# MARKET ANALYSIS: 2018 REVIEW AND 2019 MARKET OUTLOOK

## 2018 MARKET EVENTS

- Despite strong economic growth, major U.S. stock indices post negative annual returns for the first time in a decade
- Confident in the U.S. economy, the Federal Reserve raises interest rates four times
- Amid political uncertainty, economic growth in international developed markets slows

## U.S. EQUITY MARKETS FINISH DOWN

*S&P 500 TR index returns -4.38%*

The U.S. equity markets were somewhat vexing in 2018. Despite positive economic data and strong growth, major U.S. stock indices posted negative annual returns for the first time in a decade. The final quarter of the year, especially the final month, brought sharp declines in the S&P 500, Dow Jones Industrial Average and tech-heavy Nasdaq, erasing gains from the first nine months as 2018 came to an especially volatile close.

U.S. large-cap equity returned -4.38% for the year, as measured by the S&P 500 TR index, while U.S. small to mid-cap equity returned -10.00%, as measured by the Russell 2500 TR index. Several factors contributed to the late-year drawdown, with fluctuations following announcements regarding U.S.-China trade policy, Federal Reserve strategy, the partial government shutdown and economic forecasts for 2019, which indicate the pace of growth will begin to slow. The December pullback, which stopped short of the 20% mark that signals the end of a bull market, was orderly in that stocks with higher valuations and asset classes with greater risk, such as small caps and growth stocks, declined the most.

## INTEREST RATES APPROACH NEUTRAL LEVEL

*Bloomberg Barclays U.S. Aggregate Core Bond TR index returns 0.01%*

The U.S. Federal Reserve, in keeping with its 2018 forecast, raised its short-term federal funds rate four times last year, once each quarter by 0.25%. December's increase lifted the target range to 2.25-2.50%, which Fed Chairman Jerome Powell said was "just below" neutral – an indication the majority of increases likely are behind us. Facing the headwinds of a rising-rate environment, core fixed income returned 0.01% for the year, as measured by the Bloomberg Barclays U.S. Aggregate Bond TR index. Though rising interest rates typically drive bond prices down, the yields for longer-term bonds held relatively steady compared to the increase in short-term yields. As a result, bond prices remained higher, allowing core fixed income to avoid a negative return.

For sector information relating to commentary above, see index definitions on pages 4 through 5. Portfolio Positioning reflects the AMS IC's general opinions regarding how exposure to various market sectors may help or hinder achieving the portfolio's long term objective. The policy and sector allocations are subject to change without notice. Indices and peer groups are not available for direct investment. Any investor who attempts to mimic the performance of an index and peer group would incur fees and expenses which would reduce returns. Asset Allocation and diversification does not ensure a profit or protect against a loss. All investments are subject to risk and you may incur a profit or a loss. There is no assurance that any investment strategy will be successful. Past performance is not a guarantee of future results. Dividends are not guaranteed and a company's future ability to pay dividends may be limited.

## INTERNATIONAL ECONOMIC GROWTH DIPS

*MSCI EAFE NR index returns -13.79%*

Though international markets began 2018 optimistically, promising growth stalled amid uncertainty regarding a number of geopolitical factors, including the United Kingdom's fitful withdrawal from the European Union, the debt crisis in Italy, trade policy and tariffs, as well a slowdown in China. International developed markets returned -13.79% for the year, as measured by the MSCI EAFE NR index, and emerging markets returned -14.58%, as measured by the MSCI Emerging Markets NR index. While these markets posted losses in local currencies, the increasing value of the dollar cost U.S. investors in international markets an additional 4.5%.

## 2019 MARKET THEMES

- The U.S. economy remains stable, though growth may begin to slow
- Conditions in international developed markets appear favorable after a sluggish 2018
- The U.S. Federal Reserve, forecasted to raise interest rates multiple times in 2019, could alter its course based on incoming data; most other central banks are expected to remain supportive

As we turn the page on 2018, a year that saw remarkable economic and earnings growth in the United States, it's time to look forward. The Asset Management Services (AMS) Investment Committee (IC) expects the volatility that returned to the markets in 2018 to continue in 2019. While economic data suggests the equity and fixed income markets have the potential for gains, the markets have much to digest given the anticipated deceleration in global economic growth.

## EQUITY

The AMS IC sees evidence for continued economic growth in the United States in 2019, though at a slower pace than 2018, which received a boost from tax cuts. While it would be difficult to improve upon the impressive growth of recent years, economic data such as the unemployment rate and labor-force participation rate indicate the U.S. economy remains on solid footing. That said, the markets could react – positively or negatively – to a number of factors, including the Fed meeting in January, the deadline for U.S.-China trade negotiations in early March and reports on economic growth in China and Europe.

The drawdown at the end of 2018 helped to create a more level playing field for equities, with previously high price-to-earnings valuations for U.S. equities, especially in small caps, coming down considerably relative to 2017 and 2018. When valuations were high, the AMS IC positioned Freedom portfolios more defensively, including increasing exposure to dividend and/or low-volatility U.S. equity, which proved to be helpful for risk management purposes.

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In 2019, the AMS IC will look for attractive opportunities to reengage with riskier areas of the market, acknowledging that the United States is in the later stage of the economic cycle. The AMS IC sees opportunity in international markets, as well, given their attractive valuations and supportive monetary policy, yet further market declines in the United States could make U.S. investments more attractive.

## FIXED INCOME

The Fed has increased short-term interest rates nine times since December 2015, confident the economy is healthy enough to stand on its own without the supportive monetary policy that dropped rates to near zero after the financial crisis. Higher short-term interest rates create the potential for higher fixed income yields, though the AMS IC will be keeping a close eye on whether long-term interest rates, which are set by the market, move higher as well. If they do not, there is the potential for the Fed to hold back on additional short-term increases or for the yield curve to invert. An inverted yield curve – an illogical condition in which short-term rates are higher than long-term rates – typically is a harbinger for recession. Based on economic data, the AMS IC sees little sign of a recession in 2019 and doubts the Fed would intentionally cause the yield curve to invert.

Though the current target range of 2.25-2.50% remains low from a historical perspective, investors seem wary of the impact increased borrowing costs could have for consumers and businesses at a time when forecasts call for slower economic growth in 2019. Around the world, central banks in emerging markets began to raise interest rates in 2018, in an effort to keep pace with the increasing U.S. dollar. In international developed markets, such as Japan and the Eurozone, central bank policy is expected to remain accommodative, with rates at or below zero to boost economic growth.

## ALTERNATIVES

If equity markets respond positively to forecasts for continued economic growth and the bond market produces higher yields, alternatives could struggle to outperform most equity and fixed income markets.

## FINAL THOUGHTS

In summary, the AMS IC anticipates a volatile 2019, but without the sharp declines that characterized the end of 2018 because the U.S. markets enter the year priced relatively fairly. While new data could cause the Federal Reserve to reconsider its rate-normalization plan, the Fed is likely to raise its short-term lending rate once or twice, creating the possibility bonds could perform well, especially high-quality bonds. Though Freedom portfolios begin the year positioned somewhat defensively, the AMS IC will look for opportunities to reengage and take risk back to its normal levels.

**Further information on the funds selected for the Freedom portfolios is available by prospectus, which can be obtained through your financial advisor. Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and exchange-traded funds before investing. All investments are subject to risk. The prospectus contains this and other information about the funds and should be read carefully before investing.**

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There is no assurance that any investment strategy will be successful. All investments carry a certain degree of risk and you may incur a profit or a loss.

**RISK:** It is important to review the investment objectives, risk tolerance, tax objectives and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk and no one particular investment style or manager is suitable for all types of investors, you may incur a profit or a loss.

- Fixed-income securities (or "bonds") are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks.
- There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. Short-term bonds with maturities of three years or less will generally have lower yields than long term bonds which are more susceptible to interest rate risk.
- Callable bonds generally offer a higher yield than non-callable bonds as they have the option to call the bonds and repay the principal prior to maturity. Issuers will generally be inclined to initiate a call if interest rates have declined since the bonds were first issued, as they can reissue new bonds at a lower interest rate. Investors will then be positioned to reinvest return on principal in a declining interest rate environment, thus receiving a lower yield going forward.
- Credit risk includes the creditworthiness of the issuer or insurer, and possible prepayments of principal and interest. Bonds may receive credit ratings from a number of agencies however, Standard & Poor's ratings range from AAA to D, with any bond with a rating BBB or higher considered to be investment grade. Securities rated below investment grade generally provide a higher yield but carry a higher risk of default which could result on a loss of the principal investment. Because high-yield bonds have greater credit and default risk they may not be appropriate for all investors. While bonds rated investment grade have lower credit and default risk, there is no guarantee securing the principal investment.
- Investors should consider the Yield to Worst (YTW) of a bond or bond portfolio versus the Current Yield as the YTW is the lowest potential yield that that can be received without default. YTW takes into account any bonds that could be called prior to maturity.
- Securities issued by certain U.S. government-related organizations are not backed by the full faith and credit of the U.S. government and therefore no assurance can be given that the U.S. government will provide financial backing should an issue default.
- Mortgage Backed securities (MBS) are exposed to various risks including but not limited to credit (risk of default of principal and interest payments), market, interest rate, prepayment, and reinvestment risks. Unless issued by GNMA, MBS's are not backed or guaranteed by any government agency. Actual payments received from a MBS frequently differ from the terms stated at purchase. Payments consist of pass through income and principal repayment, can fluctuate over time, and receive no special tax treatment. Changes in interest rates can affect the value and maturity date of a MBS. Prepayment caused by the underlying mortgages being unexpectedly paid off or refinanced is likely and will result in an unpredictable rate of income payment and principal repayment.
- Please note these portfolios may be subject to state, local, and/or alternative minimum taxes. You should discuss any tax or legal matters with the appropriate professional.
- International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility.
- Investing in emerging markets can be riskier than investing in well-established foreign markets. Emerging and developing markets may be less liquid and more volatile because they tend to reflect economic structures that are generally less diverse and mature and political systems that may be less stable than those in more developed countries.
- Investing in small-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Stocks of smaller or newer or midsized companies may be more likely to realize more substantial growth as well as suffer more significant losses than larger or more established issuers.
- Commodities trading is generally considered speculative because of the significant potential for investment loss. Among the factors that could affect the value of the fund's investments in commodities are cyclical economic conditions, sudden political events, changes in sectors affecting a particular industry or commodity, and adverse international monetary policies. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.
- Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.
- Some accounts may invest in Master Limited Partnership ("MLP") units, which may result in unique tax treatment. MLPs may not be appropriate for ERISA or IRA accounts, and cause K-1 tax treatment. Please consult your tax adviser for additional information regarding the tax implications associated with MLP investments.
- Alternative investments are generally considered speculative in nature and may involve a high degree of risk, particularly if concentrating investments in one or few alternative investments. These risks are potentially greater and substantially different than those associated with traditional equity or fixed income investments. The investment strategies used by certain Funds may require a substantial use of leverage. The investment strategies employed and associated risks are more fully disclosed in each Fund's prospectus, which is available from your financial advisor.
- Changes in the value of a hedging instrument may not match those of the investment being hedged.
- These portfolios may be subject to international, small-cap and sector-focus exposures as well. Accounts may have over weighted sector and issuer positions, and may result in greater volatility and risk.
- Companies in the technology industry are subject to fierce competition, and their products and services may be subject to rapid obsolescence.
- An ETF is a type of Investment Company whose investment objective is to achieve a return similar to that of a particular market index. An ETF will invest in either all of the securities or a representative sample of the securities included in the index they track. ETFs may be bought or sold throughout the day in the secondary market, but are generally not redeemable by retail investors for the underlying basket of securities they track. Clients likely to find a ETF strategy most appropriate are those willing to accept market-like returns, lower management fees and operating expenses, with little potential for the individual ETFs to outperform the indices they track. Mutual funds are typically actively managed,

and as a result, the underlying management fees and operating expenses assessed by the fund companies are generally higher than those for ETFs (1% to 1.5% for mutual funds versus .20% to .30% for ETFs). Potential investors should understand that the annual advisory fee charged in the ETF program is in addition to the management fees, operating expenses, and other expenses associated with an investment in ETFs. Because ETFs have the characteristics of both stocks and mutual funds, it is possible to measure performance in two ways. Because ETFs are traded in the secondary market like stocks, performance can be measured in terms of the market price of the ETF. However, since the underlying value of the ETF is based on the securities held in the fund, like a mutual fund, it also can be measured in terms of the Net Asset Value. Both of these are shown above, with the total returns based on the closing market price of the ETF listed first and NAV performance shown below. We believe that market price performance is more representative of our clients' experiences due to the fact that all transactions conducted for ETF are done in the secondary market.

**INDEX AND PEER GROUP DESCRIPTIONS:**

These indices and peer groups are not available for direct investment. Any product which attempts to mimic the performance will incur expenses such as management fees and transaction costs that reduce returns.

**Bloomberg Barclays U.S. Aggregate Bond Index (U.S. Fixed Income):** This index includes investment grade U.S. Government bonds, corporate bonds, mortgage pass-through securities and asset-backed securities that are publicly offered for sale in the United States. The securities in the index must have at least one year remaining to maturity.

**MSCI EAFE Index (International Large Cap):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S & Canada. It consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

**MSCI Emerging Market Index (Emerging Markets Equities):** A free float- adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 2009 the MSCI Emerging Markets Index consisted of the following 22 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

**MSCI EM NR USD (Emerging Markets Large Cap):** The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey* and United Arab Emirates. The MSCI EM NR USD takes only the large cap returns into account.

**Morningstar US OE Multialternative (Multialternative):** These funds will use a combination of alternative strategies such as taking long and short positions in equity and debt, trading futures, or using convertible arbitrage, among others. Funds in this category have a majority of their assets exposed to alternative strategies and include both funds with static allocations to alternative strategies and funds tactically allocating among alternative strategies and asset classes.

**Russell 2500 (U.S. Small to Mid Cap):** A broad index featuring 2,500 stocks that cover the small and mid-cap market capitalizations. The Russell 2500 is a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

**S&P 500 Index (U.S. Large Cap):** The index consists of 500 of the largest stocks in the U.S. stock market. A market value weighted index (stock price times number of shares outstanding after float adjustment), with each stock's weight in the index proportionate to its market value.

**TERMS & DEFINITIONS:**

**Gross domestic product (GDP):** GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

**Total return:** when measuring performance, total return is the actual rate of return of an investment or a pool of investments over a given evaluation period. Total return includes interest, capital gains, dividends and distributions realized over a given period of time.



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880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863 // 727.567.1000 // RJFREEDOM.COM