INVESTMENT
UPDATE

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December 2018

WHAT GOES UP, MUST COME DOWN: THE WAY OF THE MARKET

Despite positive economic data in 2018, namely a 49 year record low unemployment rate of 3.7% and robust GDP growth of 4.2% in the second quarter followed by 3.7% in the third, markets have largely struggled to find their way. After record low volatility and strong returns in recent years, the market has failed to enter double digit territory at any point this year, and instead is now in its fourth quarter at or near correction territory of -10%.

Sharp declines in stocks, corporate credits, and commodities have occurred seemingly due to the Federal Reserve's steadfast commitment to raising interest rates at the end of their September meeting and rising trade tensions with China, as we approach the Trump administration's threatened 25% tariff hike on Chinese goods come January 1, 2019.

This has left the S&P 500 down 1.54% on the year, while it dropped 4% the week of Thanksgiving alone. Obviously, a lot has happened since that September FOMC (Federal Open Market Committee) meeting, and while the market anticipates a 74% probability of a 25 basis point (0.25%) rate hike in December, it has priced in only one rate hike in 2019 versus the Fed's three anticipated hikes. In-house bond expert Doug Geisser explores the past and future interest rate environment further in his piece inside.

Perhaps the most interesting phenomenon has been the fall from grace of the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix and Google). Countless headlines told of their fairy tale ascent in 2017 and in the first eight months of 2018, these five stocks comprised 14.7% of the weight of the S&P index and accounted for 7.1 percentage points of the 8.5% gain in the index.

Since that September meeting, the NASDAQ Composite has led the decline with a 13.7% drop. Since their recent peaks, all FAANG stocks are

Figure 1

in bear market territory (20% or more declines) with Alphabet (Google Parent) down 20% at one extreme while Netflix and Facebook round out the other at near 40% declines. Headlines now read that the FAANGs have lost $1.1 trillion in market value and interestingly, have given back virtually all of their outperformance relative to the S&P 500 (see Figure 1).

As value investors, with the FAANG run-up it had been a difficult 18 month period not broadly owning these stocks in our portfolios and a true test of our, and more importantly your, resolve. Many of you rightly asked why not own the group, and accepted our explanation that we preferred more reasonable valued stocks with less volatility. While we are never happy at the loss of others, we do feel somewhat vindicated. These stocks have led the decline and have had 30% greater volatility than the broader market.

Having seen other manias in my now 23 year career (internet, housing) and the firm's 55+ years (the Nifty 50, gold, oil), we may not have known exactly when, but we knew it was coming. Consider

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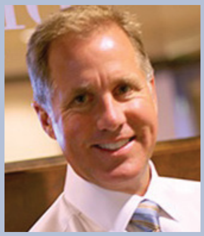
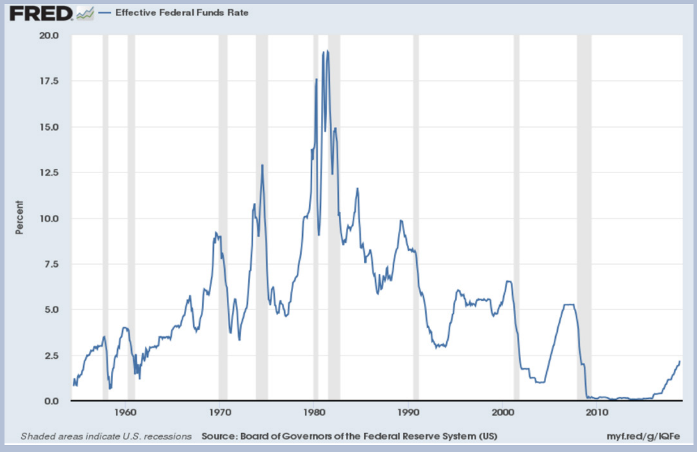
WHAT IS NORMAL?



This past quarter we reached the 10-year anniversary of the 2008 financial crisis. Just prior to the fall season of 2008, stock markets indices were reaching all-time highs, housing prices were elevated and interest rates were considered "normal" with shorter term yields near 5%. This all came crashing down after housing prices began to weaken causing defaults within mortgage backed securities and newly created derivative products that hedge funds, banks and insurance companies used to try and profit from.

The resulting effects of the crisis were historical. Equity indices plunged nearly 40%, in some markets housing prices fell over 50% and short-term interest rates were reduced to essentially 0%. The economy, housing, and investment markets have all clawed their way back over the past decade. Stock indices recently reached new record highs while housing prices and starts have increased in all areas of the country. However, it has taken longer for interest rates to recover and move closer to "normalization" than the other sectors. The recent rise in interest rates has offered investors alternatives to stocks and perhaps been a catalyst to this year's volatility in equity markets.

The interest rate that has the largest impact on overall rates and markets is the federal funds rate. Technically the federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight, and the rate is determined by our FOMC (Federal Open Market Committee). The FOMC changes the fed funds rate to control inflation and maintain healthy economic growth. The FOMC members watch economic indicators for signs of inflation or recession. When the economy is weak, the funds rate will be lowered to reduce borrowing costs for businesses and consumers, hopefully increasing spending and growth.



In 2008 after the market collapse, the Fed made the unprecedented move of reducing the federal funds rate to 0%. After awhile this proved to be successful in aiding our economic growth but perhaps distorted certain asset prices (stocks) as investors turned their back on the negligible returns in bonds for greater potential returns in stocks. How often have you been able to walk into a bank and obtain a loan where the bank doesn't charge you any interest? Essentially, many financial institutions and corporations were able to do just that. This isn't the "norm" as one should expect to earn a return on principal for giving up the use of it for a specific period.

Over the past fifty years the fed funds rate has averaged 4.82%. If you take out the 10% plus inflationary high rates of the 1980's and the unprecedented 0% rates from 2008 -2014, the average drops to 4%. Currently the fed funds rate sits at 2.25%. Since our economy is now growing nicely, has low unemployment, and has recently seen an increase in wage and other inflationary pressures, the FOMC has indicated they want to continue to raise rates over the next couple of years. The FOMC has implied a target rate of 3.25%-3.50% will be reached by the middle of 2020. However, futures traders feel the markets and economy will weaken if rates are moved that high and believe a move to the 2.50%-2.75% is all we will see.

Either way, an end to the recent rise in short term rates appears to be near. It's interesting to note that the stock market touched all time highs in 2000 when the funds rate was at 6% and again in 2008 when it was above 5%. Whether we end this cycle at 2.5% or 3.50%, either would still be well below historical norms. History has shown economic growth can occur with rates higher than todays levels.

There are some positives to higher interest rates. First it enables conservative investors the potential for a higher return on their principal thus increasing cash flow and resources for consumer purchases. It strengthens financial institutions potential to earn higher returns on their assets, improving balance sheets and liquidity. Lastly it gives the FOMC future ammunition to lower interest rates should a weakening economy warrant it.

Fixed income investors have suffered for awhile and the rise in rates over the past 18 months has pushed existing bond prices lower. However, we hold most client bond positions to maturity, negating the market price drops and absolutely welcome the ability to reinvest principal near more normal, higher yields.

Doug Geisser, *VP Fixed Income Principal* our past several newsletters: In December 2017 Doug Geisser explored the dominant weighting of the FAANG stocks, and I warned of a "Mega Cap bubble…[that] could set the stage for a sizeable, emotional decline that could erase many gains." In June of 2018 I warned about the Amazon effect and Portfolio Manager Brett Larson studied the length of our current bull market and cautioned about a possible end to it. What goes up must come down, and that theme has been oft repeated throughout market history.

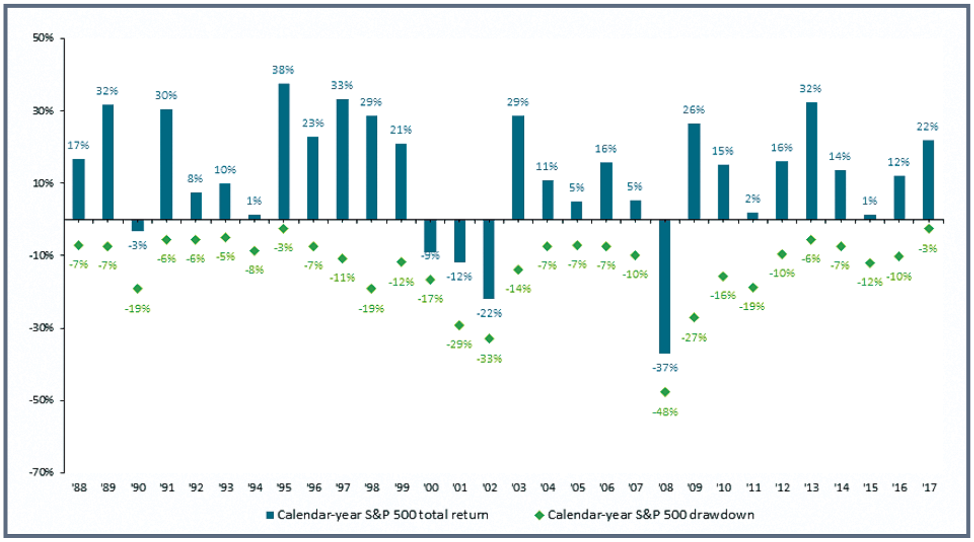


Figure 2 Sources: FactSet and Wells Fargo Investment Institute, as of December 31, 2017.

So where do we go from here? Do the FAANG stocks rebound? Does the broader market go lower? Or does the Fed soften its stance and trade worries too pass? Hard to say. But what is certain is that the market does not move up in straight line increments, and volatility, corrections, and bear markets are common place. Like prairie fires, they are the creative destruction of the market place that allows for the seeds of the next bull run to take hold. While they are no doubt difficult to endure, they are also no reason to exit the market (see Figure 2). Patient investors are rewarded over time, and believe in the long term growth of stocks. We still believe.

Thank you for being patient, and for your continued trust and confidence in us. We wish you and your family the best this holiday season and throughout 2019. We look forward to continuing to grow together.

Joe Romano
PRESIDENT

ROMANO NEWS

Romano Wealth 7th Grade Flag Football Team Makes Consecutive Championship Appearance

For the third year in a row, Romano Wealth sponsored a team in the local Third Coast Flag Football league. Tradition held strong with not one but two Romanos involved: player Leo Romano (eldest child of Joe Romano) and assistant coach Valerie Romano, who represents the third generation of Romanos working at the firm! The team finished the regular season with a record of 6-1 before making their appearance in the championship game for the second year in a row. Despite a strong lead at half-time, Team Romano was edged out of a final win by Team Curt's Café (the only undefeated team in the conference). All in all not a bad season! We'll get another shot next year, Meatballs!

First Clearing Increases Online Security

Beginning in the first quarter of 2019, First Clearing will require an email address and telephone number to access your account information via the internet. If you have online access, and have not yet entered this information, you will be required to add this the next time you log in. First Clearing is adding this to increase the security of your account information. Make sure you add this necessary information before quarter's end to avoid being locked out of your online viewing account. Please contact your portfolio manager if you have any questions.

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WEDDING BELLS AT ROMANO!

Following in the footsteps of our esteemed leader, Joe Romano, who met his wife Natalie working at Romano Wealth 15+ years ago, two more Romano employees have blissfully tied the knot! In a beautiful ceremony at St. George Greek Orthodox Church, 5-year Bond Assistant and Portfolio Manager Holly Nanos said 'I do' to 4-year employee and second generation Romano Portfolio Manager, Peter Hemwall. Shortly after Peter's arrival at Romano Wealth, his father, Rick Hemwall, a 22-year Portfolio Manager with Romano, told his son he and Holly would become "good friends." Little did they know Peter would soon begin dating Holly secretly for a whole year before Joe cornered him in the elevator to ask what was going on! Surrounded by plenty of friends and family, Peter and Holly celebrated their union at a gorgeous reception at Gallery 1028 in Chicago. Congratulations and all the best to the two of them from all of us here at Romano Wealth!