



Fed Caves Markets Fly Sky-High...Stay Vigilant April 2019

My Dear Client:

It is often said that the market climbs a wall of worry, and, as we discussed last quarter, there are tariffs, trade wars, debt, and interest rate hikes to worry about. So, no one should be surprised that the markets are up, investors are happy, and the economy appears to be humming along. Nor should we be surprised when signs of trouble begin to surface.

First Quarter Review



Can we say “*Deja’ Vu?*” Well, once again—What a difference a quarter can make on individual and market psyche.

Just a few months ago investors, pundits, politicians and even some fiscal policy experts were seriously concerned about U. S. growth going negative for the first quarter. Because the U.S. Federal Reserve (Fed) indicated that it would raise rates at least three times in 2019, prognosticators foresaw the end of the ten-year bull market and advised investors to proceed with caution. These forecasters suggested that a slowdown in global growth in 2018, led by decelerating growth in China, persistent trade tensions, the fading effects of tax reform in the U.S., and unsettling geopolitical issues like the Brexit fiasco would combine to create trepidation among investors and cause a dive in stock prices. This narrative further predicted that the resulting increase in uncertainty would cause businesses and consumers to put investment and spending plans on hiatus – leading to a slowdown that could evolve downwardly into a recession. Then out of nowhere, on January 30, the Fed, led by chairman Jerome Powell, did a complete about-face and pressed the pause button on their prior plans to raise interest rates in 2019. They also indicated that they would stop taking measures to reduce their mammoth balance sheet sometime during the third or fourth quarter of 2019. The reversal of these two policies to normalize interest rates and reign in financial liquidity immediately gave traders and investors the green light to buy stocks which pushed equities higher everywhere. Risk assets have rallied on expectations that growth has not stalled (but only paused briefly), and that corporate earnings’ levels will rise significantly in the second

half of 2019. *We shall see if the data in Q2, Q3, and Q4 will affirm or challenge this new outlook.*

In Q1 2019, global equities posted their best quarterly performance since Q3 2010, despite fading slightly in March. January and February's euphoria over easing U.S. central bank policies turned into concerns about a global growth slowdown, U.S. yield curve inversion, and looming recession concerns. Despite these apprehensions, U.S. large-cap stocks returned their highest quarterly gains in almost 10 years. Chinese equities continued to enjoy their newly-found sweet spot, following their inclusion in the MSCI index and the appearance of de-escalation in the trade war with the United States. Theresa May, the Prime Minister of the U.K., suffered two resounding defeats as British Parliament voted against her proposed Brexit plans. The March 29th deadline for the U.K. to present its exit strategy to the European Union (E.U.) came, went, and then was sort of extended. In the background to all of this, E.U. politicians and planners in Brussels have been balancing the need for policy enforcement, while also 1) minimizing the inevitable disruptions from the U.K. withdrawal and 2) sending appropriate signals to other countries that may consider leaving the union, particularly Spain and Italy.

U.S. Equity Market

The first quarter saw the broad U.S. equity market (as measured by the MSCI USA IMI Index) roar up 14%. U.S. large-cap stocks (as measured by the S&P 500® Index) posted an impressive gain of slightly less than 14%, its best quarterly performance since Q3 2009. U.S. small caps lost more than 2% in March, thus diverging from the gains posted by large caps. However, these small cap stocks remained the forerunner in YTD performance with an overall first-quarter gain of nearly 15%. Growth-oriented equities roared past value stocks, primarily driven by the Fed's actions, and returned 16% for the quarter. However, value-oriented stocks still posted strong performance numbers, with a 12% gain for the first quarter. In the tech sector, the combination of a flight to traditional defensive (value) stock sectors, along with the impact of slowing growth and sales of I-phones in China, led to a bigger decline in tech-related growth stocks than the sector's value stocks.



Not surprisingly among the 11 economic sectors within the S&P 500 Index, the top performers were Information Technology stocks, which gained by an eye-catching 20%, followed by Real Estate & Industrials, which rose 17%. In fact, unlike the prior quarter when only a defensive sector like Utilities saw positive results, during Q1 2019, the only sectors that did not deliver double-digit gains were Health Care (up 7%) and Financials (up 9%). The lagging (but still strong) performance of these sectors can be attributed, in large part, to two observations. First, Biogen's discontinuance of its Alzheimer's drug trial weighed down the stock and the Health Care sector as a whole. Second, the Financial

sector's gains were negatively correlated to the Fed's plans to delay interest rate increases – banks outperform when interest rates rise.

Emerging Markets



The International equity markets were less robust than domestic markets in the first quarter of 2019. Markets in Europe were quite resilient, in spite of the ongoing Brexit drama and the slowing economic trends which had a negative impact on all developed markets. International developed markets, as measured by the MSCI EAFE Index (net of taxes), were up 10% for the quarter. In comparison, after a sizzling January rally with gains in excess of 9%, emerging markets (as measured by the MSCI Emerging Markets Index) ran out of steam and ended the quarter with gains fractionally lower than those posted by developed market equities. Some of the factors driving emerging market performance were: 1) China's rally which was bolstered by government stimulus packages; 2) increased optimism about US trade agreements; and 3) reported improvements in economic data. If news about the Chinese economy remains positive and relations between China and the U.S. stabilize, I think that investors will look back on the first quarter of 2019 as the low point of in a long-term positive story for emerging market stock performance.

Bonds



Responding to the Fed's change of heart, many investors aggressively moved to reallocate their bond holdings to lower-rated credit bonds. The Treasury yield curve inverted this quarter and the yield on 10-year U. S. Treasuries fell to 2.41%, with a -0.24% return for the quarter. This move reduced the interest rate spread between 2-year and 10-year Treasuries to 0.16% -- yields almost interchangeable. The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, was up 2.94% this past quarter. Despite increased demand for equities and riskier fixed income securities, non-U.S. fixed income markets experienced further fundamental deterioration, pushing global rates lower.

The U-turn in Fed policy has given other central banks more flexibility to follow suit and ease monetary policy – actions that are putting yields in markets across the globe under pressure. The amount of outstanding global debt that trades at negative interest rates has again increased to more than nine trillion U.S. dollars. I see this as restoring “*reach for yield*” conditions in which investors tend to buy riskier assets in order to achieve higher yields, potentially intensifying market turbulence when the business cycle eventually turns downward. While the stock market showed euphoria, the Bond market is intimating something else - *a far less rosy picture down the road*.

As Q1 drew to a close, bond market watchers' attention was drawn to the 3-month/10-year spread, which inverted in March. Simply said, when a bondholder can receive equal or greater interest for a 3-month bill as received for a longer-maturity 10-year note of the same credit quality, then there is a problem and trouble may follow! As investors, we will keep a keen eye on the inversion, which tends to be a reliable predictor of recessionary concerns in the near term (generally speaking – the following 3-5 quarters).

If there's one area of the U.S. that remains a conundrum, it's housing. It looks like we had a fifth straight quarter of slowed activity in this sector. We expect these conditions to improve moving forward. But for the time being, we see a decline at a -2.6% annual rate, which translates into a 0.1-point strain on real GDP growth. (-2.6 multiplied by the 4% residential construction share of GDP equals -0.1). This drag could be the beginning of a negative trend. As Dowell Myers, co-author of the 2018 Fannie Mae report, "The Coming Exodus of Older Homeowners" noted, the home-building problem is expected to worsen in the 2020s, as more baby boomers advance into their 70s and 80s, the age when people typically exit homeownership due to downsizing, poor health, or death. Boomers currently own 32 million homes and account for two of every five homeowners in the country, and millennials do not seem to be interested in the housing that the Boomers will be vacating. Given these factors, I believe that all investors must watch out for a new growing concern — the combination of 1) unsellable Boomer McMansions, 2) the negative effects on housing of State and Local Tax (SALT) reductions in the recent tax bill, and 3) millennial debt that makes home ownership very difficult. This could be the start of an important generational shift, that will alter both economic activity and the structure of communities.

I remain cautious about the medium to longer-term (roughly 1-5 year) outlook. Extremely high overall equity allocations are becoming riskier – steep valuations and low expected average returns over the next ten years all fit the inevitable reversion to the mean. In other words, all good things must come to an end.

A Look Ahead

I urge clients to remain focused on a risk-balanced, multi-asset class approach and to evaluate opportunities should larger short-term dislocations occur. My portfolio considerations continue within the theme of the recommendations I have made over the past few quarters, as the periods of high multi-year gains are very likely behind us. I would suggest consideration of the following portfolio actions:

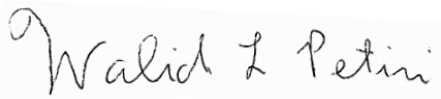


- 1) maintain overall U.S. equity allocation to target;
- 2) continue to use gains in U.S. equities for liquidity needs;
- 3) rebalance portfolios toward the following: bond allocation targets, hold the cash

- from gains and increase the margin of safety;
- 4) maintain the allocation tilt towards the emerging market and international equities and away from U.S. equities;
 - 5) favor small caps over large caps, be they at home or abroad;
 - 6) seek out selected niche and special illiquid private investments;
 - 7) consider giving preference to U.S. value stocks versus U.S. growth stocks.

We will remain watchful over your asset allocation plan and the targets, along with rebalancing thoughtfully to continue achieving your financial objectives and goals. We should discuss whether any changes are needed or if the plan in place remains suitable. As always, it is a pleasure to serve you, and I look forward to continuing to work with you toward achieving your investment goals.

Appreciatively,

A handwritten signature in black ink that reads "Walid L. Petiri". The signature is written in a cursive style with a large initial 'W'.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board,