fourth quarter 2018

INVESTMENT *perspective*

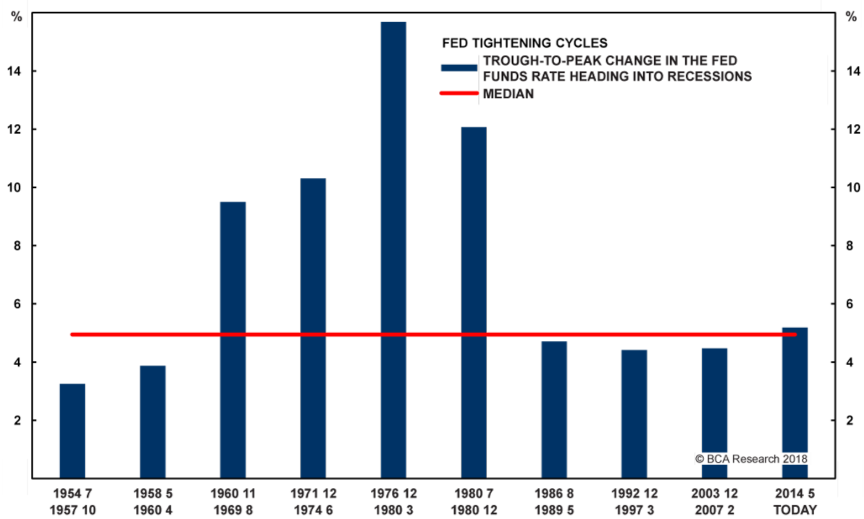
During the fourth quarter of 2018, equity markets experienced one of the largest sell-offs in market history. The S&P 500 and Russell 2000 Value declined approximately 13.5% and 18.7%, respectively.

Since the second quarter, we warned that central bank policy normalization needed to pause for the economy and capital markets to adjust to tighter monetary conditions (**Chart 1)**. Unfortunately, the Federal Reserve raised interest rates by another 25 basis points in September and December and continued to reduce its balance sheet. Meanwhile, the European and Japanese central banks also reduced its monetary stimulus. During the fourth quarter, global liquidity fell at an annualized rate of 10% compared to normally rising at an annualized rate of 7%.

After decades of financial engineering with the last nine years turbo charged by quantitative easing, the ability to fund/hold positions in risk assets can be more important to the price of an asset than the underlying asset's fundamentals. Therefore, the size of central bank balance sheets has become as important, if not more, as the level of interest rates. With global government deficits set to rise in 2019 any further decline in global liquidity will necessitate a further crowding out of liquidity available to support risk assets. This implies that multiple compression/disinflationary pressures will continue until central banks stop/reverse quantitative tightening or markets reduce leverage sufficiently that fundamentals become more important than funding liquidity.

Chart 1

Trough-To-Peak Tightening Cycle Already Above Historical Median



In 2019, economic activity will likely continue to slow, which will further pressure margins and ultimately earnings growth. Although valuations have improved through 2018, they still do not fully reflect an earnings or economic recession in an environment where central banks have minimal ammunition to fight a slowing economy.

Treasuries rallied significantly in the risk off environment. The 10-year Treasury yield declined to 2.69% from 3.06% at the end of September **(Chart 2)**. For the year, the 10-year Treasury yield increased 28 basis points from 2.41% to 2.69%.

conclusion on back ...

Vaughan Nelson Investment Management
600 Travis, Suite 6300
Houston, Texas 77002-3071

713.224.2545
888.888.8676
713.228.4292 fax
www.vaughannelson.com

CEO and CIO
Chris Wallis, CFA, CPA

PRESIDENT
Steven Psaledakis

EQUITY INVESTMENTS
Dennis Alff, CFA
Benjamin Carrier
Keith Cioci
Stephen Davis, CFA
James Eisenman, CFA, CPA
Chad Fargason, PhD
Tyler Fry
Adam Rich, CFA
Scott Weber, CFA
William Wojciechowski, PhD

FIXED INCOME INVESTMENTS
Charles Ellis
Blanca Garza
Steven Henriksen

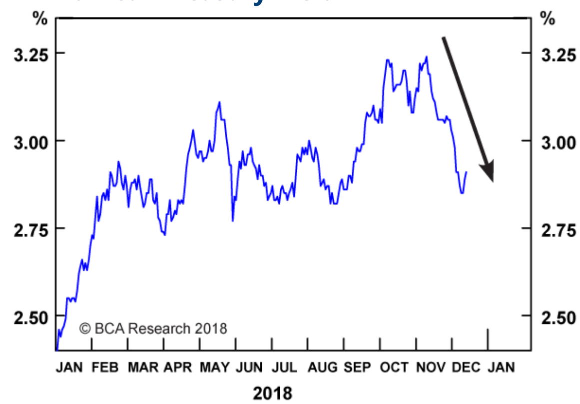
MARKETING/CLIENT SERVICE
Mark Farrell
Michael Hanna
Danika Haselden, CFP®
George Holewyne
Daniel Hughes
Cynthia Lones

The U.S. high yield index declined 4.7%, U.S. investment grade index declined 0.2%, while the U.S. Treasury index returned 2.6%.

There were several factors influencing the market decline in riskier asset classes. Certainly, the negative rhetoric in the ongoing trade discussions had a major impact as well as the rapid decline in oil prices, which finished the quarter down 38%. Finally, the Federal Reserve's ongoing effort to reduce the super accommodative policies implemented during the financial crisis reached an inflection point which began to weigh on global growth expectations for 2019 and beyond.

Chart 2

10-Year Treasury Yield



*SOURCE: BLOOMBERG BARCLAYS INDICES

While dysfunctional governments and future moves by central banks could lead to policy mistakes, our current base case for 2019 is for U.S. GDP growth to slow back to 2015-2016 levels of 2.0-2.5%. We expect 10-year Treasury yields to remain in a range of 2.50%-3.50% and therefore will remain defensive with shorter portfolio durations.

During the quarter, the Bloomberg Barclays Aggregate Index generated a positive return of 1.64%, which brought the 2018 return into positive territory at 0.01%. The corporate bond sector of the Aggregate Index performed poorly in the fourth quarter "flight to safety" underperforming the index by 297 basis points. Lower quality BBB-rated credits significantly underperformed higher A-rated credits (-0.90% vs. 0.35%) and longer than 10-year corporate bonds underperformed bonds shorter than 10 years in maturity (-1.80% vs. 0.58%).

We believe the excessive widening of investment grade credit spreads was greatly impacted by the lack of marketplace liquidity into year end. We would expect risk premiums to narrow during the first half of 2019, therefore we will remain overweight the corporate sector but maintain our shorter average duration compared to the benchmark.

The municipal market benefitted greatly from the fourth quarter rally in high quality sectors. The ICE Bank of America Merrill Lynch 1-10 year AAA-A Municipal Bond Index returned 1.53% in the quarter and was up 1.60% for the year. We expect investor demand to remain strong in 2019 and therefore municipals should continue to provide taxable equivalent returns well above taxable alternatives.