SPINNAKER

SPINNAKER TRUST QUARTERLY NEWSLETTER JANUARY, 2019

Spinnaker Trust Fourth Quarter of 2018 Market Review & Outlook

The Nightmare Before Christmas:
Global equity markets fell dramatically during the month of December, punctuated by the worst Christmas Eve trading day in history (a short trading day no less). Despite the largest point rally in the history of the Dow Jones on the day after Christmas, the fourth quarter of 2018 proved to be a nightmare for investors, with equity markets falling about -20% from their recent peaks. This fourth quarter performance was unusual in that equity markets have historically been weak during the summer only to roar back to life in the final months of the year. 2018 was particularly odd because equity markets have also historically performed very well following a mid-term election. With the benefit of hindsight, we can say that 2018 was volatile and news-driven, making it difficult for investors to follow their historical "playbooks." Never have we had the confluence of the longest economic growth cycle in history, a rush of unnecessary fiscal stimulus, tightening monetary policy across the globe, tremendous corporate earnings growth, a growing trade war with a large and economically powerful country and, last but certainly not least, an unpredictable and nonconforming POTUS.

To summarize, the S&P 500 fell by -4.5% on a total return basis in 2018. The S&P 500, Dow Jones, Nasdaq and U.S.-based oil prices fell by -13.5%, -14.9%, -17.3% and -38% for the fourth quarter, respectively. While U.S.-based equity markets saw a sharp, downward pivot in the fourth quarter of the year, international equity markets performed poorly throughout 2018 with the Emerging Market and EAFE (developed international) indexes falling by -15% and -14% on a total return basis. Most international indexes peaked in January of 2018, while the U.S. indexes peaked in late September. For the fourth quarter of 2018, the worst performing sectors were the highly cyclical energy and industrials while the best performers were defensive – utilities and consumer staples. For the full-year, the best performing sectors were defensive – health care and utilities. The worst-performing sectors in 2018 were materials and energy.

The bond market also presented a challenge in 2018. The yield of the 10-year U.S. Treasury bond started 2018 at 2.44%, rose to as high as 3.23% in the early fall, and collapsed back to as low as 2.66% as equity markets fell. Remember, when bond yields rise, bond prices fall. The long-simmering fear of a pick-up in inflation has yet to materialize. Yield spreads over similar duration U.S. Treasury Bonds for the high yield and investment-grade corporate bond sectors rose by 2% and 0.6%, respectively. The Barclays Aggregate Bond Index, the most widely used benchmark for fixed income investing, offered investors an uninspiring 0.01% return for 2018.

He Said, Xi Said:
No 2018 newsletter would be complete without mentioning our nation's brewing trade war with China. We give credit to Barry Ritholz for coining the punchy subtitle for this section. Our team laughed out loud when we saw Barry's Twitter feed the day after the very confusing meeting at the G20 summit in Argentina between President Trump and Chinese President Xi Jingping. The following morning was a Monday, and President Trump Tweeted out a series of very positive messages about the meeting. Markets reacted quite positively. However, there was no confirmation provided by the Chinese.

Later in the day, President Trump made a series of Tweets that contradicted his earlier sentiment, calling himself "the tariff man." The following day, we learned that Canadian authorities had, at the behest of the United States, arrested the CFO of a strategically important Chinese smartphone company called Huawei. The target's father created Huawei and is a respected business leader in China. He also has an official seat with the Communist Party of China. Her arrest was the equivalent of Dick Cheney's daughter being arrested in Vietnam at the behest of the Chinese. The arrest presented investors with a sharp turn for the worse in the trade war with China, and investors responded by selling stocks with abandon.

We focused on the relationship between China and the United States in our last newsletter. While our current administration wants to improve our terms of trade with China, its long-term agenda is to slow China's technological advancement and theft of intellectual property. As a communist nation without election cycles, China has the means to "wait out" economic pressure from the U.S., especially if PBOC officials believe that President Trump may not be re-elected in 2020. We do not see any short-term "fix" to the issues at hand. While President Trump may declare victory about one or two trade issues in the coming year to improve his chances for re-election, we believe that the issues are much longer-term and structural in nature.

It's Been a Great Run: Moving to Reduce Risk in our Equity Portfolios:
After the 2016 elections, our clients were nervous about having an unorthodox Commander in Chief and the tremendous market performance that we had enjoyed since the Global Financial Crisis. At that time, we felt strongly that our clients should remain fully invested and needed a dispassionate way to demonstrate our conviction and the factors that would cause us to recalibrate.

In response, Spinnaker's investment team put together an economic framework for assessing the health of the business cycle using 20 equally-weighted, commonly-used economic indicators, effectively formalizing what had been an often discussed but less structured process. We felt that it was important to develop a straight-forward process to tune out the noise and take emotions out of our investment decisions.

The 20 economic indicators fall into several broad categories including the following: level of interest rates/monetary policy, rate of change of inflation measures, health of the labor market, broad measures of manufacturing health and/or capacity utilization, health of the Chinese economy, long and short-term valuation levels, broad business and retail investor confidence, and the strength of the U.S. dollar.

We agreed that when half of the indicators were flashing caution, a level at which the U.S. and/or global economy has typically started to struggle, we would sell a predefined percentage of equities in client portfolios and use the proceeds to fund a new short-term bond position. When 2/3 of the indicators are flashing caution, we plan to add further to our short-term bond allocation. At the end of November, half of our 20 economic indicators flashed caution. Over the ensuing days, we sold equities on behalf of client portfolios and introduced these defensive, new positions to our equity portfolios.

Our process for re-investing the short-term bond allocations will be driven by market price rather than the movement of the 20 economic indicators. Had one waited for a relatively high ratio of the indicators to become benign following the Global Financial Crisis, he or she would not have been fully invested until the end of 2013 missing a great deal of the upside.

In Conclusion:
2018 will go down as one of the worst years on record for performance of a balanced portfolio. Broad bond indexes were flat, U.S. and international equities are down for the year, and often-used portfolio diversifiers like commodities and precious metals also delivered a negative price return. The irony is that this negative performance came in a year when corporate earnings growth in the U.S. was nearly 22% on a year-over-year basis.

The question, of course, is whether a recession is around the corner or may have even already begun. We only know with hindsight when recessions begin. There are three examples of significant market drops not followed by a recession in 1962, 1987, and 1998. The trailing P/E multiple of the S&P 500 has fallen by 5 points or 20% this year, a near record. In 15 of the previous 20 occurrences, this multiple compression turned out to be a tremendous buying opportunity.

The Spinnaker investment team believes that we need to see three things happen for equity markets to return to previous peak levels during this business cycle: a complete stop to the Federal Reserve interest rate hiking cycle, a trade truce between China and the U.S. and, lastly, the Technology sector and small-capitalization stocks leading markets once again.

On a short-term more tactical basis, we feel that equity markets are now quite oversold, and we could see the market form a base during the first quarter of 2019 that may lead to a true market rally during the first half of 2019. Unemployment rates should continue to improve, wages should continue to rise, and inflation should be modest at best. These factors plus the plunge in oil prices mean that the consumer should continue to be quite strong. Consumer spending is the backbone of our economy. "Real" U.S. interest rates are only slightly above 0%, and the Federal Reserve will likely pause its interest rate hikes during the beginning of 2019. While manufacturing measures in the U.S. have peaked, they are still expansionary. There is also the question of who is left to sell? The month of December saw the biggest month of outflows on record.

Longer term, we believe that markets will be faced with a set of very difficult externalities during the second half of 2019 that should warrant a less aggressive stance to asset allocation. These include: a contraction in year-over-year corporate earnings growth, a pronounced slow-down in U.S. GDP growth, a massive slowdown in fiscal policy stimulus from the Trump administration, unresolved trade issues with China, the refinancing of masses of corporate and government debt at higher interest rates and, potentially, a Federal Reserve that errs in hiking interest rates to economically "neutral" levels. And all of this is then complicated by the lead up to the 2020 election, which certainly offers the potential for far greater scrutiny of the current pro-business regulatory and tax regimes.

So, we enter 2019 with a more cautious mind-set but aware that markets often overshoot in both directions. We remain mindful that betting against the economic vigor and vitality of the United States has been a losing proposition for the past century, and we must balance that fact against the growing wave of uncertainties and challenges that appear to be cresting. We will continue our efforts to maintain meaningful diversity for our clients while trying to sidestep those areas that appear most threatened by the economic environment or vulnerable due to inflated prices.

2018 was a memorable year. After a benign 2017 that saw markets only go up for the most part, we returned to more normal market volatility in 2018 and experienced some of the biggest market swings on record during the fourth quarter. As Jessamyn Norton, our CIO, highlights in her update here, we took advantage of this volatility for clients throughout the year.

We remain humbled by our mission to help our clients secure their financial futures and feel fortunate to have added many new client families and businesses in the past year. We continue to make investments in our team and our technology to ensure that we have the expertise and tools to serve our clients now and well into the future. We have multiple team members pursuing advanced professional designations, and we have upgraded our technology throughout the year. We introduced a new client portal for online account access with a corresponding app for mobile access and made several internal technology advancements to help our team operate more efficiently and at the highest level.

We also managed to have some fun along the way, with various team building events throughout the year. Be sure to follow us on LinkedIn to stay abreast of all that's going on at Spinnaker.

Thank you for partnering with us in 2018. We look forward to continuing to work with all of you in 2019.

Amanda Rand

Tax News: Large Gifts Now Will Not Harm Estates After 2025

The 2017 Tax Cuts and Job Act (TCJA) temporarily doubled the base estate and gift tax exclusion amount from 2018 through 2025, indexed for inflation. For 2019, the amount is $11.4 million. This increase is scheduled to revert to the lower pre-2018 amount after 2025. There were some concerns that after the exclusion amount decreased back to the lower pre-2018 amount, those taxpayers that had used the higher exclusion amount would be retroactively denied the full benefits of the amount of the higher exclusion used.

The IRS and Treasury issued proposed regulations in November that addressed this potential issue. Under the proposed regulations, taxpayers who take advantage of the higher exclusion will not be adversely affected when the exclusion reverts to the pre-2018 amount after 2025.

Welcome to the Team:

We'd like to welcome Kelsie Boudreau to the Spinnaker Team. Kelsie will be supporting both the tax and operations groups. She has a wonderful can-do attitude and we are very excited that she has chosen to work with us at Spinnaker.

MARKET DATA

Index		*2018*	*2017*	*2016*	*2015*
S&P 500	*U.S. Large-Capitalization Stocks*	-4.83%	21.83%	11.95%	1.37%
S&P 400	*U.S. Mid-Cap Stocks*	-11.08%	16.24%	20.73%	-2.18%
S&P 600	*U.S. Small-Cap Stocks*	-8.48%	13.23%	26.46%	-2.01%
Russell 1000	*U.S. Large- and Mid-Cap*	-4.78%	21.69%	12.04%	0.91%
Russell 1000 Growth	*Growth Stocks broken out*	-1.51%	30.21%	7.07%	5.67%
Russell 1000 Value	*Value Stocks broken out*	-8.27%	13.66%	17.33%	-3.84%
MSCI EAFE Index	*Established International Markets*	-13.36%	25.62%	1.59%	-0.28%
MSCI Emerging Markets	*Developing International Markets*	-14.25%	37.75%	11.27%	-14.61%
		12/31/18	**12/31/17**	**12/31/16**	**12/31/15**
90 day T-Bill	*Short-Term Interest Rate*	2.45%	1.39%	0.51%	0.17%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.65%	2.43%	2.45%	2.28%
VIX Index	*Risk Measurement*	25.4	11.0	14.0	18.2
Corporate Bond Spread	*Risk Measurement*	153 bps	93 bps	120 bps	165 bps
TIPS Spread	*Inflation expectations*	203 bps	198 bps	197 bps	171 bps

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