2019 First Quarter Review of the Markets

Index	1st Qtr Return
S&P 500	13.65%
MSCI ACWI Ex USA IMI	10.31%
Barclay's Bond Index	2.94%
Consumer Price Index	0.56%

Market Commentary

After a difficult 2018, a year in which nothing really worked from an investment perspective, 2019 has started off as a year in which everything has worked. Stocks rebounded off of their December lows during the first quarter of 2019. The S&P 500 returned 13.65%. This represents the largest quarterly gain since 2009.

Non-U.S. stocks also increased, with the MSCI ACWI Ex USA IMI up 10.3%. Emerging market stocks did nearly as well as their developed market peers, despite declining less during the fourth quarter. The MSCI EM index returned 9.9%.

Declining interest rates, predominately during the month of March, led to positive performance in the bond market. Additionally, credit spreads (the risk premium above Treasury yields associated with riskier bonds) decreased steadily throughout the quarter. This led to higher returns in the riskier areas of the bond market. The Bloomberg Barclays Aggregate Bond index returned 2.9% for the quarter.

Oil's decline in the fourth quarter was caused in part by concerns about slowing global growth. The price of oil rebounded 33% as measured by West Texas Intermediate during the first quarter.

Investment Outlook

The unemployment picture in the United States remained favorable despite some volatility in readings associated with the government shutdown early in the first quarter. The reading for February dropped back down to 3.8%. Unemployment hit its lowest level since the financial crisis at 3.7% last year, a level that had not been seen since the late 1960s. The Conference Board Leading Economic Index increased, even though its growth rate has slowed over the past six months. It does not appear that the government shutdown which ran from December 22 to January 25 impacted economic data to a meaningful degree.

The Federal Reserve ("The Fed") reacted to concerns of a slowdown in global growth and tightening financial conditions in January in what is being referred to as a "dovish pivot" in monetary policy. This means The Fed will suspend interest rate increases until economic data become more supportive of the notion that monetary policy needs to tighten. Additionally, the Fed signaled that they are likely to end the reduction of their balance sheet. The abrupt change in direction from the Fed (they were previously guiding that they would continue to raise the federal funds rate throughout 2019) has clearly stimulated a return to risk-taking behavior on the part of market participants.

Estimates for 2019 earnings growth are much lower than what companies experienced in 2018. This reflects the run off of the one-time benefit of tax cuts on earnings growth. While the tax cuts may not benefit earnings *growth*, companies will still have reduced tax expenses for as long as the current rates are in effect. This continues to be a positive for corporations. Insofar as those tax savings go towards higher wages or capital investments, the tax cuts could lead to further growth down the road.

In terms of valuations, the price to earnings (P/E) ratio on U.S. stocks at the end of the first quarter is above long-term averages, but this is partially mitigated by the decrease in interest rates since the last time we saw a similar P/E ratio. The result of declining interest rates makes bonds relatively less attractive to stocks at the same valuation. Foreign stocks continue to look attractive on a relative basis. This trend has persisted for some time now and likely reflects structural concerns abroad.

Much has been discussed about the yield on the 10 year Treasury falling below that of the three month Treasury for the first time since the third quarter of 2007 (a phenomenon known as an inverted yield curve). As we discussed last quarter, this is not something that should be ignored right out of the gate. It is worth noting that, while 2007 was the most recent negative reading for this measure, the first time during that cycle that the yield curve inverted was in January 2006, well in advance of the Global Financial Crisis. Stock markets performed strongly in 2006 despite the inversion of the yield curve with the S&P 500 returning in excess of 15% and foreign stocks returning over 26% that year. With that said, we do not believe it would be prudent to make an aggressive shift in client portfolios given the current environment.

Portfolio Strategy

In hindsight, the equity market lows of December presented at least a short-term buying opportunity. While no significant additions to equities were made, staying the course as the fourth quarter ended and the first quarter began served clients well as valuations rebounded and 70% of S&P 500 companies reported actual earnings per share in excess of analyst estimates. Forward earnings growth estimates remain well below their 20 year average at 6%. This suggests that today's moderately above average valuations are not based on unattainable earnings growth.

In our last newsletter we wrote about the potential opportunity in emerging market stocks at the beginning of the year. While we maintain that EM valuations in isolation were attractive at the beginning of the year, developed market stocks were not expensive enough to justify rotating out of in favor of their emerging market counterparts. Index returns for the first quarter supported this thesis as EM stocks were up, but not quite as much as developed market stocks. We continue to closely monitor developments in emerging markets where the fundamental economic backdrop appears to be continuing its improvement.

The decline in interest rates has not materially changed our fixed income positioning. Spreads on agency-backed mortgage bonds (i.e. those issued by government sponsored enterprises) have increased over the past year and may represent an opportunity versus Treasuries.

The last 12 months have seen volatility return to global markets, something we see as likely to persist for the remainder of this economic cycle. In light of this, we think our disciplined rebalancing process makes sense, allowing us to trim exposure to global stocks on strength and add to global stocks on weakness. We encourage clients to think long-term through both the thrill of victory (Q1 2019) and the agony of defeat (Q4 2018) and continue to ensure that their risk profiles are consistent with their willingness and ability to take risk.