Investment Perspective

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FROM STORMY WEATHER TO SMOOTHER SAILING

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Investors were hit by a perfect storm of geopolitical issues and policy decisions during the final quarter of 2018, and it led to an exceedingly gloomy end to the year. But what a difference a quarter can make. As we shifted into the first quarter of 2019, instability began to dissipate and calmer conditions ushered in a shift in sentiment, as well as a calmer environment in the market. Here, we'll give you a quick recap of the Q4 market forces, dig deeper into what helped bring the market back to life in Q1 and peer into the future with some predictions for Q2.

1Q 2019 Produced Much Improved Performance Results

Asset Class Index Performance *(select indices)*	**2018**	**YTD 2019***
Bloomberg Barclays U.S. Aggregate Bond	0.01%	2.94%
Russell 1000 Growth	-1.51%	16.10%
Bloomberg Barclays U.S. High Yield 2% Issuer Cap	-2.08%	4.87%
JPM Emerging Market Bond Index Global Diversified	-4.26%	6.95%
S&P 500	-4.38%	13.65%
Russell 1000	-4.78%	14.00%
FTSE EPRA/NAREIT Developed NR (REITS)	-5.60%	14.59%
Russell 1000 Value	-8.27%	11.93%
Russell 2000	-11.01%	14.58%
S&P 400 Midcap	-11.08%	14.49%
Bloomberg Commodity TR USD	-11.25%	6.32%
Alerian MLP	-12.42%	16.82%
Russell Microcap	-13.08%	13.10%
MSCI EAFE	-13.79%	9.98%
MSCI ACWI Ex USA NR USD	-14.20%	10.31%
MSCI Emerging Markets NR	-14.58%	9.91%
S&P Developed ex US Small Cap	-18.41%	10.38%

Source: Morningstar
*YTD as of March, 2019

Understanding the Storm

In the fourth quarter of 2018, the global economy was slowing, trade tensions with China were escalating and Brexit was shifting to the front burner. Meanwhile, U.S. economic growth was moderating and, with it, analysts began ratcheting down 2019 earnings estimates. If that weren't enough, investors began to worry that the Federal Reserve would move rates upwards too much and too fast in the face of an economy that was slowing.

Many speculated that algorithm-based computer selling began to escalate the selloff right before Christmas, and as a result, the S&P 500 Index came within a whisker of entering a bear market (a 20% decline). That said, the tech-heavy NASDAQ and the Russell 2000, which measures small-cap stocks, briefly entered bear market territory.

All of this positioned the market perfectly for the jarring downshift that we saw play out.

The Clouds Break with a Kinder, Gentler Fed

Enter Q1 2019, and the skies have brightened dramatically. Starting the turnaround, stocks were extremely oversold, and much more attractive valuations enticed investors. Moreover, last year's selloff didn't reflect the economic fundamentals in our view.

Of at least equal importance, the Federal Reserve took notice of tighter financial conditions and the economic signals the downdraft in shares were telegraphing. No longer were policymakers discussing one or two rate hikes this year. Instead, a newfound flexibility and dovish remarks from Fed Chief Jerome Powell greatly reduced odds that a policy mistake might lead to a recession.

Today, the Fed is in a holding pattern, and we believe the next move is more likely to be a rate cut rather than a hike.

Hope for a U.S.-China Deal

Cautiously optimistic headlines regarding U.S.-Chinese trade negotiations have helped defuse tensions. As we inch our way toward an agreement, various reports suggest that 90% of the deal is complete.[1]

President Trump recently hailed the latest round of discussions as a "big success" and said an announcement might be possible by late May. Such an agreement would remove a cloud that's been hanging over the market, but the thorniest issues have yet to be resolved. For example, how quickly might the U.S. remove tariffs imposed last year? Will enforcement mechanisms have teeth? And how will U.S. intellectual property rights be protected?

Currently, there appears to be a widely-held belief that any potential agreement will be a weak one, which, we believe, provides an opportunity for an upside surprise. Aside from the question of a timeline for removing existing tariffs, other tariffs may be reduced so that the average tariff rate in China will fall from 10 percent (pre-Trump action) to somewhere, we believe, between 6 and 7 percent. This would be positive for global growth and U.S. exporters.

Of course, there is a risk that differences could prove insurmountable. But odds favor an eventual deal, as both sides would face a serious backlash if talks break down permanently.

Powered by the American Economic Machine

U.S. growth has moderated from last year's heady pace. Yet we're not seeing signs that it's set to stall. In part, the slowdown appears to reflect a pattern that has been embedded in the data for many years.

Analysts have noted that the U.S. economy experiences what's called "residual seasonality," which can be loosely defined as artificially weak Q1 growth. Economists believe Q1's relative weakness, which has become more pronounced since the financial crisis, has its roots in the models that adjust for seasonal variations.

Though odds of a recession have crept higher, we remain confident that a 2019 recession can be avoided. In part, financial conditions have eased, and the labor market remains strong, which arguably is an important driver of activity since it has an outsized influence on income, spending, inflation and consumer sentiment.

Despite unsettled weather, the government shutdown and historically weak Q1 patterns, we believe 2% GDP growth in Q1 is achievable. We don't anticipate seeing a recession this year, since recession-inducing conditions are not in abundance, in our view. In fact, barring an unexpected recession, the economy will enter its eleventh year of economic expansion in July, marking it as the longest expansion on record.[2]

Yield Curves and the Q2 Forecast

As we enter Q2, we remain upbeat. We recognize that equities are no longer cheap, and we don't expect that the current quarter will deliver a repeat of the gains seen in Q1. However, the generally bullish tailwinds have yet to dissipate.

We did experience a recession scare when the yield curve briefly inverted. But we don't think this is a harbinger of doom.

As a refresher, the yield curve plots the yields of a bond with the same credit quality (such as Treasuries) over various maturities. A normally sloped curve sports higher yields for bonds with longer maturities. However, on occasions, the yield curve can invert or partially invert. That means a longer-dated bond has a lower yield than a shorter-dated bond.

In late March 2019, the yield on the 3-month T-bill exceeded the yield on the 10-year Treasury, which marked the first time such an event has occurred since 2006.

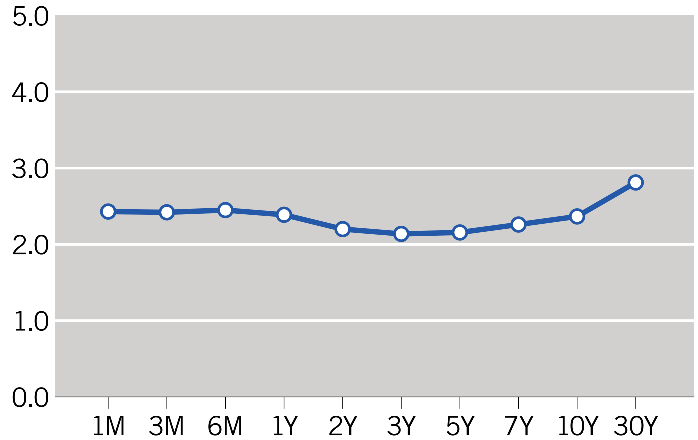
Why might this be important? The last seven recessions were marked by an inversion prior to the onset of a recession (see Table 1). On average, a recession ensued nearly 11 months after the curve inverted. Notably, a recession did not follow the 1966 inversion of the curve, although it did telegraph a sharp slowdown in growth.

The 10-year Treasury yield slips below the 3-month T-Bill

Date of Inversion	Months to Recession
September 1966	No Recession
January 1969	11
June 1973	5
November 1978	14
November 1980	8
June 1989	13
August 2000	7
August 2006	16
March 2019	?

Source: NBER, St. Louis Federal Reserve

Yield Curve as of March 27, 2019



Source: Bloomberg

Note: In Sept 1998, the yield on the 3-month T-bill came within 0.04 percentage points of the 10-year but did not invert on a closing basis.[3]

Today, we feel the minor inversion is sending a false recessionary signal. Here are few reasons why we are cautiously optimistic:

1: Barring a significant change, the inversion lasted a matter of days and was barely measurable. Today's curve is best described as flat, not inverted.

2: The 10-year/2-year Treasury yields inverted an average of 20 months prior to the last seven recessions (St. Louis Federal Reserve, NBER data). It remains positive.

3: The Conference Board's Leading Economic Index has been stable since October. It is not sniffing out a recession.

4: Weekly jobless claims, which are an excellent leading indicator, dropped to a 50-year low this month.[3]

5: Low yields around the world may be encouraging investors to park cash in the U.S., artificially depressing yields of U.S. Treasuries.

6: The Fed is on hold and financial conditions have eased, meaning we aren't seeing a recession-inducing credit crunch.

7: Specific data points are encouraging. ISM surveys continue to signal moderate economic growth, employment is rising, and consumer confidence remains on solid ground.[3]

We take the view that today's yield curve is probably telling us the Fed is done hiking rates this year, and the next move is more likely to be a cut than an increase.

China Picks Up the Pace

A slowdown in China has had repercussions on the global economy. Recently, the IMF downgraded its global outlook and expects worldwide GDP to expand at its slowest pace since 2008.[3] But let's not discount nascent signs that we view as supportive.

China has been very aggressive in its efforts to reinvigorate its economy, and we are beginning to see green sprouts emerge, as evidenced by a bounce in the latest purchasing managers index. If a trade deal is reached, it would likely lift sentiment, lending support to healthier economic activity.

Brexit Battles On

Ultimately, U.S. economic strength, or lack thereof, determines the longer-term direction of U.S. stock prices. But short-term uncertainty sometimes enters the mix. Such is the case with Brexit.

Neither the United Kingdom nor the European Union wants a no-deal Brexit, but the current situation is an unknown that could generate volatility. The UK parliament has not been able to ratify an already-negotiated break-up with the EU.

Given the lack of meaningful progress, both sides agreed to extend the scheduled departure date until October 31, although the UK may exit sooner. The extension gives the UK and the EU more time to craft a workable deal. It also reduces near-term uncertainty—but kicks the can down the road. Altogether, though, we believe a no-deal hard Brexit is unlikely.

A Steady Earnings Outlook

Finally, Q1 profit growth will slow sharply from 2018's robust pace. Last year's boost from the cut in the corporate tax rate won't be repeated, and growth at home and abroad has slowed. Yet, the bar is set low, and we believe most companies will clear a very low hurdle.

Weathering Change and Risk

Over the long term, we have a bullish stance on equities. A quick review of stock market performance since World War II is a testament to the strength and resilience of the U.S. economy. Solid long-term fundamentals give us no reason to alter our view.

Nevertheless, we won't discount the potential for volatility over the shorter term. It's why we continue to recommend that you adhere to a disciplined approach. We can't eliminate risks, but we can help you develop a financial plan that helps manage potential pitfalls and keeps you aligned with your financial goals. If you would like a personal consultation with one of our financial consultants, let's talk.

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Sources:
[1] Myron Brilliant, executive vice-president for international affairs at the U.S. Chamber of Commerce
[2] Bureau of Economic Analysis (BEA)
[3] Bloomberg Finance, L.P.