

February 2019

Dear Clients,

As we wrote in last year's annual letter and have reiterated in our conference calls, we expected that the market would be more volatile in 2018 after an extraordinary 2017 – and it certainly was. In 2017 we saw tremendous returns, with the S&P 500 up 21%, and low volatility, with the largest intra-year decline of only 3%. January got 2018 off to a very strong start, only to have that momentum derailed over the rest of the year by a host of concerns: the Bitcoin speculation (and later crisis), geopolitical events, Brexit, Tweeting, rising interest rates, the potential of an inverted yield curve, tariff battles, recession worries, and finally a government shutdown to end the year. The result of all of this? A lot of uncertainty, volatility, and the worst market for equities since the financial crisis of 2008/09.

But while the market was weak, the US economy headed into its 10th year of economic expansion, growing by 3%. Inflation remained tame at 2.2%, and unemployment was as low as it has been since the 1960s (*Source: Federal Reserve*). In addition, corporations posted record profits in 2018 (*Source: Bloomberg*). So what happened to the stock market in the midst of all this good economic news?

In January 2018 the market got off to one of the best starts on record and was up by more than 5.5%. But things changed quickly. In February inflation fears led to a spike in bond rates, and the S&P 500 sank by 12% in just two weeks. The market recovered over the next several months and reached a new all-time high in late September. But then the market ran out of steam, weakened by concerns about a global economic slowdown, trade issues, and growing uncertainty. It plunged 7% in October and another 9% in December, resulting in the worst December since 1931! It was also an extremely volatile month, with nine days when the market was either up or down by at least 1% – quite different from 2017 when direction shifts of 1% or more in one day occurred only eight times over the entire year (*Source: Standard and Poor's*).

The 4th quarter was a bear market, defined as a 20% or greater drop. The S&P 500 dropped 20%, US mid-caps (S&P 400) were down 23%, and US small caps (Russell 2000 index) plummeted 27%. For the year, US large-cap stocks lost 4.5%, US mid-caps lost 9%, and US small caps lost 11%. International stocks fared even worse in 2018 after topping the charts in 2017. International stocks (the MSCI EAFE index) were down 13.5%, and emerging markets ended the year down 14.2% (*Source: Wells Fargo Investment Institute*).

The Federal Reserve raised interest rates four times in 2018, putting pressure on bond prices. When interest rates rise, bond prices drop, and that drop contributed to listless returns for bonds overall. Bloomberg Barclays US Aggregate Bonds Index was flat at 0.0%, JP Morgan Global Ex-United States Bond Index was down 1.7%, and Barclays US Corporate High-Yield Bond Index was down 2.1% (*Source: Wells Fargo Investment Institute*). Other asset classes didn't fare much better. The commodities index was down 12.5%, reflecting a 25% plunge in oil prices and a 2% decline in gold. Real estate securities were down 8.5%.

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Diversification, which aids in balancing risk and return, did not lend as strong a helping hand as usual in 2018. In fact, just about the only asset class that was positive last year was cash/US Treasury Bills (*Source*: Wells Fargo Investment Institute). Over the longer term, however, asset allocation has proven to be a valuable investment tool. To get your own long-term-perspective, take a look at the different asset-class returns over the past 15 years on the attached PDF document, *The Value of Asset Allocation*, one of our favorites. It is also available on our website, www.CaudronMegaryBlackburn.com, along with other helpful resources.

With markets so volatile, investors may be wondering whether they should change their asset allocation or approach investments differently. It cannot be repeated too often that the key to long-term investment success is to remain patient and balanced over time, during both market outperformance (not chasing winners) and bear markets (not selling out on the way down – or even worse, at the bottom).

Market downturns are normal. How normal? If you look at the history of market declines over 1900-2017, you'll see that the Dow Jones Industrial Average fell 5% or more an average of three times a year, 10% or more about once a year, 15% or more about every two years, and 20% or more (defined as a bear market) about every four years (*Source*: Capital Group). But although market downturns are normal, they never feel normal while you are experiencing them. Certainly, the 24-hour news cycle and the internet contribute to the volatility frenzy, making it more difficult to maintain equilibrium in the face of the constant barrage of sensational news.

Risk is easier to evaluate when you are not in the midst of a crisis. When confronted with alarming news, investors have a tendency to think “this time it’s different.” But it rarely is. Most of us tend to be loss averse: we dislike losses more than we enjoy gains. Reacting to that feeling by selling and then “waiting for things to settle down” is a recipe for financial disaster. A look at past declines shows that the strongest part of the recovery is typically right at the beginning, long before things start to look or feel better.

It is a losing proposition to attempt to time the market. Too often, investors who are spooked by a stock market downturn and sell their investments on the way down miss most of the recovery as the market rebounds. For example, let’s take a look at the 10-year period following the 2000-2002 “tech bubble” stock market decline of 49.29%. An investor who invested \$10,000 before the decline and had the resolve to stay the course would have realized a 10-year average annual return of 6.38%, which with the power of compounding would have resulted in an ending balance of \$18,560 (*Source*: Capital Group). Many investors, however, sold out on the way down and were not able to invest back into the market until it was significantly higher. A 2017 research study by Dalbar demonstrated that investors over the past 20 years have underperformed the S&P 500 index benchmark by 26% by timing mistakes alone. This is consistent with our advice to you to determine your risk-adjusted asset allocation and stick with it despite market conditions.

The volatility in 2018 makes predicting outcomes for 2019 even more uncertain than usual – and the usual is uncertain enough. The standard caveats apply: all of us – from Federal Reserve Chair Jay Powell to Wall Street pundits, to the average investor on the street – are simply guessing. And that’s the beauty and the frustration of trying to predict the market.

As we look ahead to 2019, there are many positives. Earnings are projected to grow again this year, at least moderately. Stock market valuations are at a very reasonable level of about 16 times earnings, right around the historical average. We will eventually have a recession, a normal part of the business cycle, but we don’t think that is likely to happen this year. By the way, Australia is

enjoying their 28th year of continuous economic expansion, so growth can continue for longer periods of time (*Source: The Wall Street Journal*). Consensus economic projections call for US growth to be around 2%-2.5% and worldwide growth around 2.5%-3%. We have also had continued employment growth, with net new jobs every month in 2018 and over 200,000 net new jobs in December and another 300,000 in January (*Source: Bureau of Labor Statistics*). Unemployment has been at its lowest rate in decades. Since the mild investor “panic” back in December, the market has recovered considerably and is off to a great start in 2019. Many stock-market indices were up sharply in January, including a 7.9% improvement in the S&P 500 (*Source: Wells Fargo Investment Institute*). We expect these positives to drive the market in 2019, but if unanticipated headwinds arise, we are here to help you weather them.

As usual, this letter is where we announce the winner of our Guess the Dow contest. The Dow Jones Industrial Average ended 2018 at 23,327. Our winner for 2018 is Esther D, with a guess of 23,232, narrowly edging out Bob C, with a guess of 23,200. Esther will enjoy a meal at Landini Brothers – on us! Please let Lichelle know your 2019 Guess the Dow entry by March 31st, at lichelle.yalung1@wellsfargoadvisors.com or 703-739-4540, and you may be the lucky winner of dinner on us, while basking in our unqualified admiration for your investment savvy.

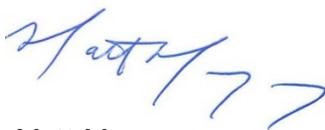
In closing, we want you to know that we cherish your trust and your willingness to let us into your lives. We appreciate the opportunity to know and serve you and your family and to develop long-term, often multi-generational, relationships of trust and mutual respect. We will continue to strive to meet your needs at each stage of your life, providing sound financial advice and investment planning tailored to your circumstances. One of our great pleasures is to share your satisfaction and joy when your investment planning helps you achieve important life goals. But whether you have financial nerves of steel or get queasy when markets hiccup, we are ready to provide whatever support you need whenever you need it.

On behalf of the entire team – Tristan Caudron, Matt Megary, Laurie Blackburn, Ivana McNeill, Jessica Jackson, Laura Newton, Lori Polonsky, Chalee Ricciardi, and Lichelle Yalung – thank you for affording us the great pleasure of working with you. We wish you a wonderful 2019, filled with health, happiness, and prosperity.

Very truly yours,



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Attached Documents:

1. *The Value of Asset Allocation*
2. *2019 Tax Planning Tables*

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Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Diversification does not guarantee profit or protect against loss in declining markets.

The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

S&P Midcap 400 Index: The S&P Midcap 400 Index is a capitalization-weighted index measuring the performance of the mid-range sector of the U.S. stock market, and represents approximately 7% of the total market value of U.S. equities. Companies in the Index fall between the S&P 500 Index and the S&P SmallCap 600 Index in size: between \$1-4 billion.

The S&P 100 Index measures large cap company performance and consists of up of 100 major, blue chip companies across diverse industry groups. The primary criterion for index inclusion is the availability of individual stock options for each constituent.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Bloomberg Barclays U.S. Aggregate Bond Index is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index. The Bloomberg Barclays U.S. Government/Credit Bond Index is an unmanaged, market-weighted index generally representative of intermediate and long-term government and investment grade corporate debt securities having maturities of greater than one year. The Bloomberg Barclays Mortgage Backed Securities Index is an unmanaged index of mortgage pools of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association.

The MSCI Europe, Australasia and Far East ("MSCI EAFE") Stock Index is an unmanaged group of securities widely regarded by investors to be representations of the stock markets of Europe, Australasia and the Far East. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

MSCI Emerging Markets Index: 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 Index consists of the following 23 emerging market country indices: Argentina, 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. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

Russell Midcap® Index: The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Merrill Lynch U.S. Treasury Index: The Merrill Lynch U.S. Treasury Index tracks the performance of the direct Sovereign debt of the U.S. Government. It includes all U.S. dollar-denominated U.S. Treasury Notes and Bonds having at least one year remaining term to maturity and a minimum amount outstanding of \$1 billion. Additional sub-indices are available that segment the Index by maturity.

The Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities and is designed to minimize concentration in any one commodity or sector. It currently has 22 commodity futures in seven sectors. No one commodity can compose less than 2% or more than 15% of the index and no sector can represent more than 33% of the index.

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