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Investment Committee Update

Q1 Review ■ 2019

In this Q1 recap: the Federal Reserve alters its outlook, the truce in the trade dispute holds, the real estate market strengthens, and stocks make an impressive comeback from Q4, even as growth concerns mount.

THE QUARTER IN BRIEF

The strongest first quarter for stocks in 21 years featured all kinds of news. Central banks revised their outlook on monetary policy, seeing less robust economies in 2019. Faint glimmers of progress emerged in the U.S.-China trade dispute. Concerns over near-term corporate earnings and bond yields grew. The possibility of a "hard" Brexit loomed in Europe. The real estate market showed signs of heating up again. As the closing bell rang on the last trading day of March, the Standard and Poor's 500 notched a 13% gain for the first three months of the year.[1]

DOMESTIC ECONOMIC HEALTH

Late last year, the Federal Reserve was forecasting two interest rate hikes for 2019 and maintaining a fairly hawkish outlook. On March 20, the central bank veered away from all that. It cut its 2019 growth forecast for the economy by 0.2% to 2.1%, indicated it would not raise interest rates this year, and projected just one quarter-point hike through 2021. At a press conference immediately after the release of the March policy statement, Fed Chairman Jerome Powell shared his view that the "growth of economic activity has slowed," but he added that Fed policymakers did not foresee a recession developing.[2]

The financial markets reacted swiftly. Demand for longer-term Treasury notes rose. By March 22, the yield on the 10-year Treasury had fallen dramatically, to the point where the yield on the 2-year Treasury exceeded it. (Bond yields fall when bond prices rise.) Economists refer to this as an inverted yield curve. Some economists see an inverted yield curve as a recession

signal, while others disagree. The sudden flight to longer-term Treasuries did seem to reflect a lessening of risk appetite among institutional investors. Just six days after the Fed made its pivot, the CMEGroup's FedWatch Tool, which tracks market expectations about interest rate changes, gave the Fed a 71.7% chance of making an interest rate cut by the end of the year.[3,4]

Some of the incoming data during the quarter seemed to correspond with the Fed's revised assessment of the economy, but some did not. (Some was actually delayed as an effect of the federal government shutdown that carried into late January.)

Inflation pressure eased. In October, the Consumer Price Index showed a 2.5% annualized advance. By February, inflation was running at just 1.5%.[5]

Job creation surged, then fell off. There were 311,000 net new jobs in January, but just 20,000 in February. From January to February, though, the unemployment rate declined from 4.0% to 3.8%, and the broader U-6 rate, encompassing the underemployed, dropped from 8.1% to 7.3%. (The federal government shutdown may have affected some of the above numbers.)[6]

The quarter also ended with the Bureau of Economic Analysis downgrading fourth-quarter gross domestic product (GDP). The prior estimate was 2.6%; the revised estimate was 2.2%.[7]

One important consumer confidence gauge rose and fell during the quarter: the Conference Board's index declined sharply to 124.1 in March, after hitting a 3-month peak of 131.4 in February. The University of Michigan's consumer sentiment index performed better: it started the quarter with a drop of 7.1 points in January, but by late March, it was at 98.4, a tenth of a point above where it was in December.[8,9]

The Institute for Supply Management's monthly purchasing manager index, following manufacturing activity, was nowhere near 60 (a level it reached last summer), but remained well above 50 (the mark delineating sector expansion from industry contraction). ISM's manufacturing PMI was at 56.6 in January, 54.2 in February, and 55.3 in March.[10]

GLOBAL ECONOMIC HEALTH

Financial markets worldwide breathed a collective sigh of relief as the trade dispute between the U.S. and China eased. Negotiations between the two nations continued during the quarter, but no deal emerged. While some trade analysts see an agreement being reached in the second quarter, there are doubts that such an accord will resolve the issue at the center of the tariff fight – the concern that Chinese firms are using their technologies to steal U.S. intellectual property. In March, President Trump said that he would prefer leaving 25% tariffs on $50 billion of Chinese products in place, even if a new trade deal was forged.[11]

The quarter ended without a Brexit or even an accepted Brexit path – with the United Kingdom facing a potentially unpleasant outcome. The revised Brexit deal, which Prime Minister Theresa May brought to Parliament, was rejected for a third time in late March. The European Central Bank surprised financial markets in early March with a decision to revive some of the economic stimulus measures it had recently ended, and it also indicated that would leave interest rates unchanged until at least 2020. The latest forecast from the Organization for Economic Cooperation and Development (OECD) projects only 1% growth for the eurozone this year and less than that for the economies of Germany, Japan, and the United Kingdom.[12,13]

WORLD MARKETS

The S&P 500 was just one of many equity benchmarks advancing double digits in the first quarter. In fact, nearly every foreign stock index posted a quarterly gain of some kind. China's Shanghai Composite surged 26.77%; Italy's FTSE MIB, 16.17%; Hong Kong's Hang Seng, 14.41%; France's CAC 40, 13.10%; all outperformed the S&P for Q1. Other notable gains: Canada's TSX Composite, 12.42%; Euro Stoxx 50, 11.66%; Germany's DAX, 9.16%; Brazil's Bovespa, 8.56%; the United Kingdom's FTSE 100, 8.19%; India's BSE Sensex, 8.11%; Japan's Nikkei 225, 7.56%; South Korea's KOSPI, 6.19%. MCSI's World index rose 11.88% in the quarter; MSCI's Emerging Markets index, 9.56%.[14,15]

COMMODITIES MARKETS

Oil outgained all other major commodities during the quarter. The value of West Texas Intermediate crude rose 29.98% on the New York Mercantile Exchange (NYMEX), taking the per-barrel price to $60.18 at the March 29 close. Other major Q1 advances: unleaded gasoline, 25.52%; palladium, 14.98%; copper, 9.29%; platinum, 6.59%; lumber, 6.07%; cotton, 5.61%. The significant retreats: natural gas, 4.21%; cocoa, 6.44%; corn, 6.98%; coffee, 9.22%; wheat, 11.76%. Gold gained but 0.29% for the quarter, while silver lost 2.65%. On the NYMEX Commodity Exchange, gold was worth $1,290.80 per ounce at the close on March 29; silver, $15.10 per ounce. The U.S. Dollar Index closed out Q1 1.27% higher at 97.20.[16,17]

REAL ESTATE

Is a buyer's market returning? As the quarter ended, some real estate industry journalists and analysts wondered if that was the case. Existing home sales surged 11.8% in February, according to the National

Association of Realtors. That was the largest monthly gain seen since December 2015. While residential resales were still down 1.8%, year-over-year, this latest NAR report was certainly encouraging. NAR chief economist Lawrence Yun cited "lower mortgage rates, more inventory, rising income, and higher consumer confidence" as contributing factors in the increase. Additionally, the Census Bureau said that the pace of new home buying improved 4.9% during February; economists surveyed by Reuters had forecast a 1.3% advance.[18,19]

As Yun noted, cheaper home loans factored in to all this. The decline in longer-term Treasury yields influenced mortgage rates. By the last week of March, a 30-year, fixed-rate mortgage was carrying an average interest rate of just 4.06%, according to the calculations of mortgage buyer Freddie Mac. Compare that with 4.95% as recently as November. (The 15-year, fixed-rate mortgage carried an average interest rate of just 3.57% as March ended.)[20]

In February, the median sale price of an existing home was $249,500, representing a year-over-year increase of 3.6%. The median new home purchase price was $315,300, and that was down 3.6% from a year earlier.[18,19]

LOOKING BACK, LOOKING FORWARD

As the table below shows, the major U.S. equity benchmarks recorded great gains in the quarter. The closing settlements on the last trading day of Q1: Dow Jones Industrial Average, 25,928.68; S&P 500, 2,834.40; Nasdaq Composite, 7,729.32. The S&P Smallcap 600 ended the quarter at 939.30, advancing 11.17%.[21]

Just as the bulls seemed beaten down, they came running right back. After diving nearly 14% in the last three months of 2018, the S&P 500 rebounded more than 13% in the opening quarter of 2019. While consumer spending is still strong, many analysts still see slightly less economic growth this year (between 2%-2.5%). Stock market analytics firm FactSet is now projecting 4% profit growth for S&P 500 firms in 2019; when 2018 ended, the projection was near 10%. Economies in Europe and China appear to be less robust, and that could put a drag on the revenue of S&P 500 companies, 40% of which comes from outside the U.S. An abrupt April Brexit could also be a negative for global equity markets. The financial markets showed great resilience in Q1, forcing some financial firms to reconsider their full-year outlook.[1]

MARKET INDEX	Q1 CHANGE	Q4 CHANGE	2018
DJIA	+11.15	-11.83	-5.63
NASDAQ	+16.49	-17.54	-3.88
S&P 500	+13.07	-13.97	-6.24
BOND YIELD	**3/29 RATE**	**12/31 RATE**	**1 YR AGO**
10-YEAR TREASURY	2.41	2.69	2.74

Sources: barchart.com, treasury.gov - 3/29/18[21,22,23]

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends. 10-year Treasury yield = projected return on investment, expressed as a percentage, on the U.S. government's 10-year bond.

Summary

Global growth in 1Q was at its weakest since the great financial crisis, according to our new GDP tracker. A weaker outlook was reflected in a dip in sovereign bond yields to their lowest levels in years in March, as a dovish Federal Reserve and ECB led to a repricing of interest rate outlooks. The U.S. yield curve even flashed recession for the first time since 2007.

The world economy is poised to exit from a period of panicked uncertainty. Based on Bloomberg's GDP tracker, 1Q growth is expected at 2.2%, down from close to 4% in mid-2018 and the slowest since the great financial crisis. We think 1Q will mark the bottom for global growth. Forward looking policy signals, though, are more positive. For the U.S., leaving aside the February jobs glitch, the labor market remains tight. That will keep consumption, the main engine of demand, humming. In China, if monetary stimulus does not gain traction, fiscal stimulus certainly will. The outlook for Europe is more uncertain.

U.S. economic growth in the first quarter is estimated to slow sharply from the stellar 3.1% pace in 2018. The latest GDP figures showed an inventory build over the second half of the year, which should weigh on growth early in 2019. Another reason for the expected slowdown, though, could be more benign, residual seasonality. Residual seasonality is a well-known recurring seasonal aberration in GDP data. Data-dependent policy makers know this aberration. Still, they will likely wait for it to clear out before resuming policy tightening.

The Federal Reserve's decision to stop shrinking the balance sheet is a part of a two prong dovish approach to calm the markets, which were disappointed by the central bank's policy at the end of last year. While lowering the projected path for interest rates in the dot plot is

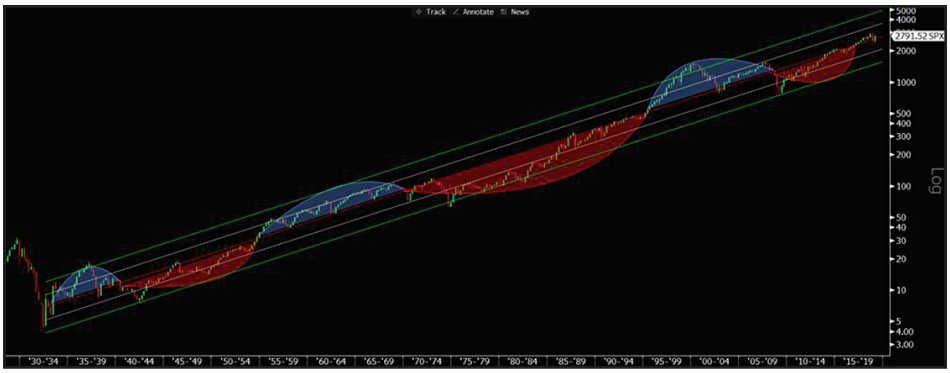
widely understood, we view the decision to stop the balance-sheet unwind at an earlier point than previously anticipated and to initiate tapering of the reduction as another dovish signal.

Ten-year Anniversary

March 2019 represented a decade of the current U.S. equity bull market. In March 2009, major market indexes hit their lowest points before reversing as sellers exhausted themselves amid the fear triggered by the 2009 financial crisis. The S&P 500 Index marked 666 as its low. With the economy in free fall, after four months of reporting monthly job losses of more than 700,000, the U.S. Department of Labor disclosed that 800,000 jobs disappeared in March 2009.

Bull Market History

The current bull market is the longest in history, but at the same time one of the least impressive in terms of annualized returns. At 17.5% a year since March 2009, the S&P 500's return trails all but one of the 12 bull runs since the Great Depression. In fact, along with the 2002-2007 bull market, it's one of only two cycles that hasn't reached annualized returns of 20% or more.



Source: Bloomberg

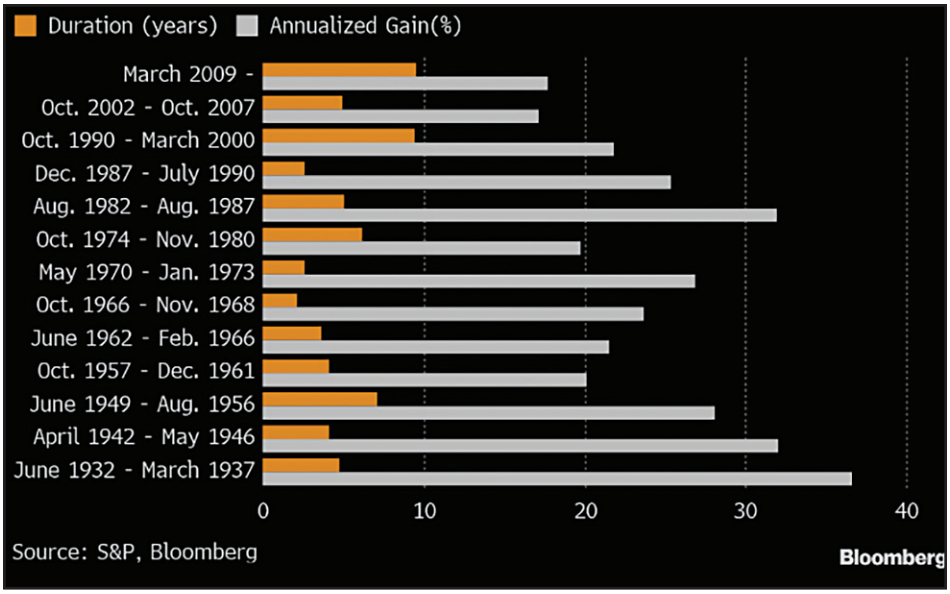
Future Market Direction

Looking at a regression analysis of the S&P 500 since 1932, The S&P has stayed well within the regression lines that have marked the index's evolution over the last 90 years. The regression lines may offer clues about where the S&P 500 may move next.

The chart above is a logarithmic chart, in which the Y axis scale is shown in percentage terms, not absolute values. The chart shows two standard deviation bands on either side of the index going back almost 90 years. The blue curves represent times when the index was above the regression line. The red curves represent periods when it was below the regression line.

Looking at the context of the full chart, the bull market of the last decade has evolved almost completely within the one standard deviation band of the index. Since early 2014, the index has remained close to the central regression line itself. Based on this study, the index could rally 30% to 3,670 before it moved forward to the one standard deviation band at the top. It could also drop more than 27% to about 2,068 before it fell beyond the one standard deviation band on the bottom.

Of course, this is not a forecast, but it affords us one way of extrapolating/analyzing historical market behavior.



"As goes January, so goes the year"

U.S. stocks had their best January gains in more than 30 years, and that should mean 2019 will be a pretty good year for the market according to this January Barometer theory.

In 1972, Yale Hirsch, editor-in-chief of the Stock Trader's Almanac put together something called the January Barometer.

The thesis: As goes January, so goes the year.

Back to 1950, Hirsch showed that the January Barometer was accurate more than 85% of the time. It held up for a while, BUT something funny happened to the January Barometer recently.

It's been wrong seven times in the last 10 years. From 2009 to 2011 the barometer didn't work. Then, there was another three years of misses from 2014 to 2016. And last year, the S&P 500 gained 5.6% in January but ended the year down more than 6%.

So while the barometer still has a better rate of accuracy than many active money managers, there's an argument to be made that January isn't what it used to be.

In any case, the S&P 500 gained 7.8% in January.

Fed's January Pause: What Comes After Powell Pause? Gauging the Risks

Fed Chair Powell took the markets by surprise in January with a dovish statement indicating patience in the face of elevated uncertainties. In particular, the Chair identified risks from a slowdown in Europe and China, the trade war, Brexit, and the recently ended U.S. government shutdown.

In the months ahead, we expect those risks to be resolved in the direction of stability.

Uncertainty is elevated and there are lots of things that could go wrong. Our view, though, is that they probably won't, or at least not badly enough to knock U.S. growth substantially off course. Ultimately, our forecast is for risks to decline but tight U.S. labor markets to push wages higher — as such, we believe the Fed's rate hike cycle has paused, not ended.

Europe has slowed, but in our view the evidence across Germany, France, and Italy reflects this being driven by idiosyncratic and temporary shocks, not the beginning of a sustained downshift.

China has also slowed, with 6.4% growth in 4Q the lowest since the financial crisis. Our view is that with steadily increasing stimulus the government will succeed in putting a floor under growth in the months ahead.

On trade, we view the White House as unwilling to risk a further battering from the markets through an escalating trade war. We also expect the Chinese side to package together enough concessions for President Trump to declare a partial win.

On Brexit, uncertainty is extremely elevated — it's not possible to put a high degree of certainty on any particular scenario. Our view, though, is that deal or delay are the most likely outcomes. We'd also note that even in the unlikely event of a disorderly Brexit, ripple effects to the U.S. would likely be limited.

U.S. government shutdown is now over. The drag on 1Q GDP growth will be 0.3 ppt according to the market consensus. It's possible President Trump, determined to get funding for the border wall, will go back down that route. The widespread unpopularity of the shutdown argues against it.

Economic Soft Patch in First Half, But Transitory

The Fed's March forecast updates show policy makers becoming even more cautious toward the economic outlook. While Fed Chairman described it as "positive" during the March FOMC post-meeting press conference, official projections for growth continued to deteriorate.

We expect much of the recent economic weakness to be transitory; we maintain a mild growth slowdown combined with slightly higher inflation and sideway market action. Nonetheless, following the Fed's shift in tone, we are reevaluating our projection and following interest rates and inflation closely.

Since many of the factors poised to depress growth in the near term will be temporary, we are wary of being overly pessimistic and not recommending any drastic risk-off portfolio adjustments. Economic fundamentals are still sound, and some measures have strengthened relative to periods earlier in the current cycle, particularly the unemployment rate which is at a five-decade low.

Fed Policy

Policy makers appear to have given up on any material, sustained economic benefit from the 2018 tax reforms, nor do they anticipate stronger growth over the next few years relative to what prevailed since the end of the last recession. In turn, the Fed sees little need to continue normalizing (tightening) monetary policy.

The FOMC's median forecasts show growth reverting to trend in the medium term, with little adjustment to their main policy levers. The inflation-adjusted fed funds rate will remain barely in positive territory, as officials anticipate the terminal funds rate to be just 25 bps above current levels. The balance-sheet unwind will fade to a conclusion by the end of September, leaving the central bank's securities holdings significantly above pre-crisis levels.

The flatness of the yield curve will make it difficult for policy makers to walk back their dovish message without instigating a potential market disruption similar to late 2018. Most Fed officials will be unwilling to tighten policy if it threatens to exacerbate a yield-curve inversion.

Headwind: Soft Patch in 1H from a Confluence of Events

The list of factors is extensive: a lengthy government shutdown; a likely recurrence of residual seasonality in Q1 GDP; heightened anxieties about European

and Chinese growth prospects; lingering uncertainty toward trade tensions; a widely anticipated corporate earnings recession in Q1, driven by margin pressures and largely in the technology, energy and materials sectors; a shock to household and business confidence in response to the Q4 market decline; many households receiving smaller-than-anticipated income tax refunds; and a factory slump in response to a significant inventory overhang that developed in the latter half of last year.

The list is daunting, particularly its short time period. GDP growth could register some alarming weakness during the first two quarters of the year, which will fuel recession fears. Quarterly GDP growth averaged near 3% last year. Current consensus projection for Q1 falls shy of 2%. A reading below 1% is not implausible, as inventory corrections can have a particularly serious impact on headline growth.

Tailwind: Slowing but Solid Fundamentals

Labor inflation is running at the fastest pace of the cycle, providing a tailwind to consumer spending, the main support of economic growth. Meanwhile, corporate tax reforms and capacity utilization forces should help to extend a multi-quarter acceleration in business investment. Even the housing sector may see renewed demand following the retreat in mortgage rates.

Signs of a rebound from the soft patch are already emerging. Business and household sentiment metrics have begun to spring back. January retail sales data showed an encouraging pickup in discretionary spending. Financial conditions, as measured by the Bloomberg Financial Conditions Index, have recovered by nearly 90% from the Q4 decline.

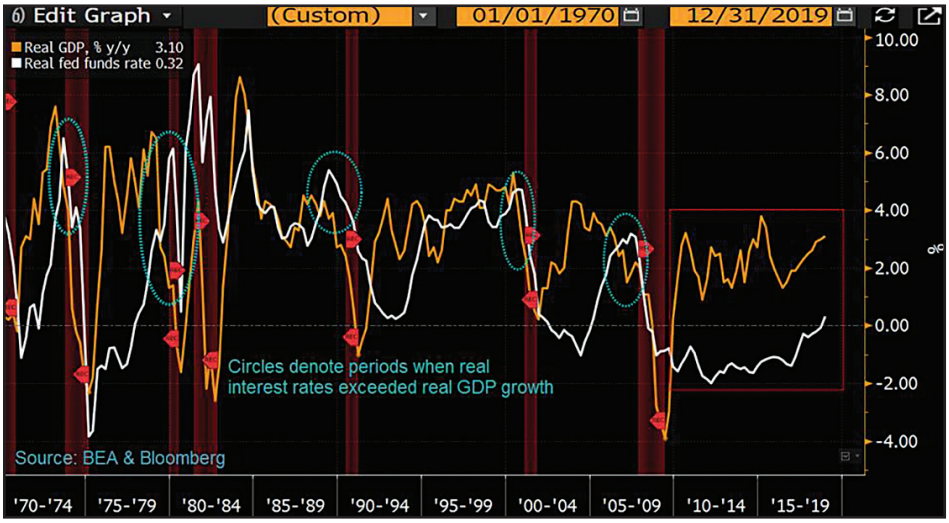
Of course, the news is not entirely favorable. The inventory rebalancing appears to be proving more difficult in the face of weaker demand, external growth signals out of Europe (especially in Germany) and China have been mixed and a messy Brexit could trigger larger-than-expected consequences.

Silver Lining: No Recession has occurred with Rates This Low

While the Fed's core inflation gauge has run below target for all but one year of the current cycle, the missing element over much of this period, wage pressures has finally materialized, thanks to both labor scarcity and an extended stretch of above-trend growth.

Fed's policy makers will welcome some degree of inflation overshoot, after failing to reach their objective for most of the current cycle. Yet as it becomes apparent that core inflation is poised to overshoot by more than just a tenth or two, the financial markets, and policy makers, will ultimately be reminded that over the last 50 years, no recession has occurred with real rates this low.

Additionally, there are still $1.5 trillion in excess reserves in the system. Never, in the history of the US, has a recession started with anywhere near this level of excess reserves in the system.



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