Hemenway Trust Company LLC

Winter 2019 Investment Report

By all definitions, 2018 was a challenging year for investors. The year started off on a high note, as the positive effects of $1.5 trillion in US tax cuts were being factored into an economy that had seen strong growth the year before. While there were periods when the US equity market was driven higher by strong earnings and favorable employment numbers, there were also periods when fears of a slowing economy and tighter monetary policy by the Federal Reserve took equity valuations down. These fears were enhanced in Q4, as companies warned about the impact of a trade war on their operations and a partial US government shutdown set in. Given these uncertainties, companies reduced their forward guidance for 2019 and US stocks lost 13.5% in Q4, ending the year down 4.4% - the first negative calendar year return since 2008.

Beyond equities, other asset classes struggled in 2018, as well. As we noted in our Fall 2018 Investment Report, slowing growth in Europe and Asia and a rising US Dollar saw international stocks fall further - down 10-14% for the year. Even bonds, typically a safe haven, posted flat to negative returns, as US interest rates rose. This left cash and cash equivalents (i.e. money market funds) as the year's best performing asset class, returning 1.8%.

With so much volatility in the market, we were encouraged that the high quality of our investments dampened market instability and resulted in most client portfolios posting flat to positive returns for the year, despite a healthy weighting to stocks. For comparison, even the iShares Conservative Allocation Index Fund, with a 40% equity allocation, lost 3% in 2018.

Dissecting the Past Quarter

Looking at the investment returns in Q4, one might fear that we were in in the midst of another 2008, with indiscriminate, panic selling. While losses were severe for many parts of the equity market, we saw good depth and liquidity and feel the markets behaved quite rationally on the consensus view that growth would be lower. As noted in the chart below, the negative impact was most pronounced in cyclical sectors where growth expectations were highest (tech, energy, industrials), while sectors with defensive characteristics (healthcare, consumer staples, utilities) fared better. Also, unlike 2008, we saw a rational bond market, with higher risk (most indebted) credits selling off the most.

Returns by Sector

	Financials	Materials	Industrials	Real Estate	Cons. Discr.	Energy	Technology	Comm. Services	Health Care	Cons. Staples	Utilities	S&P 500 Index	
S&P weight	13.3%	2.7%	9.2%	3.0%	9.9%	5.3%	20.1%	10.1%	15.5%	7.4%	3.3%	100.0%	Weight
Russell Growth weight	4.4%	1.8%	11.8%	2.3%	15.1%	0.8%	31.5%	11.9%	14.3%	6.0%	0.0%	100.0%	
Russell Value weight	22.5%	4.1%	7.4%	4.9%	5.2%	9.3%	9.3%	7.3%	15.7%	7.8%	6.5%	100.0%	
4Q 2018	-13.1	-12.3	-17.3	-3.8	-16.4	-23.8	-17.3	-13.2	-8.7	-5.2	1.4	-13.5	Return (%)
2018	-13.0	-14.7	-13.3	-2.2	0.8	-18.1	-0.3	-12.5	6.5	-8.4	4.1	-4.4	
Since market peak (October 2007)	3.3	50.7	85.3	63.7	212.4	-4.8	198.2	35.1	195.7	147.9	98.8	103.7	
Since market low (March 2009)	463.7	259.0	409.3	506.9	623.1	74.4	524.7	158.0	376.7	247.7	248.0	355.2	

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management

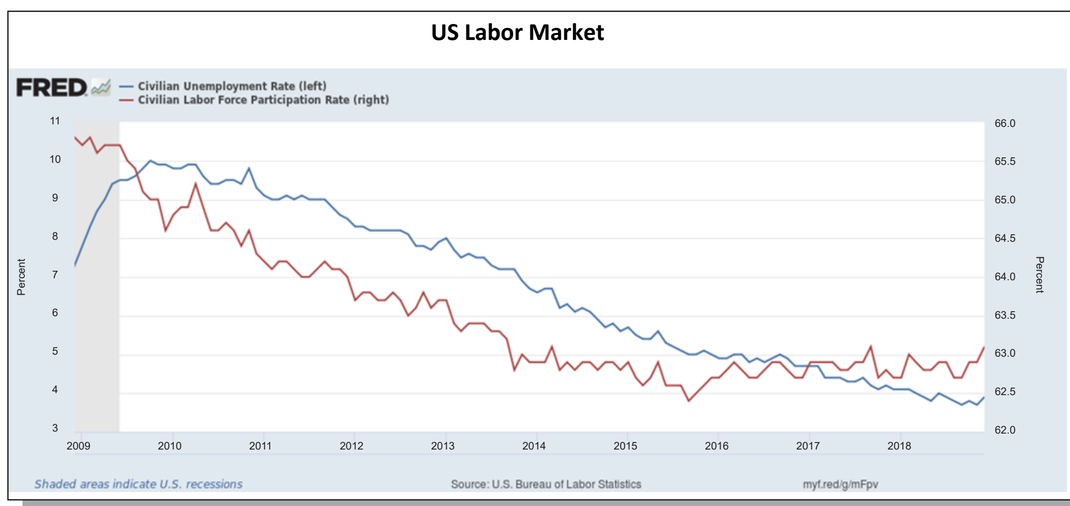
Outlook for 2019 (and beyond)

It is that time of year, where investment advisors pull out their crystal ball, and predict how markets will perform over the next 12 months. While these predictions can make for interesting reading, most will be either vague or specific and dead wrong. We avoid making projections over the next quarter or year, primarily, because our investment time horizon is far longer than one year. Generally, new

investments are added, not because we see a short-term dislocation in price, but because we see either a company that can take advantage of a long-term investment theme or a company that has long-term structural advantages over peers in essential industries.

While we do remain cautious on growth, we do not see a recession in the near future. As the December nonfarm payrolls report showed, the US continues to attract new workers into the labor market. At first glance, the jobless rate moving from 3.7% to 3.9% would seem a negative, but as shown in the chart below, the labor force participation rate increased from 62.9% to 63.1%. In total, 2.6 million jobs were added in 2018, the highest level since 2006. Market volatility will likely continue, as trade negotiations are worked out and investors are weaned off accommodative monetary and fiscal policies. The current market expansion has proven resilient, but we realize an extended period of reduced global trade can impair consumer and business confidence and stall the economy.

We continue to have confidence in our core equity holdings and are looking at new investment opportunities after the recent market sell off. We are also upgrading clients' bond portfolios by replacing lower quality corporate bonds with treasuries as the yield differential has narrowed.



As always, we invite your thoughts and comments and welcome your questions.

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