CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 2, 2019

1. December was a wild ride for investors
2. Stock market prices have fallen. Should investors buy?
3. Snowboarders and investors should both expect falls

Market Performance

Equities	DECEMBER	YTD '18	12-MONTH
Global Equity Market[1]	-7.04%	-9.42%	-9.42%
Total U.S. Market[2]	-9.31%	-5.24%	-5.24%
Domestic Large-Cap Equity[3]	-9.03%	-4.38%	-4.38%
Domestic Small-Cap Equity[4]	-11.88%	-11.01%	-11.01%
International Equity[5]	-4.53%	-14.20%	-14.20%
Developed International Equity[6]	-4.85%	-13.79%	-13.79%
Emerging Market Equity[7]	-2.66%	-14.58%	-14.58%
Diversifiers	**DECEMBER**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[8]	+1.84%	+0.01%	+0.01%
Cash Equivalent[9]	+0.19%	+1.82%	+1.82%
Commodity[10]	-6.89%	-11.25%	-11.25%
Diversified Alternatives[11]	-2.75%	-3.49%	-3.49%

[1]MSCI ACWI Index [2]Russell 3000 Index [3]S&P 500 Index [4]Russell 2000 Index [5]MSCI ACWI ex-U.S. Index [6]MSCI EAFE Index [7]MSCI Emerging Markets Index [8]Bloomberg Barclays Capital U.S. Aggregate Bond Index [9]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index [10]Bloomberg Commodity Index [11]Morningstar Diversified Alternatives Index As of 12/31/2018

December Market and Portfolio Review

December was a tough month for the financial markets, and it pushed most financial assets to losses on the year. Prices did not fall by 20% or more, which means the bull market in U.S. stocks is still officially alive, continuing as the second longest and strongest in U.S. stock market history. But by year's end, it was hanging by a thread.

Though the magnitude of losses was not as steep as in 2008, only a few asset classes were able to generate returns above 5%, which made 2018 worse than 2008 in some ways. There was really no place to generate attractive real returns last year.

The reasons losses were so steep during a time of year when gains are more typical include rich valuations - typical in mature bull markets, decelerating corporate earnings growth - to be expected after the phenomenal growth in prior quarters, and higher interest rates - also foreseeable given the normalcy of the economy and the abnormality of low interest rates over the last 10 years. Mix in extreme political uncertainty created by the president during a period in the four-year presidential cycle when political uncertainty is typically at low tide, and it was a difficult environment for the stock market, especially U.S. stocks.

The outlook for 2019 is much brighter. The stock markets typically move higher on a calendar year basis - the last 150 years have set the long-term historical probability at about 75% positive, and that probability moves even higher after the stock market experiences a setback like it has in recent months. The odds for above-average gains are even higher. Generally speaking, now is a better time to buy, not sell.

Here is a breakdown of market performance in December. The overall global market lost nearly 7%. The U.S. stock market lost more than 9%. Larger companies lost nearly 9%, while smaller companies lost nearly 12%. Growth-oriented stocks lost almost 9%, while value-oriented stocks lost just under 10%.

International equity markets fared much better but were also down. International stocks lost more than 4%, while developed international markets, such as Europe and Japan, were down nearly 5%, and emerging markets, such as China and India, were down less than 3%.

The bond market - arguably the most hated asset class at the beginning of the year - gained nearly 2% and finished the year essentially unchanged, beating the stock market for the first time in many years. The 10-year U.S. Treasury yield ended the year at 2.69%. The three-month U.S. Treasury yield ended the month at 2.45%.

Real assets were mixed. Commodities lost nearly 7%, and global real estate investment trusts lost just over 5%.

In general, CLS portfolios had temporary losses last month, but on a relative basis performed well given the positive performance of bonds and the outperformance of emerging markets.

A December To Remember

It was a sensational December that pushed the U.S. stock market to one of its worst quarters in nearly 100 years. Even over the final week of the month, in just two and a half days, the S&P 500 witnessed its worst Christmas Eve ever, its biggest gain since 2009, and its largest intraday positive reversal since 2010.

And that was just the last week of December. The rest of the month had plenty of notable news. CLS analyst Dustin Dorhout provided some more sensational December headline makers, listed below along with a collection of financial news snapshots that paint a turbulent picture. The happiest note – it appears that the market has tried to find a bottom, at least for the time being.

1. December 3: The yield curve inverts

- The U.S. yield curve inverted for the first time in more than a decade. The inversion indicated some longer-term maturity bonds have lower yields than some shorter-term maturity bonds.

2. December 4: Consecutive slumps

- The S&P 500 logged five one-day drops of at least 3% without a rise of that magnitude for the first time in a calendar year, according to Dow Jones market data. The last time it got close to this trend was in 1936, when the benchmark recorded four one-day 3% declines and no similar advances.
- According to the Wall Street Journal, the Dow Jones Industrial Average posted four slumps of 3% or more in 2018 without a rise of that size. That's a history-making streak. The blue-chip gauge last posted three 3% down days without a 3% increase in 1897.

3. December 10: Tech stocks rally

- The Dow swung higher from a tech stock rally, which helped an earlier 500-point loss that would have pulled it into correction territory.
- At the same time, the S&P 500 and Nasdaq rose slightly, and the Russell 2000, a small-cap index, was unable to recoup losses. It fell 0.3% and hit its lowest closing value in more than a year.

4. December 11: A day of wild swings

- The Dow swung 570 points from its high to its low and changed direction seven times as investors parsed headlines about trade and a potential government shutdown.

5. December 17: On pace for a bad December

- The Dow and S&P were on pace for their worst December performance since 1931 (Great Depression).
- CNBC reporter Michael Sheetz writes: "December is typically a very positive month for markets. The Dow has only fallen during 25 Decembers going back to 1931."
- From the Stock Trader's Almanac: "The S&P 500 averages a 1.6 percent gain for December, making it typically the best month for the market."

6. December 18: Nasdaq moves into red for the year

- All 30 stocks in the Dow industrials and all 11 sectors in the S&P 500 ended lower.
- These declines pushed the Nasdaq into red for the year. The Russell 2000 moved into a bear market (20% decline from its August high, thus ending its bull run that began in April 2016). U.S. crude oil prices fell below $50 a barrel for the first time in 14 months.

7. December 19: Markets fall after the Fed raises rates

- The U.S. Federal Reserve (Fed) raised rates for the ninth time since 2015 and the 100th since 1970. As CLS's Dorhout noted: "Given the quantity and frequency with which the Fed raises rates, one would expect market participants to be much better at pricing in these decisions, but this was not the case. The S&P 500 dropped by more than 150 bps, and the Nasdaq dropped even more, roughly 210 bps."
- From the Wall Street Journal: "The broad Standard & Poor's 500 stock index, which tumbled 1.6 percent, is now down 10.6 percent from the end of September, which marks its worst start to December since the Great Depression, according to Bespoke Investment Group. The large-company stock index fell 14.53 percent in December 1931, according to data from S&P Dow Jones Indices."

8. December 21: Nasdaq moves into a bear market

- Reuters: The Nasdaq falls into a bear market, the first of the three major U.S. indexes to do so.
- From the Wall Street Journal: "All three indexes are on track for their steepest monthly losses since October 2008."

9. December 23: The worst week since the global financial crisis

- Stocks suffered their worst week since the global financial crisis, and the market is having its worst December since the Great Depression. The Nasdaq is officially in a bear market.
- Across the world, all asset classes (except for cash) are down for the year for the first time since 1972. We may be in a rare non-recessionary bear market.

10. December 24: Dow's worst performance ahead of Christmas – ever

- Monday's more than 2% drop was the Dow's worst performance ahead of Christmas, trumping a 1918 record.

11. December 26: Markets turn around with a massive, post-Christmas comeback

- U.S. stocks staged one of the biggest rallies of the nine-and-a-half-year bull market after coming within points of seeing it end. Major indexes surged at least 4.9 percent. Crude oil jumped almost 10% (best rally since 2016).

12. December 27: The rebound continues

- Dow Industrials storm back in a record rebound.
- From the Wall Street Journal: "The Dow Jones Industrial Average staged a dramatic comeback in the final 90 minutes of Thursday's session, swinging more than 850 points and offering a respite for investors bruised by the biggest selloff since the wake of the financial crisis."
    - "Major indexes spent much of the day in the red — the blue-chip index slumped more than 600 points, or 2.7%, in afternoon trading. But for the second consecutive session, stocks got an unexplained jolt of adrenaline heading into the closing bell, and a day that started as a fierce selloff morphed into a broad rally."
    - "The 30-stock index ended the session up 260.37 points, or 1.1%, at 23138.82. It was the biggest single-day point rebound in the blue chips' more-than-120-year history. The recovery rounds out a record-setting week during which the index has set new marks for the worst-ever Christmas Eve selloff, followed by Wednesday's 1,086-point climb, the biggest one-day gain on record."

13. December 28: Another positive day

- All three major U.S. indexes rose at least 2.7% this week, snapping a three-week losing streak. Despite the gains, the indexes are all poised for annual losses for the first time since 2008, while the blue chips and the S&P 500 are on pace for their worst December since 1931.

It was indeed a sensational month. Many reasons have been cited for the market volatility, but here are my thoughts on why 2018 is ending so poorly:

1. A backdrop of rich asset prices (U.S. equities, corporate debt).
2. The adjustment to more "normalized" monetary policy (this is healthy for the economy and markets in the long term).
3. Economic growth and corporate earnings growth slowing from "awesome" to merely "really good" (historically, markets do poorly when this happens).

I believe there are two additional reasons behind the December losses:

4. The vicious cycle of negative price volatility leading to more negative volatility.
5. The massive amount of political uncertainty created by President Trump regarding a variety of issues, including: threatening the independence of the Fed, staff instability, government shutdowns, erratic communications, trade policy, possible 2019 impeachment talks, and (perhaps something very underrated by the market) military policy.

Market pundits cited several other reasons for the poor market performance:

- Quants and their algorithms – I think the fact that the market is being driven more by data-driven traders accelerates losses but doesn't necessarily cause them.
- Liquidity – the relative lack of liquidity, which means fewer market participants are willing to provide an orderly market, has also prompted faster declines but hasn't caused losses.
- Recession – this does not appear likely at this point. Of course, the stock market could help create a recession.
- Stock buybacks – these slowed in the fall and are indeed a negative factor.
- Flatter yield curve – this certainly doesn't help financials.
- Lower commodity prices – this could point toward lower global growth, but at this point I am downplaying this risk.

All this said, I'm more optimistic about market returns in 2019 and beyond. A few potential reasons:

- Since the president uses the stock market as a validator of his policies and actions, I imagine he will start saying and doing more market-friendly things. Then again, I've been wrong about forecasting the president before – as everybody has!
- A more reliable signal is that investor sentiment is extremely negative. This suggests an overwhelming probability for higher prices and above-average returns in the months ahead.

Should Investors Buy Now?

Stocks are on sale.

How often are prices marked down nearly 20%? Not often. When it comes to nearly every other purchase decision, consumers buy when they have a 20%-off coupon. But in the stock market, most investors head the other way.

Let's review some historical data to put things into perspective. How often does the stock market provide sales? How often is the market down 5, 10, 15, or 20%? According to data from Ned Davis Research, reviewing U.S. large company stocks (S&P 500):

- The market drops 5% or more about every four months.
- It drops 10% or more at least once a year.
- It falls 15% or more every two years.
- It drops 20% or more about every three years.
- Part of the stock market investing experience is feeling the pinch when prices go down. Thankfully, the stock market goes up about 8-10% a year on average, which is well above bonds, cash, and inflation. But the price paid is the discomfort of market volatility and temporary short-term losses.

The Anatomy of Standard & Poor's 500 Stock Index Declines 1/03/1928 to 12/27/2018

	Type of Decline			
	Dip (5% or more)	Moderate Correction (10% or more)	Severe Correction (15% or more)	"Bear" Market (20% or more)
Number of Occurrences	308	97	43	25
Mean Number of Occurrences Per Year	3.4	1.1	0.5	0.3
Mean Number of Days	36	101	191	299
Mean Decline (%)	10.9	19.4	28.2	35.7
Chances of Decline Moving to Next Stage (%)	31	44	58	N/A
Last Occurrence	12/03/2018	9/20/2018	9/20/2018	1/06/2009

The market sometimes drops. Now that it has, instead of appreciating the lower prices, it is currently creating angst among investors. Even over the last week of December when I was on holiday (more on that later), I talked to several investors who said they were significantly liquidating their equity holdings, if not entirely selling everything.

Based simply on what the market typically does after it drops about 20%, it does not appear that a sound course of action to disrupt what was likely an appropriate, all-weather, balanced investment portfolio.

The data below, from Bespoke Investments, shows all the bear markets (losses of 20% or more) since World War II. There have been 13 bear market drops (not including the recent stock market swoon – which was almost a 20% loss).

The columns to the far right show the stock market returns after a 20% loss. (The key rows to the table are at the bottom.) In short, the average return has been above average over all time periods:

- The next week, the average return has been better than the long-term average (+0.3 vs. +0.2). Returns have been positive 62% of the time.
- The next month, the average return has been better (+2.6 vs. +0.7). Returns have been positive 69% of the time.
- The next three months, the average return has been better (+2.5 vs. +2.1). Returns have been positive 69% of the time.

Post-WW2 S&P 500 Bear Markets*

									S&P 500 % Change Once -20% Threshold is Hit				
Cycle	Start	-20%	Days to Bear	End	Days from -20% to End	% Chg from -20% to End	Full Bear % Chg	Full Bear # of Days	Next Week	Next Month	Next 3 Months	Next 6 Months	Next Year
Bear	5/29/46	9/3/46	97	5/19/47	258	-8.20	-28.47	355	-2.73	0.00	-2.40	4.33	2.20
Bear	6/15/48	6/13/49	363	6/13/49	0	0.00	-20.57	363	3.84	9.08	16.16	23.03	39.70
Bear	8/2/56	10/21/57	445	10.22/57	1	-0.43	-21.63	446	3.24	1,97	5.64	9.32	30.11
Bear	12/12/61	5/28/62	167	6/26/62	29	-5.73	-27.97	196	3.73	-5.23	5.93	11.23	25.89
Bear	2/9/66	8/29/66	201	10/7/66	39	-1.78	-22.18	240	3.26	3.46	7.94	17.64	24.30
Bear	11/29/68	1/29/70	426	5/26/70	117	-19.14	-36.06	543	0.25	4.69	-4.96	-8.93	11.55
Bear	1/11/73	11/27/73	320	10/3/74	310	-34.92	-48.20	630	-2.20	2.13	0.54	-9.21	-28.08
Bear	11/28/80	2/22/82	451	8/12/82	171	-8.22	-27.11	622	1.54	1.76	2.87	1.28	32.12
Bear	8/25/87	10/19/87	55	12/4/87	46	-0.41	-33.51	101	1.26	8.09	7.91	14.71	22.53
Bear	3/24/00	3/12/01	353	9/21/01	193	-18.16	-36.77	546	-0.79	-1.00	6.41	-7.42	-1.19
Bear	1/4/02	7/10/02	187	7/23/02	13	-13.34	-31.97	200	-1.57	-1.63	-15.61	-1.15	8.88
Bear	10/9/07	7/9/08	274	11/20/08	134	-39.55	-51.93	408	0.05	1.72	-20.87	-27.16	-29.34
Bear	1/6/09	2/23/09	48	3/9/09	14	-8.99	-27.62	62	-5.72	8.45	22.47	38.05	49.06
Bear?	9/20/18	?	?	?			?	?	?	?	?	?	?
		Average	261		102	-12.22	-31.85	362	0.32	2.58	2.46	5.06	14.44
		Median	274		46	-8.22	-28.47	363	0.25	1.97	5.64	4.33	22.53
		% Positive	--		--	--	--	--	61.5%	69.2%	69.2%	61.5%	76.9%
		Avg. All Periods							0.16	0.66	2.05	4.20	8.67

*Bear Market definition of 20%+ decline that was preceded by a 20%+ rally, all on a closing basis.

Should Investors Buy Now? (Cont.)

- The next six months, the average return has been better (+5.1 vs. +4.2). Returns have been positive 62% of the time.
- The next year, the average return has been better (+14.4 vs. +8.7). Returns have been positive 77% of the time.

Bottom line: Hitting the sidelines for a few months or more to wait for the coast to clear appears to compromise investment results.

So, when is the best time to buy? As the great financial writer Ben Carlson recently wrote: "Buy whenever you have savings you don't need for a number of years." Short and sweet counsel.

Rusty Vanneman, CFA, CMT

President, Chief Investment Officer

Rusty Vanneman is responsible for leading CLS's Portfolio Management Team and overseeing all investment operations at CLS, including investment philosophy, process, positioning, and performance. Mr. Vanneman is also responsible for internal and external communications regarding market environment and current investment strategies. He is part of the management team for several of CLS's proprietary mutual funds.

*Mr. Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, he served as Chief Investment Officer and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO.*

*Mr. Vanneman received a Bachelor of Science degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst (CFA) designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician (CMT) since 1999, and is a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

Did you know? Rusty had a brief stint as a cowboy near the town of Valentine in Cherry County, Nebraska.

Shreddin' The Gnar

My family went snowboarding in Colorado over the holiday break as we've been doing for years (although my son is a skier – the rebel!). I started snowboarding in 1992, and each year that I'm able to go it always creates lifetime memories, especially when I'm riding with my kids.

We were in Steamboat Springs this year. With fresh snow falling each day, we had plenty of "pow" or "gnar" to ride in. This in conjunction with our early mornings let us make a lot of fresh tracks. (I needed the early starts anyway – the markets didn't exactly cooperate with my family holiday. Clients were called, comments were written, and trades were made before we jumped on the first lift!) We hit it hard all week, but I must admit, on the last day we were getting gassed; on one of our last runs, we took a black diamond run through the trees, which, at that stage of the trip, was above our skill level.

Halfway down the run, my daughter fell into a tree well and had a difficult time getting out. I was already downhill so I could only watch and laugh as my son tried to help her get out. It wasn't easy. She had to somersault through the wall of powder, giggling her way down the hill for probably 20 yards before she was finally able to find her snowboard edges and ride out. Moments later my son bit it and, with his skis and equipment going every which way, it could indeed have qualified as a yard sale.

When we all grouped back together, we stood on the steep pitch catching our breath and realizing our legs would not bounce back anytime soon. We knew, however, that if we stuck to our plan, we would be able to ride downhill and achieve our goal. And yes – you knew it was coming – that's a great analogy for investing in the markets!

The difference, however, is the markets usually go up over time. Despite bumps and the occasional fall, the markets allow long-term investors to participate in the relentlessly inevitable, long-term global economic growth. Markets go up, they go down, and then they go up again.

We had a great trip, and I'm deeply thankful as always to be able to enjoy time with my children (especially now that they've gone off to college), the time outside in a gorgeous environment, and the ability to still shred the powder (even though sometimes it shreds me)!

Thank You and Happy New Year

As always, a sincere thank you for reading. If you have any questions or feedback, please let me know.

Stay balanced, and happy new year!

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The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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CLS Investments, LLC ("CLS") Chief Investment Officer, Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.

7-CLS-1/2/2019