Investment Strategy Update December 31, 2018

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For nearly 70 years, December had never been the worst month in any calendar year for stock prices – until now. Since the beginning of 2018, we have been concerned about a violent correction or even a bear market (drop of over 20%). We positioned portfolios to reduce risk rather than seek return. This past quarter devolved into a bear market for some (small US stocks, oil, tech stocks) with the S&P 500 not far behind.

The effects on Blue Oak portfolios have been significant, but far less than the stock market averages. Our exposure to Alternatives dramatically reduced risk and volatility. By design these investments act as diversifiers to stocks and bonds, reducing risk in portfolios, and in the fourth quarter, they held their own significantly cushioning the decline.

With valuations akin to a "tightly coiled spring", it does not take much to foster the selling pressure we just experienced. Briefly during the quarter, the yield on the two-year Treasury Bond exceed that of the five-year Treasury. Thus, a portion of the yield curve inverted, leading many to wonder if this would be the beginning of a recession. The spread on the more meaningful 90-day Bill versus the ten-year Treasury Bond remains positive suggesting that a recession is not imminent. The partial inversion of the yield curve does speak to a broader message though – rates are becoming restrictive and monetary policy is reducing liquidity – the stock market's lifeblood.

We agree with the market expectations for additional, data-dependent, interest rate increases despite the hand wringing at the White House. More increases will harm bond prices, but much of that pain appears to be behind us with the lion's share of the increases complete. Investors are now able to buy fixed income instruments that provide solid income as older, lower yielding bonds mature and are replaced by higher yielding bonds.

Domestically, the U.S. remains in an enviable position with very low unemployment, inflation, and steady, growing GDP. We do continue to have anxiety that our current leadership in Washington may not be able to successfully navigate actual (not manufactured) crises. With liquidity being reigned in, and the benefits of the 2017 tax cuts waning, the attention has turned to bullying the Federal Reserve Chairman for the correction. This focus seems to miss the point that after the greatest liquidity infusion ever, we are bound to have significant corrections as markets adjust to a new reality of nominal rates other than zero.

Global economic growth has also slowed, in part due to the new tariffs and harsh rhetoric from Washington, D.C., but expectations remain positive for 2019. We are concerned about debt levels around the world, but they do not point to a wider problem - yet. We have experienced rough, slow patches during this expansion previously and this appears to be following in the same manner. We do not see the kind of excesses that suggest a global or U.S. recession in the near term.

Amid the year end volatility, we have been carefully nudging portfolios to increase stock allocations. While we agree that we have the potential for more instability from Washington even after the current government shutdown is resolved, the market ultimately looks to economic reality for long-term returns. We expect more volatility as liquidity is removed from the system. It seems implausible that as that happens it would be completed without corrections along the way. This quarter though has provided us with opportunities as is always the case when we see markets adjust.

We thank you for your continued trust and wish you all the best into 2019.