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Investment Perspective

March 2019

Market Recap

After falling 19.8% between September 20 and December 24, U.S. stocks staged a furious rally to start 2019. The S&P 500 is off to its best start to a year since 1987 and now sits roughly 2% away from eclipsing new all-time highs. While the recent strength has been led by U.S. large-cap growth stocks, the gains have been broad-based with U.S. small-caps and most international markets also notably higher. Fixed income markets also rose significantly to start the year.

Index Returns as of March 31, 2019			
		QTR	1-YR
Domestic Equity	S&P 500 TR	13.65%	9.48%
	Russell 2000	14.57%	2.01%
Intl Equity	MSCI EAFE NR	9.98%	-3.72%
	MSCI Emerging NR	9.92%	-7.41%
Fixed-Income	Barclays U.S. Aggregate	2.94%	4.48%
	Barclays U.S. High Yield	7.26%	5.93%
	Barclays U.S. Corporate	-6.32%	5.43%

The catalysts for the rally? In response to evidence of slowing growth, inflation, and credit creation during the fourth quarter, the United States Federal Reserve fully reversed course on interest rate hikes and adopted a dovish policy approach. The futures market is now pricing in a 40% chance of a rate cut by year end. The Chinese also stimulated their economy more aggressively than expected through a new package of relaxed lending, tax cuts, and infrastructure spending. As a result, China manufacturing PMI rebounded strongly in March, rising to 50.8 from 49.9 in February. And a U.S.-China trade deal, albeit likely a more modest one than some had hoped for, appears to be at hand.

Despite the optimism, stocks and bonds sent conflicting messages. Longer-term (10-year) Treasury yields continued to decline from a peak of 3.24% in early-November to around 2.50% at quarter end, leaving many investors to wonder whether the bond market is forecasting a U.S. recession and/or deflation. The yield on 10-year Treasuries dipped below the yield on 3-year Treasury bonds during the quarter. Once the yield curve inverts like this, the U.S. has historically often slipped into a recession within a year. This condition can become a self-fulfilling prophecy as it erodes the spread between what banks earn on loans versus what they pay on overnight deposits. When bank profitability falls, lending institutions often retrench their loans to the real economy.

However, yield curve inversions are not uncommon late in business cycles. The lead time between an inversion of the yield curve and recessions has also been highly variable and several parts of the U.S. yield curve have yet to invert. Some economic slowdown is to be expected given the length of the current economic expansion, which will represent the longest such cycle in U.S. history later this summer. The U.S. economy accelerated in terms of real or inflation-adjusted GDP for a record ten consecutive quarters, and the short-term benefits from U.S. tax cuts are starting to fade. That said, favorable seasonal trends await as the Dow Jones Industrial Average has finished positive for the month of April in each of the past 14 years.

Data compiled by FactSet on March 29th shows estimated earnings for the S&P 500 declining 3.9% in the first quarter, which would be the first year-over-year decline in earnings for the index since the second quarter of 2016. In the 2016 case, a strong rebound in earnings growth subsequently took hold, fueled by a large corporate tax cut and a period of synchronized global growth. In addition, a significant portion of the 2016 earnings weakness came from the energy sector. By contrast, in the current episode the breadth of earnings weakness appears broader. For example, all eleven sectors experienced downward revisions to earnings estimates in the past three months. With U.S. labor markets now very tight by many measures, rising wages could also pressure corporate margins over the remainder of 2019. While we do not currently expect a substantial decline in earnings (i.e. greater than 10%) that has often been associated with bear markets, the upside for U.S. equities could be constrained by an ongoing challenging environment for profit growth.

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Looking forward, as long as the U.S. can sidestep a recession, low interest rates boost the relative attractiveness of equities relative to bonds. We view the recent partial yield curve inversion as a reason to be alert for a potential looming recession, but we do not currently see confirmation of a downturn in most of the other macro indicators we follow. In particular, the riskier parts of the credit market are not showing many signs of stress and most equity markets are now in intermediate-term uptrends. As a result, we do not believe the evidence currently supports a defensive portfolio allocation.

Index Definitions

S&P 500 TR - An index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Russell 2000 - An index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

MSCI EAFE NR - An index that serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

MSCI Emerging Markets NR - An index that serves as a benchmark of the performance in global emerging markets as represented by 23 emerging economies. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

Barclays U.S. Aggregate - A broad base index, maintained by Barclays Capital, and is often used to represent investment grade bonds being traded in the U.S. Barclays Capital (BarCap) U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

Thomson/Reuters CRB - The index track baskets of 19 commodities and is intended to be a representative indicator of global commodity markets.

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