Monthly Scorecard

January 4, 2019 | Portfolio Advisory Group – U.S. Equities

Performance (Total return % change)

Index	12/31/18	1 mo.	3 mos.	YTD	1 yr.	2 yrs.
Dow (DJIA)	23,327.46	-8.59	-11.31	-3.48	-3.48	23.65
S&P 500	2,506.85	-9.03	-13.52	-4.39	-4.39	16.47
NASDAQ	6,635.28	-9.38	-17.28	-2.81	-2.81	26.08
Russell 2000	1,348.56	-11.88	-20.21	-11.03	-11.03	1.99
Russell 3000	1,472.14	-9.31	-14.31	-5.25	-5.25	14.76
S&P 500 Equal Wgt.	3,706.35	-9.72	-13.91	-7.65	-7.65	9.80
MSCI AC World	455.66	-7.03	-12.67	-8.95	-8.95	13.50
MSCI Europe	114.20	-4.36	-12.49	-14.34	-14.34	8.19
MSCI EAFE	1,719.88	-4.83	-12.49	-13.32	-13.32	8.95
MSCI Asia-Pacific	146.71	-4.38	-11.03	-13.27	-13.27	14.74
MSCI Emerg. Mkts.	965.67	-2.81	-7.60	-14.49	-14.49	17.82
60/40 Allocation[1]	N/A	-4.68	-7.46	-2.63	-2.63	11.3
S&P 500 Sector	**12/31/18**	**1 mo.**	**3 mos.**	**YTD**	**1 yr.**	**2 yrs.**
Consumer Disc.	781.50	-8.37	-16.42	0.82	0.82	23.98
Consumer Staples	521.88	-9.11	-5.22	-8.39	-8.39	3.97
Energy	424.07	-12.67	-23.78	-18.10	-18.10	-18.92
Financials	395.90	-11.29	-13.12	-13.04	-13.04	6.21
Health Care	1,001.18	-8.62	-8.72	6.47	6.47	29.97
Industrials	542.16	-10.73	-17.32	-13.32	-13.32	4.89
Information Tech.	1,088.31	-8.46	-17.34	-0.29	-0.29	38.43
Materials	316.62	-6.90	-12.31	-14.70	-14.70	5.63
Real Estate	192.36	-7.41	-3.84	-2.23	-2.23	8.38
Comm. Services[2]	138.78	-7.29	-13.19	-12.53	-12.53	-13.63
Utilities	268.61	-4.02	1.36	4.11	4.11	16.71
FI, FX, & Commod.	**12/31/18**	**1 mo.**	**3 mos.**	**YTD**	**1 yr.**	**2 yrs.**
U.S. Treasuries[3]	2.69%	2.15	2.57	0.86	0.86	3.19
Invest-Grade Credit[4]	4.20%	1.47	-0.18	-2.51	-2.51	3.75
High-Yield Credit[4]	7.95%	-2.14	-4.53	-2.08	-2.08	5.27
WTI Crude Oil[5]	$45.41	-10.84	-38.01	-24.84	-24.84	-15.47
Dollar Index[5]	$96.17	-1.13	1.09	4.40	4.40	-5.91
Gold[5]	$1,282.45	4.90	7.54	-1.58	-1.58	11.30

[1] 60% S&P 500 and 40% Bloomberg Barclays U.S. Aggregate; [2] Communication Services returns include data from the previously labeled Telecom sector for returns including dates prior to 9/30/18. [3] Yield reflects 10-year U.S. Treasury, total returns reflect Bloomberg Barclays U.S. Treasury Index; [4] Yield and total returns reflect that of the respective Bloomberg; Barclays Index; [5] Spot prices and price returns.
Source - Bloomberg, RBC Wealth Management

Priced (in USD) as of December 31, 2018, market close (unless otherwise stated).

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Mr. Grinch's silver lining

Investors found coal in their proverbial stock market stockings as Christmas Eve declines capped a bumpy ride that nearly pushed the S&P 500 into a bear market. The Dow Jones had its worst Christmas Eve showing in the history of the index when it declined 2.91% on December 24. More than 60% of the S&P 500 traded in bear market territory, defined as 20% or more below 52-week highs. Fortunately, there was a slight reprieve after Christmas and into the New Year. December's Grinch-like losses are almost, but not entirely, unprecedented. In fact, only eight times since 1980 has the market delivered returns this bad or worse in a single calendar month. However, as we highlight below, history suggests the next twelve months should be better than the last twelve.

A roller coaster 2018 saw stocks finish the year with their worst annual returns since 2008. In the course of the wild ride, the S&P 500 climbed 10% to its 2018 peak in the first three quarters before reversing course and dropping nearly 20% though Christmas Eve, then settling down and ending the year 4.4% lower on a total return basis. Volatility rose by all measures, and both U.S. GDP and corporate earnings grew at their fastest clips since 2011.

Monthly returns saw calendar-year leaders falter as laggards outperformed by virtue of declining less. U.S. stocks struggled badly, while international stocks merely struggled. Emerging markets and the Asia Pacific region have now delivered back-to-back months of outperformance for the first time since January 2018. Our trusty global barometer, the MSCI All Country World Index, declined 7.0% on the U.S.-led weakness. The S&P 500 declined 9.0% after being down nearly 15.0% for the month. The 5.0% rally on December 26 was the single best day for the index since March 2009—in the immediate aftermath of the Great Recession bottom.

RBC Wealth Management

Suffice it to say that the investor experience in December was shockingly negative and our view is that the pain will subside, albeit more slowly than it appeared.

In the U.S., the best-performing sector—Utilities—declined 4.0%. The second-best-performing group was nearly 300 bps worse, as Materials registered a 6.9% decline. And that was the good news. The bad saw Energy fall 12.7% and Financials decline 11.3%, after each had been down almost 20% at their worst in December alone.

The silver lining

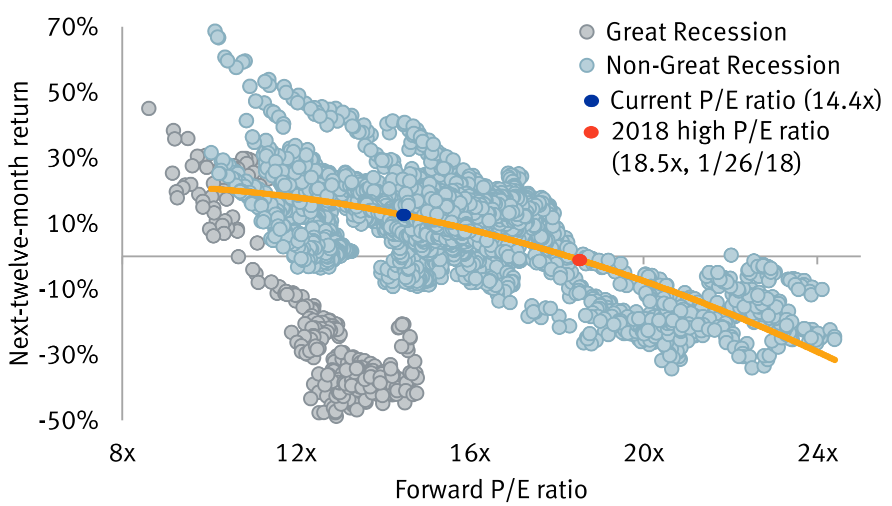
Mr. Market has decided to test the intestinal fortitude of investors this quarter, and the silver lining we've found to the recent investor experience is that the table is currently set for a reasonable recovery with a favorable upside/downside tradeoff, in our view. Starting with the economy, we do not believe we are entering an economic downturn yet. As a reminder, the most dramatic equity bear markets occur during or just prior to a recession. This view increases our confidence that the rest of the data we're looking at indicate a sizable rebound from the December lows. In fact, if history is a guide, we see the potential for double-digit returns in 2019. This view is supported by four pillars of market data.

The first pillar is valuation. We believe concerns about elevated valuations dampening future returns have largely evaporated in the wake of the current selloff, which has produced a rapid unwinding of market multiples. Specifically, the forward P/E ratio on the S&P 500 has declined from its peak of 18.5x in January 2018 to a low of 13.5x on Christmas Eve before ending December at 14.4x. While tax reform tailwinds certainly played a role in the decline as earnings growth outstripped market appreciation in 2018, we note that other valuation metrics unaffected by tax law changes saw similar declines. Simply put, the abrupt market de-rating from peak to trough vastly changed the outlook for future returns.

In the chart below, we examine the S&P 500's average next-twelve-month return across a range of valuations. When valuations creep as high as they did in January 2018, or are higher, positive returns occur only 0.2% of the time. That challenging backdrop is no longer in place. Fast-forward to the intraday low on Christmas Eve, when the forward multiple declined to 13.5x: in this scenario, the average next-twelve-month return is 16.0% with a positive return occurring 98% of the time—clearly more favorable.

The forward P/E ratio on the S&P 500 indicates the potential for mid-teens appreciation from current levels.

S&P 500 and next-twelve-month returns



Source - RBC Wealth Management, FactSet; data through 12/31/18

December saw the VIX rise into the mid-30s, setting the table for above-average returns in coming months.

The second pillar supporting our view of the future is volatility. When volatility (as measured by the CBOE Volatility Index, or VIX) rises, as it has since October, ensuing equity market returns have been better than average. In fact, during the current economic expansion, the next-twelve-month return has been about seven percentage points better than average (19.3% versus 12.0%) when the VIX has risen above 30.

Volatility and future returns since 2010

	Return: Next one month	Return: Next three months	Return: Next six months	Return: Next twelve months
VIX › 20	2.0%	6.1%	9.9%	14.8%
VIX › 25	2.2%	6.7%	12.7%	18.0%
VIX › 30	1.8%	6.0%	13.7%	19.3%
Average	0.9%	2.7%	5.7%	12.0%

Source - RBC Wealth Management, Bloomberg; data through 12/31/18

The third pillar indicating positive future returns is the degree to which investor sentiment has soured. Since 1999, there have only been four non-recessionary readings with more negative sentiment as measured by the AAII Investor Sentiment Survey. In those four previous occurrences, the average return in the following twelve months was 23.5%. Given our view that we are not currently in a recession, we believe sentiment is indicative of bullish returns to come.

Finally, historical precedent shows that sudden, violent market declines create a build-up in pressure that, when released, eventually results in positive returns over the ensuing twelve months. Since 1980, we've seen eight previous episodes of equivalent or worse monthly returns on the S&P 500 (December 2018 price return: -9.2%), and several of these were notable months: the Great Recession months of October 2008 and February 2009; the tech bubble months of February 2001 and September 2002; and the Black Monday month of October 1987 all stand out. The key is that investors who have stomached the pain of these challenging months were subsequently rewarded with an average return of 21.7%. While we're not forecasting returns over 20%, in our view it's hard to deny the favorable position this painful December has created for returns in the coming year in light of past experience.

S&P 500 monthly returns worse than December 2018, since 1980

	Monthly decline	Next-twelve-month return
December 2018	-9.2%	*TBD*
February 2009	-11.0%	50.3%
October 2008	-16.9%	7.0%
September 2002	-11.0%	22.2%
February 2001	-9.2%	-10.7%
August 1998	-14.6%	37.9%
August 1990	-9.4%	22.6%
October 1987	-21.8%	10.8%
March 1980	-10.2%	33.2%
Average	-12.6%	21.7%

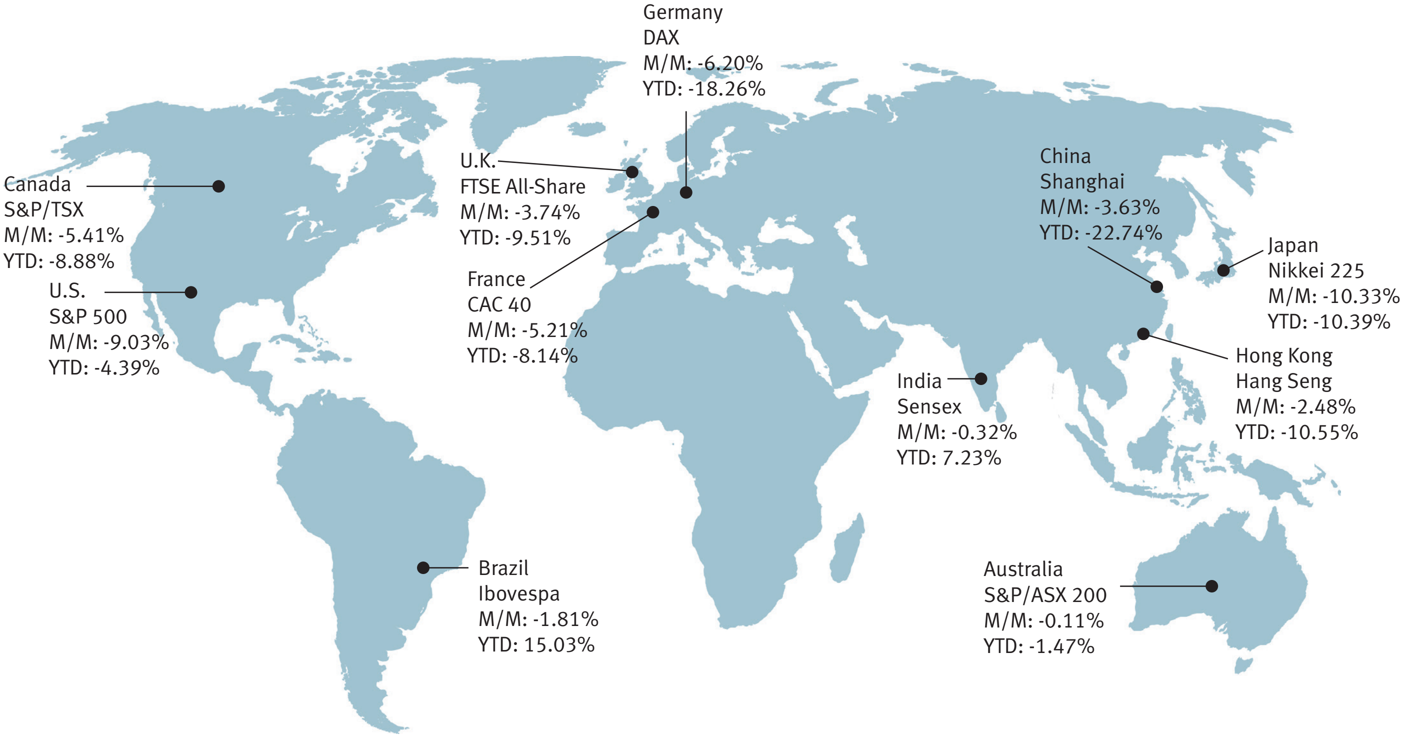
Source - RBC Wealth Management, Bloomberg; data through 12/31/18

We hope to experience the powerful returns historically generated when valuations were this reasonable, sentiment this bearish, and recent returns this painful.

Market corrections are always more violent than expected, and the most recent has been no exception. Global economic deceleration, slowing U.S. corporate earnings growth, geopolitical tensions, and possible central bank missteps all came together to create an environment where much of the world was pushed into a bear market, with the U.S. avoiding one so far by a whisker. That's how we got here. But as markets move on from these challenges, the path forward doesn't look all that bad. In fact, we don't want this time to be different. We hope to experience the powerful returns historically generated when valuations were this reasonable, sentiment this bearish, and recent returns this painful. If this time is like all the other times when similar conditions have prevailed, investors should be far happier with their stock market stockings in 2019 than they were in 2018.

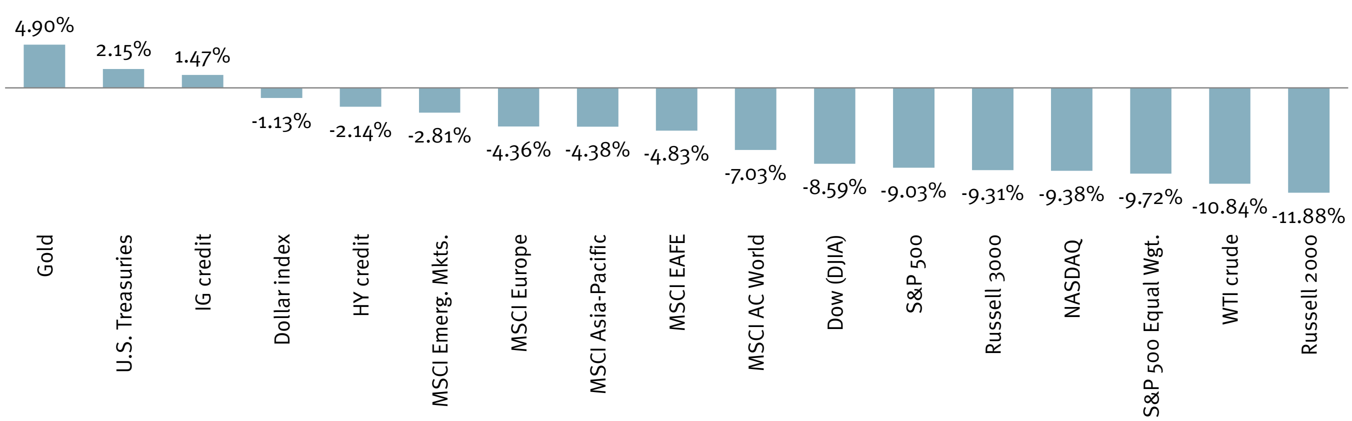
World markets

December month-over-month and year-to-date total return



Source - Bloomberg; priced in local currency

Total monthly returns for select indexes – December 2018



Source - Bloomberg

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