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FIRST QUARTER 2019 MARKET REVIEW & OUTLOOK

Market Review of the First Quarter: After a miserable fourth quarter of 2018, punctuated by a historic month of December, equity and bond markets alike have completely reversed course in the early months of 2019. Equity markets rose all over the world, with U.S. equities leading the charge in the strongest opening quarter since 1991. Not one, but two dovish (less likely to raise interest rates) policy shifts by the Federal Reserve and an abrupt slowdown in global economic growth caused bond prices to rise and yields to fall precipitously.

The S&P 500 rose by nearly 13.5% in the first quarter and by more than 25% since the Christmas Eve market low. U.S. small-capitalization stocks rose by 11.5% and are 19% off their late 2018 low. The best-performing sectors in the U.S. were an odd pairing of defensive and cyclical as REITs, Technology and Industrials led the way. Developed overseas equity markets rose by 10.3% while Emerging Market equities rose by 10%. Oil prices increased by a stunning 32% during the quarter, commodities rose by roughly 7%, and gold was basically flat. Bonds as measured by the Barclays Aggregate Index rose by nearly 3%.

The Yield Curve & Interest Rates: In late March, the U.S. yield curve inverted for the first time since 2007 following the Federal Reserve's second dovish move in three months. This was all over the news, but what does it mean and why does it matter?

A yield curve inversion means that the three-month U.S. treasury yield exceeds the 10-year U.S. treasury yield. Three-month yields are typically reflective of the Federal Funds rate, which is simply the interest rate at which banks lend reserve balances to other banks on an overnight basis. This rate is controlled by the Fed and is a function of monetary policy. However, 10-year U.S. Treasury yield is subject to market forces, historically driven by expected levels of inflation and GDP growth for the United States. Over the last decade, 10-year yields have also been influenced by the global rate of inflation and GDP growth. If long-term growth and inflation are lower than the overnight rate of lending, there is generally a problem in the economy.

Investors and economists place a lot of emphasis on this indicator because it has had an 85% accuracy record for calling U.S. recessions. The rub is that the time between yield curve inversion and entry into a recession has varied widely – from

3-Month/10-Year Curve Since 1984

Source: Strategas Research Partners

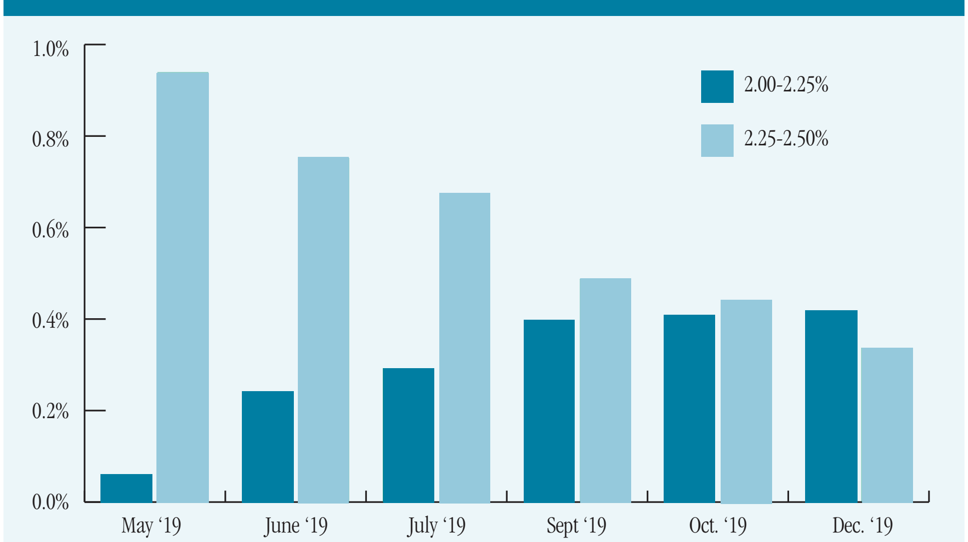
two months to three years! The average has been about one year, and equity markets have historically peaked about six months before recessions.

The Fed has indicated that it will not raise interest rates any further in 2019 and might only raise rates one more time this cycle. Further, the Fed committed to the completion of its balance sheet run-off this fall. Investors believe that this cycle of interest rate increases by the Fed is effectively over, and this has driven yields lower across all maturities. To put this abrupt change into perspective, the 10-Year U.S. Treasury yield peaked at 3.23% in early October of 2018 and has fallen to 2.4% in six months. In other words, expectations for growth and inflation have fallen by about 25% in a relatively short time. There is evidence to suggest that investors have been on the wrong side of this move, as there has long been a degree of stubborn bullishness that growth has nowhere to go but up! The Fed is now clearly targeting a strategy of pausing on further interest rate increases in order to keep the economy humming, and this is, at least in theory, negative for the U.S. dollar and positive for cyclical U.S. equities.

One of our concerns is that this reflation effort is eventually too effective, that inflation starts to rise in tandem with accelerating wage growth. This scenario would mean that the Fed would have to raise interest rates again, something that investors are not even considering today. Investors are quite skeptical about this narrative and Fed funds futures are now pricing in a 40% probability of an interest rate cut by the end of this year (please see the chart below). Historically, the Fed has cut interest rates six months after its final rate hike.

Mixed Messages on the Market:
Today, U.S. markets are sending conflicting signals about where we are in the business cycle and the next moves for economic growth. The U.S. was a standout grower against a backdrop of slowing global fundamentals in 2018. We have finally joined the party as nearly all U.S. economic indicators have slowed in concert, albeit from high levels. U.S. business and consumer confidence continues to weaken. While manufacturing activity continues to grow in the U.S., the rate of that growth is falling rapidly. The performance of U.S. transportation stocks is seen as its own indicator, and those companies have recently performed quite poorly. U.S. small and mid-sized stocks have underperformed the large-caps of the S&P 500 over the last few months as investors have fled to the land of better balance sheets and liquidity. U.S. housing data has been very choppy but the trend has been negative. Auto sales have been poor. The U.S. dollar is up about 8% versus a basket of global currencies on a year-over-year basis. A rising dollar has historically been challenging for U.S. multinational companies as approximately 40% of S&P 500 revenues come from overseas. As we addressed above, the yield curve has inverted.

Current Probabilities of Fed Meetings & Outcomes



Source: Strategas Research Partners

However, not all the signals are negative. Another well-followed indicator for the health of the U.S. economy is the performance of semiconductor stocks, and those have done very well this year. Labor and wage data in the U.S. remains incredibly strong and shows no signs of weakening over the near-term. Retail sales stumbled in December but bounced back nicely in January. While European and Chinese economic data has been very negative, the Chinese government is actively trying to stimulate its economy through interest rate and tax cuts. Europe is China's biggest trade partner. Many investors and economists alike feel that global economic data will be stronger in the second half of 2019 as China's efforts spread through its economy. U.S. credit conditions are holding up well and companies are actively deleveraging. Further, many strategists believe that investors are generally underinvested after having pulled substantial funds during the trauma of December. There is evidence that this money only slowly started to be reinvested at the beginning of February. Of course, the ultimate positive signal is the S&P 500, which sits a mere 4% below the all-time market high reached at the end of September and is trading at a slightly above-average forward price-to-earnings multiple.

The Road to 2020 – What Should We Expect Before the Next Election?
There is so much happening politically that it is difficult to do it all justice! We'll give it a go.

As we draw closer to the 2020 elections, we believe that drug pricing and distribution will face bipartisan scrutiny but highly partisan proposals. President Trump has begun to ramp up his effort to repeal the Affordable Care Act without providing specifics as to an alternative, while the drumbeat of Medicare For All is rapidly morphing from an idea embraced only by Bernie Sanders and others on the progressive left to a robust piece of the legislative platform for nearly all the declared Democratic presidential candidates. Comprehensive compromise seems inconceivable but there will likely be substantial headline risk in the coming months.

A more likely bipartisan issue is infrastructure funding, but it is tied to budget approval. The budget will be renegotiated in the late summer, and we believe that another debt ceiling showdown may happen in September.

Trade talks with China are ongoing, and the tariff increase deadline was pushed out. President Trump's aides are hoping for meaningful reform on the issues of our trade deficit with China and, more importantly, patent enforcement and intellectual property sharing. Our view is that President Trump will declare victory to his political base with a resolution that is viewed as mediocre by the markets. We think that there is a 20-30% probability that he walks away from the negotiations as he did recently with Kim Jong Un of North Korea. Further on trade, the "new NAFTA" is facing scrutiny in Congress.

Lastly, the candidate slate for the 2020 presidential elections is forming. There is a long list of Democratic candidates, but Joe Biden and Bernie Sanders enjoy the greatest name recognition in the early going. The markets would greatly prefer Biden to Sanders, as Sanders' progressive ideals would likely pose challenges for many industries and already spiraling government deficits. However, we will not be surprised if one of the younger candidates is more effectively able to capture the energy on the Democratic side. This will likely require a strong embrace of progressive ideals to win the primaries and the nomination, followed by a tack back toward the center to win the election. But, of course, nothing is certain in the age of Trump.

President Trump risks alienating part of his political base with his efforts to repeal the Affordable Care Act. However, he appears likely to emerge from the Russia collusion investigation largely unscathed courtesy of the Mueller report and Attorney General Barr. What is certain is that the next 18 months will see President Trump willing to pull any lever to maintain economic growth while Democrats, following the path of the Republicans during the Obama administration, will be disinclined to do anything that might offer the President a legislative victory. Gridlock, political posturing, investigations and media manipulation seem the most likely outcome unless the nation faces a true immediate crisis.

In Conclusion:
Politics has become more extreme in recent cycles, and the current environment appears positioned to offer more of the same. Increasing income and wealth inequality are colliding with a desire for greater equity in all aspects of life. In our role as stewards of capital for our clients, we look for positive asymmetry – situations where the upside opportunity vastly outweighs the downside - and we seek to avoid the opposite. There have been only six other times since 1926 when the S&P 500 rose by double-digits in the first quarter of the year. In four of the six times, returns were still more than 10% at the end of that year. While the positive case is certainly possible again this year, we do not think it is highly likely. More importantly, we are concerned that the downside potential is greater than the upside opportunity. Our economic indicator signals have partially moved us to the sidelines within equity portfolios. Should inflation increase materially, or the labor market start to deteriorate, we will move to an even more defensive stance. It is possible that markets will continue to trend upwards, but we think a dramatic move to the upside is less likely and are more comfortable with a small amount of cash on the sidelines available for investment if there is a sharp break in markets.

MARKET DATA

Index		*Q1 2019*	*2018*	*2017*	*2016*
S&P 500	*U.S. Large-Capitalization Stocks*	13.65%	-4.83%	21.83%	11.95%
S&P 400	*U.S. Mid-Cap Stocks*	14.49%	-11.08%	16.24%	20.73%
S&P 600	*U.S. Small-Cap Stocks*	11.61%	-8.48%	13.23%	26.46%
Russell 1000	*U.S. Large- and Mid-Cap*	14.00%	-4.78%	21.69%	12.04%
Russell 1000 Growth	*Growth Stocks broken out*	16.10%	-1.51%	30.21%	7.07%
Russell 1000 Value	*Value Stocks broken out*	11.93%	-8.27%	13.66%	17.33%
MSCI EAFE Index	*Established International Markets*	10.13%	-13.36%	25.62%	1.59%
MSCI Emerging Markets	*Developing International Markets*	9.95%	-14.25%	37.75%	11.27%
		3/31/19	12/31/18	12/31/17	12/31/16
90 day T-Bill	*Short-Term Interest Rate*	2.39%	2.45%	1.39%	0.51%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.42%	2.65%	2.43%	2.45%
VIX Index	*Risk Measurement*	14	25.4	11.0	14.0
Corporate Bond Spread	*Risk Measurement*		153 bps	93 bps	120 bps
TIPS Spread	*Inflation expectations*		203 bps	198 bps	197 bps

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