the best months for markets, producing the highest average returns; hence the expression: “Santa Claus Rally.”

Well, it doesn’t seem that Santa Claus is coming to town this year. Since the market peak on September 21st, and through today, December 24th, the Bellwether S&P 500 has declined just about 20%. The technology heavy NASDAQ Composite index has declined about 23%. Small capitalization stocks have declined 25%. The damage has been even worse in particular sectors like biotechnology.

Outside the U.S. the pain has been longer lived and more severe, although interestingly, both Europe and emerging markets have been outperforming the U.S. markets since September.

So, what is going on?

We think there are a number of rational and irrational forces at work that are driving current market conditions centered around at least seven key issues:

1. Fears that a slowing economy and falling market portends an imminent recession;
2. Rising interest rates;
3. Trade wars;

4. Government Shutdown;
5. Brexit;
6. Political instability in continental Europe;
7. Political instability here in the US, especially centered around the president.

These conditions are being exacerbated by the magnifying focus of the news media, reporting an endless stream of news headlines and analysis, most of it bad and much of it sensationalized and presented without proper context.

These trends are also exacerbated by the increased presence of computerized/algorithmic trading which results in larger and faster changes in prices as money moves around the globe almost instantaneously, from one asset class to another. Buying begets buying and selling begets selling until some catalyst changes the trend. We have seen markets start the day down significantly and finish up several percent and vice versa.

People are literally exhausted by it all: the wild daily swings in markets; the daily Tweets, contradictory rumors and pronouncements; the constant bleeps on their phones with some new headline, and all the talking heads shouting at one another. Hope has given way to anxiety and fear, and a sense of order has been eclipsed by a sense of a world in disarray.

We feel this exhaustion as well. But if we look at these driving forces and issues rationally, especially in the context of current market valuations, we think the worries are overstated relative to the likely reality. As equity markets have declined, the potential reward of stocks relative to the likely risks is becoming increasingly attractive.

We don't know what will happen next, and there are significant events in the near future – namely the Brexit outcome and the Mueller Investigation - that could cause additional disruption, but we are likely getting close to a market bottom. There may be additional downside, especially at year-end with tax-related selling, but we think it is time to start adding back to risk positions.

Looking briefly at the list of concerns:

1. **Economic Growth:** With respect to the U.S. economy, the rumors of its demise have been exaggerated. Economic growth is slowing but the economy is still strong and growing at a 2% to 3% rate. Unemployment remains under 4%, consumer and business confidence are still high although has been dented by all the market and political turmoil. Economic fundamentals in this country may be less good than they were, but they are still a long way from bad. We will doubtless have a recession in the coming years, but we do not see one yet.
2. **Interest Rates:** The Federal Reserve has been raising short-term borrowing rates in response to a strong economy. Now people are worried that they are going too far and that short-term rates will kill economic growth. Higher interest rates do change the marginal costs and attractiveness of borrowing money to buy a car or house, or finance a new business venture, but from any historical perspective, interest rates are still very low and should not inhibit sensible investment and consumption.
3. **Trade:** Trade policy is a concern, especially as it relates to China. We think that it is in the interests of both China and the U.S. to come to an

agreement and that this is still the most likely outcome. Higher tariffs will hurt China more than the U.S., but they are not a good result for either economy.

4. **Government Shutdown:** The current government shut-down is more symbolic than substantive and will likely resolve itself in the coming weeks. But it does not inspire confidence in our government at a time when stable leadership is needed.
5. **Brexit:** We have no idea how Brexit will turn out. Rational minds should prevail at the last minute to prevent a "hard" Brexit, but this is not a foregone conclusion, and rational minds are often absent in political offices. No matter how the Brexit vote resolves itself, life will go on for the UK and Europe, but a hard Brexit could roil markets in the near-term and will have a detrimental impact on U.K. economic growth for many years to come. A revote would be the best and most likely outcome.
6. **European Political Turmoil:** In Continental Europe, there is also a sense of rising turmoil: The rise of populism, protests in France, political change in Germany, the Italian budget crisis, have dominated headlines. Yet support to remain in the European Union remains high with most citizens, and the European economy is still growing, albeit at a slower rate than the U.S.
7. **Domestic Political Turmoil:** Finally, there is all the domestic political turmoil, much of it centered around the president. For a while, investors seemed content to ignore the noise and focus on the economy. Now the reverse is true. At a time when investors are looking for leadership, competence, stability, and coherent economic and foreign policy, they are getting the opposite. We would expect that the Mueller investigation will conclude in the coming months and that the results will be made public. The outcome will likely be bad for the president and his family. This could destabilize markets for a period of time, but it will pass, and a more stable and conventional government would likely be very positive for the economy and markets.

And so, we see a world where there are a lot of things to worry about. Some of them are imagined or overstated; some of them are real but transitory, and some are binary and unknowable, such as Brexit.

Yet we also see a lot of positives that are being misconstrued or ignored. The U.S. economy is still strong and growing, most of the world economy is also growing, and stocks are now a lot cheaper than they were a few months ago.

In investing, we take a longer-term view towards allocating capital. We do not claim to have any special insight as to what is going to happen next week or month. The markets could continue to decline farther before finding a bottom. But we do know that over the longer term, economies tend to grow, markets tend to rise to reflect this growth and that it has been wise to buy when people are fearful, and prices are low.

We have been cautious on the markets for the last year and a half. This has not helped protect portfolios as much as we would have liked during the recent downturn, but we did back off our equity allocation and raise some cash to be redeployed into stocks when valuation levels improved.

Now, despite all the uncertainties and fear, it makes sense to us to start adding back some equity exposure, especially in areas that have been hit the hardest.

Stocks and sectors that were loved and cherished in September such as technology and biotechnology are now hated and spurned. They were over-loved then, and they are over-hated now. The companies and fundamentals have not changed enough to warrant the major mark-down in prices. Emerging markets have been shunned all year long and also look attractive, especially emerging market technology companies which have similar or better growth characteristics to U.S. companies but are even cheaper.

We have also done some year-end tax-loss harvesting in taxable portfolios and have eliminated one of our alternative managers and simplified the alternative portion of client portfolios.

As always, we are here to help, so please do not hesitate to call us if you have any questions on anything that is going on.

Finally, on behalf of all of us here at Jurika, Mills & Keifer, I want to thank you for the privilege of working with you this year and wish you all the best for the Holidays and the coming New Year.

Warm regards,

Best,

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