

## 2019 Quarter in Review & Outlook

*“Quality is not an act, it’s a habit.” – Aristotle*

### Capital markets snap back

Not much has changed since our last quarterly report except that asset prices moved significantly higher across the board after global monetary policy took on a dovish tilt. Otherwise, the same investor themes and geopolitical concerns remain: U.S.-China trade tension, late economic cycle concerns, pace of corporate earnings, British exit of the E.U., stock valuations, China growth slowing, etc. All of the concerns have been largely shrugged off by investors.

The 4<sup>th</sup> quarter 2018 bleeding stopped relatively abruptly after the Federal Reserve Board pledged patience in evaluating its next rate move. Markets have swung from pricing in two quarter-percentage-point Fed rate increases in 2019 less than six months ago to factoring in a rate cut this year. Other monetary authorities like the European Central Bank (ECB) are indicating policy will remain easy for some time. China is loosening credit

#### Asset Class Returns

Q1 2019 vs 2018 & 2017

| Index   | Annualized for period | Q1 2019 | 2018   | 2017  |
|---|-----------------------|---------|--------|-------|
| IA SBBI <b>US Inflation</b>                           | 2.1%                  | 0.4%    | 2.2%   | 2.1%  |
| IA SBBI US 30 Day TBill TR USD ( <b>Cash</b> )        | 1.4%                  | 0.6%    | 1.8%   | 0.8%  |
| BBgBarc US Agg Bond TR USD ( <b>Bonds</b> )           | 2.9%                  | 2.9%    | 0.0%   | 3.5%  |
| Russell 1000 TR USD ( <b>US Large Caps</b> )          | 13.2%                 | 14.0%   | -4.8%  | 21.7% |
| Russell 2000 TR USD ( <b>US Small Caps</b> )          | 7.2%                  | 14.6%   | -11.0% | 14.7% |
| S&P MidCap 400 TR ( <b>US Mid Caps</b> )              | 7.8%                  | 14.5%   | -11.1% | 16.2% |
| DJ US Real Estate TR USD ( <b>REITs</b> )             | 9.8%                  | 17.1%   | -4.0%  | 9.8%  |
| MSCI EAFE NR USD ( <b>Intl Large Caps</b> )           | 7.9%                  | 10.0%   | -13.8% | 25.0% |
| MSCI EAFE Small Cap NR USD ( <b>Intl Small Caps</b> ) | 8.8%                  | 10.7%   | -17.9% | 33.0% |
| MSCI EM NR USD ( <b>Emerging Markets</b> )            | 11.9%                 | 9.9%    | -14.6% | 37.3% |

Data Source: Morningstar

conditions and fiscal policy. A slowing but still growing global economy and a reduction in perceived geopolitical risk relative to U.S.-China trade tensions resulted in first quarter returns shown.

We had anticipated a rebound in global capital markets after a difficult finish to 2018, and we got a bit more than expected. In 2018, 79% of global asset classes lost money, according to Blackrock Investment Institute. Historically, when the majority of asset classes decline in a particular year, it usually bodes well for the following year, as does a strong January. Although economic growth globally had declined in 2018, we felt the slowdown in growth did not warrant the severity of the 4<sup>th</sup> quarter 2018 correction. Thus, we got our expected bounce back. We simply didn’t expect asset class returns for the quarter being enviable annualized returns.

All U.S. asset classes including REITs regained their 2018 losses and then some. Only international asset classes remained in negative territory after 2018. However, their leadership in 2017 results in decent annualized returns for the entire 27 month period (see chart).

## China bottoming?

China was a drag on global growth since early 2018. Europe and emerging markets in particular took a hit from China's slowdown, driven by tightening domestic policy and increasing trade conflict. However, according to Blackrock, the tide looks to be turning in China. They and other macro research sources have an increasing confidence that Chinese growth is likely to reaccelerate from the second quarter onward. Beijing has started to ease fiscal and monetary policies, and market expectations of easing U.S.-China trade tensions have increased. A turnaround in China is likely to lift growth globally, particularly in Asia. A Chinese economic revival could also boost global capital spending, supporting growth and favoring cyclical sectors. China has been transitioning to a consumer led economy which is shrinking its current account balance that could move into a deficit position in the coming years. If this occurs, China would no longer add to the global saving glut that has depressed interest rates.

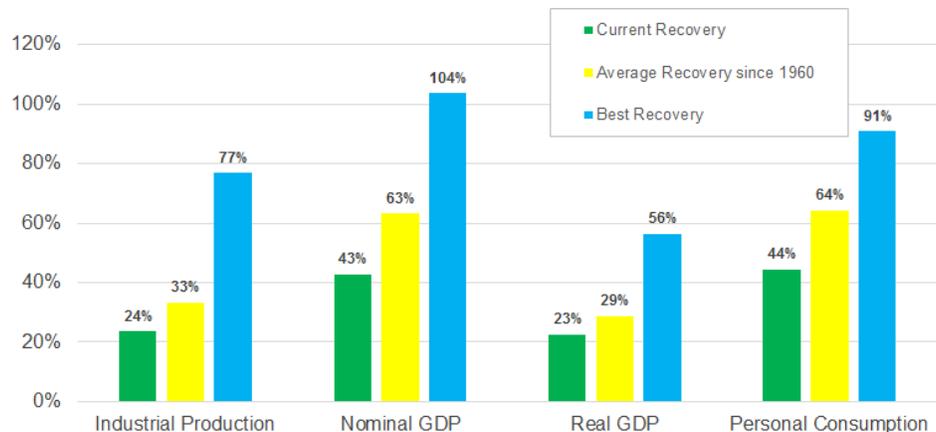
We are a bit concerned that investors have become too focused on a near term trade deal between the U.S. and China. The U.S. and China have entered a competitive phase that goes well beyond trade disputes. The two countries are competing to dominate the industries of the future. The dynamic creates the potential for long term tensions with technological, political, ideological and military dimensions. This complacency means trade flare-ups are likely to have greater market impact.

## Cycle concerns

The U.S. economy has been in the expansion phase of the business cycle since the 4th quarter 2008. That's more than 10 years.

Investors have become increasingly concerned about where we are in the current economic cycle and there are many opinions on the subject. The current economic cycle has been the second longest in history. It has been long primarily because it has

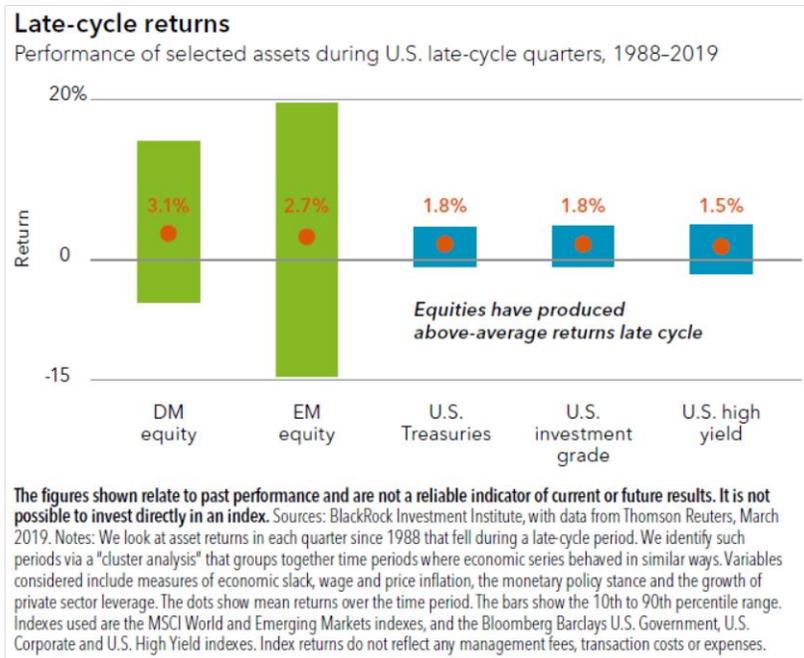
been a very slow expansion. The accompanying graphic shows that the current economic cycle has been significantly slower than the average recovery since 1960 and the best recovery by a number of different key measures (Source: Federal Reserve Bank of St. Louis, Armbruster Capital Management, Inc.). Due to the demonetizing effects of technological advancement, systemic low interest rates and inflation, just-in-time inventory management, and other factors, a number of economists believe that this current cycle has room to run, potentially years, and future economic downturns will be less pronounced.



Both research firms Blackrock and StateStreet Global Advisors believe we are late in the economic cycle with a very low probability of recession this year and a slightly higher probability next year. However, assuming we are late in the cycle, there is little sign of economic overheating or inflationary pressures. Financial imbalances are not yet at stretched levels, and financial conditions are still consistent with an expanding economy. Global capital spending should increase with an expected Chinese growth turnaround. Blackrock looked at returns in the 28 quarters that fell into "late-cycle" periods

info@scadvisors.net [www.scadvisors.net](http://www.scadvisors.net) Phone: 760-776-1488

since 1988. The result: Global equities produced quarterly returns above the full-cycle average, edging out fixed income (see graphic below).



**Portfolio matters**

Overall, the 1st quarter earnings season for our portfolio companies was strong. Starbucks Corporation (SBUX) made new highs after its January earnings reassured the market that its growth issues were behind the company. Walt Disney Company (DIS) shares soared about 13% to all time highs after it unveiled its streaming programming services. One of our smaller positions, apparel maker Hanesbrands, Inc. (HBI) was up about 44% for the quarter after stronger than expected earnings in early February and news that a major college had selected it as a primary apparel provider. We believe the stock remains significantly undervalued.

One disappointment was Biogen (BIIB) which announced the abandonment of two Phase III trials related to the treatment of Alzheimer’s disease. The stock was down about 21% for the quarter. Because of our attention to diversification, the Biogen decline did not materially affect total portfolio performance. Attempts by other biotech companies to treat Alzheimer’s and dementia have been largely disappointing. We feel for the individuals and families who are affected by this horrible disease. We think that Biogen still has a very valuable neurological portfolio and pipeline and still hold the stock.

For the quarter, Technology, Industrial, and Energy sectors led the market in performance (See Sector ETFs returns) while Financial and Healthcare sectors lagged. We find that the largest numbers of companies that have competitive barriers are in the Technology and Healthcare sectors; thus, these two sectors have the largest weightings within the Satellite or individual stock segment of our

**Sector ETFs**  
Total Returns Through 3-31-2019

| Name                       | 3 month | 6 Mont | 1 Year | 3 Year | 5 Year | 10 Year | 15 Year |
|----------------------------|---------|--------|--------|--------|--------|---------|---------|
| Technology ETF             | 19.8    | -1.0   | 14.8   | 20.4   | 17.2   | 18.8    | 10.7    |
| Industrial ETF             | 17.2    | -3.1   | 3.1    | 12.9   | 9.7    | 17.5    | 9.4     |
| Energy ETF                 | 16.2    | -11.2  | 1.2    | 5.3    | -3.1   | 7.0     | 7.7     |
| Consumer Discretionary ETF | 15.4    | -2.2   | 13.9   | 14.5   | 13.6   | 21.0    | 10.4    |
| Consumer Staples ETF       | 11.1    | 5.6    | 9.8    | 4.7    | 8.3    | 13.3    | 8.9     |
| Utilities ETF              | 10.7    | 12.3   | 19.1   | 9.0    | 10.7   | 12.7    | 9.9     |
| Materials ETF              | 10.3    | -3.2   | -0.5   | 9.5    | 5.3    | 12.0    | 7.5     |
| Financial ETF              | 8.5     | -5.7   | -4.8   | 14.1   | 9.2    | 15.6    | 2.6     |
| Health Care ETF            | 6.5     | -2.8   | 14.5   | 12.4   | 11.1   | 16.2    | 9.6     |

Data source: Morningstar

equity portfolios. Healthcare stocks in particular tend to outperform in declining economic environments, and we are very comfortable being moderately over weighted in this sector. We also like the technology sector based on the long term trend of industry transformation due to the exponential increases in computing power that is only in the very early stages.

In our Fundamental Factor ETFs, the Quality Factor was the strongest performer for the quarter in both the U.S. and International large cap space (see ETF Returns chart, last page). The Momentum Factor had a strong showing in the U.S. mid cap and emerging markets areas. We would tend to favor Quality and Low Volatility in a slowing economic environment, particularly for our most conservative client portfolios.

### Going forward

Even though returns of U.S. Large Cap stocks have outpaced other broader asset classes, we believe U.S. economic growth is poised to outpace developed market peers and will likely maintain our weightings to U.S. fundamental factors within the Core ETF segment of our equity portfolios. We also believe our individual stock positions where we emphasize companies with competitive barriers that trade at reasonable prices should do well in a late economic cycle environment where the market could become increasingly focused on earnings expectations.

We also think that our individual stock segments of our portfolios are very reasonably valued, trading at a weighted-average price- to fair-value ratio (P-FV) of 0.87. The Morningstar composite P-FV ratio of its coverage universe of nearly 1,000 companies stands at 0.99, or at fair value.

We do not expect stocks to continue the remainder of the year at the torrid pace of the 1<sup>st</sup> quarter. The global economy needs to be strong enough to avoid sparking recessionary fears and weak enough to keep monetary policymakers on hold. Key risks are a resurgence of recession fears; pressures that force the Fed to resume tightening; or a geopolitical shock such as a U.S.-Europe trade showdown.

Since no one knows for sure where we are in the economic cycle, we think it makes sense to be conservative going forward. For balanced accounts, we will likely increase fixed income on further strength in the equity market. We think U.S. equity indexes could hit all time highs going forward, particularly if this quarterly earnings season is strong and a trade deal with China is announced. We would tend to raise some cash into that strength. Market volatility has crashed which means the cost of portfolio protection has declined. This is also an option for us on further strength in stocks.

Please let us know if you have any questions.

—*Dana L. Crosby, CFA, CFP®, Rick Stein, & Scott Wilson*

**ETF Returns**

For the period ending 03-31-2019

| Name                                     | Ticker | YTD          | 1 Month | 3 Months | 12 Months | 3 Year | 5 Year | 10 Year |
|--|--------|--------------|---------|----------|-----------|--------|--------|---------|
| <b>U.S. Large Cap</b>                    |        |              |         |          |           |        |        |         |
| iShares Russell 1000                     | IWB    | 13.88        | 1.78    | 13.88    | 9.15      | 13.39  | 10.52  | 15.96   |
| iShares Edge MSCI USA Momentum Factor    | MTUM   | 12.40        | 2.12    | 12.40    | 7.35      | 16.86  | 14.63  | -       |
| iShares Edge MSCI USA Quality Factor     | QUAL   | <b>15.83</b> | 2.54    | 15.83    | 9.00      | 12.62  | 11.43  | -       |
| PowerShares S&P 500 Low Volatility ETF   | SPLV   | 13.48        | 2.29    | 13.48    | 14.56     | 11.64  | 11.56  | -       |
| Vanguard High Dividend Yield ETF         | VYM    | 10.68        | 0.52    | 10.68    | 7.31      | 10.86  | 9.64   | 15.54   |
| <b>U.S. Mid Cap</b>                      |        |              |         |          |           |        |        |         |
| SPDR® S&P MidCap 400 ETF                 | MDY    | 14.41        | -0.56   | 14.41    | 2.35      | 10.97  | 8.00   | 15.98   |
| PowerShares S&P MidCap Low Volatil ETF   | XMLV   | 12.21        | 0.73    | 12.21    | 13.07     | 12.69  | 12.84  | -       |
| PowerShares DWA Momentum ETF             | PDP    | <b>16.94</b> | 3.02    | 16.94    | 7.79      | 12.07  | 9.15   | 16.25   |
| PowerShares High Yld Eq Div Achiev™ ETF  | PEY    | 13.87        | 1.33    | 13.87    | 9.20      | 11.74  | 11.89  | 17.44   |
| <b>U.S Small Cap</b>                     |        |              |         |          |           |        |        |         |
| iShares Russell 2000                     | IWM    | 14.65        | -2.08   | 14.65    | 2.09      | 12.95  | 7.10   | 15.42   |
| PowerShares S&P SmallCap Low Volatil ETF | XSLV   | 10.17        | -2.09   | 10.17    | 6.88      | 12.66  | 10.54  | -       |
| <b>REITs</b>                             |        |              |         |          |           |        |        |         |
| iShares US Real Estate                   | IYR    | 16.96        | 4.16    | 16.96    | 10.16     | 7.67   | 9.22   | 17.52   |
| <b>International Large Cap</b>           |        |              |         |          |           |        |        |         |
| iShares MSCI EAFE                        | EFA    | 10.34        | 0.92    | 10.34    | -4.03     | 7.41   | 2.26   | 8.79    |
| iShares Edge MSCI Intl Momentum Factor   | IMTM   | 11.60        | 1.85    | 11.60    | -4.60     | 6.77   | -      | -       |
| PowerShares DWA Developed Mkts Mom ETF   | PIZ    | <b>12.74</b> | 1.86    | 12.74    | -6.30     | 5.46   | 0.58   | 10.02   |
| iShares Edge MSCI Intl Quality Factor    | IQLT   | <b>13.02</b> | 1.74    | 13.02    | 2.15      | 7.70   | -      | -       |
| PowerShares S&P Intl Dev Quality ETF     | IDHQ   | <b>11.67</b> | 0.40    | 11.67    | -2.21     | 7.20   | 4.68   | 11.34   |
| iShares Edge MSCI Min Vol EAFE           | EFAV   | 8.10         | 1.61    | 8.10     | 0.85      | 6.01   | 5.99   | -       |
| iShares International Select Dividend    | IDV    | 8.65         | -1.38   | 8.65     | -1.19     | 7.23   | 0.48   | 10.86   |
| <b>International Small Cap</b>           |        |              |         |          |           |        |        |         |
| iShares MSCI EAFE Small-Cap              | SCZ    | 10.85        | 0.51    | 10.85    | -9.66     | 7.65   | 4.48   | 12.77   |
| WisdomTree International SmallCp Div ETF | DLS    | 9.42         | -0.11   | 9.42     | -11.03    | 7.16   | 3.35   | 12.13   |
| <b>Emerging Markets</b>                  |        |              |         |          |           |        |        |         |
| iShares MSCI Emerging Markets            | EEM    | 9.88         | 1.13    | 9.88     | -9.18     | 10.00  | 3.06   | 7.72    |
| PowerShares S&P Em Mkts Low Volatil ETF  | EELV   | 5.91         | -0.31   | 5.91     | -0.37     | 5.86   | 1.09   | -       |
| PowerShares DWA Emerging Markets Mom     | PIE    | 9.25         | 2.47    | 9.25     | -18.55    | 5.55   | 0.67   | 8.16    |

Data source: Morningstar