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Recap of Q1 2019 Markets and Economy

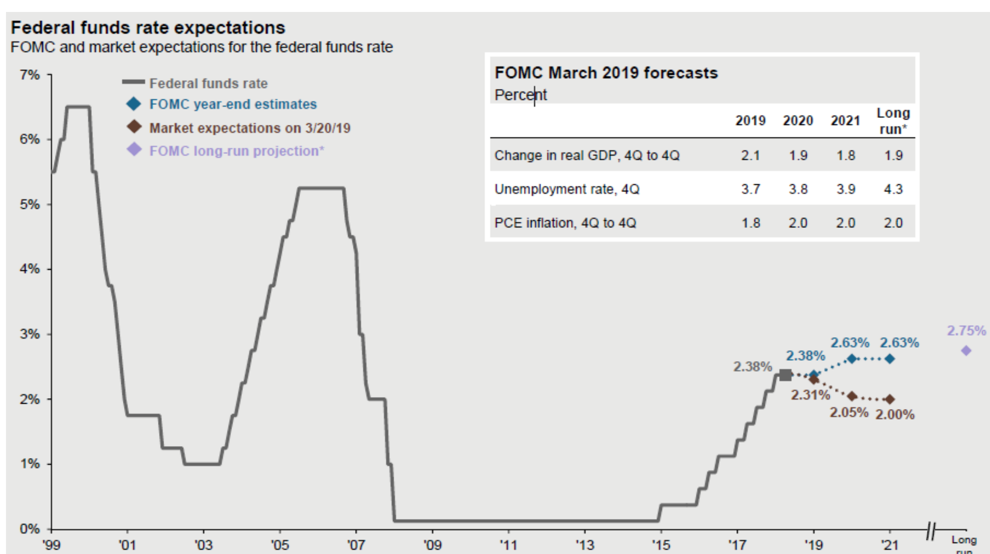
During the first three months of 2019, investors had a lot to cheer about as U.S. equity markets turned in their best quarterly gains in nearly a decade. The market U-turn was driven by a more accommodative U.S. Federal Reserve (Fed), the anticipation of solidifying a Chinese trade deal and prospects for additional stimulus from the Bank of China to jumpstart their ailing economy. This helped many of the major U.S. indexes recoup a good portion of the losses incurred during the last quarter of 2018.

For the quarter, the S&P 500 index rose sharply, marking its best start to a year since 1998. The advances for the Dow Jones Industrial Average and Russell 2000 were equally impressive with both indexes posting similar gains. Gains for the quarter were broad and all eleven S&P 500 sectors ended higher for the first quarter for the first time since 2004. *(Sources: Barron' 4/1/2019, Wall Street Journal 3/31/2019)*

While there were a few key factors that contributed to these strong equity gains, we believe that much of the first quarter's rally was attributed to investors reacting positively to the Fed's shift in interest rate policy and guidance for the year.

Federal Reserve Flip Flop

Just as the U.S. Federal Reserve's decision to increase rates made them the culprit behind the equity market losses experienced in December of last year, their March announcement to not raise rates for this year has once again turned them into an ally for the capital markets as evidenced by the positive reaction of equity prices for the quarter. This stark change from the hawkish tone taken only a few months ago has many market analysts questioning the credibility of the Fed's forecasting ability.



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On December 19, 2018, Fed officials had two additional rate hikes slated and plans to reduce their balance sheet of bonds by about $60-$80 billion per month for 2019. By comparison, on March 20, 2019 the Fed scrapped hiking rates for the year and stated that their balance sheet reduction would decrease to approximately $30 billion per month and would tentatively end in September. The bond market's rate expectations are now hinting toward the potential for rate cuts in 2020 and 2021.

Although this drastic shift in policy has many perplexed, we believe that this was the proper response given some of the weakness in U.S. economic data, concerns about slowing global growth and the geopolitical uncertainties surrounding Brexit and trade talks.

U.S. Economy

The U.S. economy is expected to slow this year as the effects of corporate tax cuts begin to wane. Last year the S&P 500's operating earnings increased by nearly 23% on a year over year basis. This year, we expect that they will increase by 3% - 3.5%. The tightness in the labor market (which translates to higher wage pressure), overhang of tariffs and corporations curtailing capital in the wake of trade negotiations are also contributing to this slow growth outlook. The reduction in the rate of growth may seem severe. However, it is important to recognize that growth is only expected to slow and not contract for 2019.

The Purchasing Manager Indexes for services and manufacturing, which are gauges for current and future business conditions, declined for the quarter but managed to stay in the expansionary range. Even though these metrics have recently trended to 2-year lows, the resilience of record low unemployment and modest wage growth give us confidence that the current economic expansion is still intact.

International Equity Markets

International developed market stocks trailed the U.S. for the first quarter but still posted noteworthy gains. This return to trend of underperformance relative to the U.S. can be credited to the longer-term structural growth concerns that currently plague Europe and Japan. The rise of entitlement liabilities, dwindling productivity and declining population have put much pressure on these economies and stock markets.

Brexit, the United Kingdom (UK), leaving the European Union (EU) is another major concern for investors. The original referendum to do this was in June of 2016. In October of 2016, Prime Minister, Theresa May, invoked Article 50 of the EU's Lisbon Treaty to start the process for an orderly exit from the EU. The UK had been due to leave on March 29. However, Prime Minister May had not yet reached a deal with the EU that outlined the UK's transition and agreement on trade. The implications for a disorderly Brexit have put much pressure on European markets. The deadline to leave the EU has recently been extended until October 31 providing optimism that the UK will reach a definitive Brexit deal before their departure.

Emerging market stocks also trailed the U.S. and international developed markets for the quarter. The Indian and Brazilian markets detracted from returns while China substantially contributed to the returns of the MSCI Emerging Markets Index on the hopes that additional monetary stimulus would allow their economy to emerge from its current slowdown. We continue to favor emerging markets when investing internationally as the growth potential of these economies and cheaper equity valuations relative to U.S. markets are compelling.

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Fixed Income Markets

The Bloomberg Barclays U.S. Aggregate Bond Index had a modest return for the quarter as the Fed's policy change and slower growth outlook sent longer-term yields lower. The yield of the U.S. 10-year treasury dropped to a low of 2.35% in March as the spread between the U.S. 10-year treasury and U.S. 3-month treasury became slightly negative causing this segment of the yield curve to invert momentarily. This event garnered much attention of the financial media as an early warning sign of an impending U.S. recession. This occurrence was faced with conflicting data as the more traditional recession indicator, the 10-year - 2-year treasury curve, did not invert and send the same signal.

Both investment grade and high yield U.S. bonds posted stronger gains than the broad bond market erasing all the losses incurred last year. Since these two asset classes are more economically sensitive, they tend to have a higher correlation to stock prices and therefore carry more risk than high-quality bonds.

We continue to favor a bond portfolio that consists of short-term and high-quality bonds given the current low yield and late stage credit environment. With 10-year treasury yields just 0.15% higher than 90-day treasury yields, we do not believe that investors are being properly compensated for the higher level of interest rate risk taken with longer-term bonds. When bond yields rise for outstanding bond issues, their prices usually fall. Even though the Fed has paused with raising rates for now, this does not necessarily mean that intermediate and long-term bond rates cannot rise further from current levels. Since the Fed is again taking a more patient approach for inflation to manifest instead of preemptively raising rates, any sign that inflation is picking up could send yields higher. We believe that we are in the later stages of the current business cycle and do not advocate reaching for higher yields through long-term or lower-quality bonds. This philosophy is reflective in the changes that we made to our bond portfolios during the quarter.

Recession Probability

As previously noted, one segment of the yield curve (10-year – 3-month) briefly inverted toward the end of the quarter causing much concern that a recession is on the horizon. The yield curve is indeed a very useful leading indicator that we follow, and we do agree that the chances for a recession over the next 12-18 months are elevated but not imminent. According to the New York Federal Reserve as of March 31, the probability of a U.S. recession 12-months ahead (March 2020) as predicted by the treasury curve alone stands at 27.07%. This reading is much higher than previous months. However, we always caution against overinterpreting one data point as the yield curve by itself has provided some erroneous recession warnings in the past. Also, other measures of the U.S. economy, namely the low unemployment rate and modest wage growth figures are sending signals to the contrary.

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We are continuously monitoring the health of U.S. and global economy. Should deterioration occur in the leading indicators, we may look to proactively position our equity exposure more defensively.

Conclusion

With the recent rise in financial markets, the slowdown in global growth, and Federal Reserve Chair Jerome Powell now stressing a much more patient approach to monetary policy, investors should make sure that their portfolio matches their goals and investment time horizon.

Completely avoiding market risk may not be appropriate for most investors because today's traditional fixed rates might not help you achieve your desired goals. Investors should review their long-term goals to determine if any new circumstances warrant a change to their risk profile. Often, this can lead to lower but less volatile returns. Looking at your entire picture can be a helpful exercise in determining if a change to your strategy is necessary.

Our focus is on helping you meet your personalized goals through customized financial planning and diversified professional investment management. We can discuss your situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial matters.

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Sources for graphs: *JP Morgan Market Insights, Bloomberg L.P., FactSet and the U.S. Federal Reserve*