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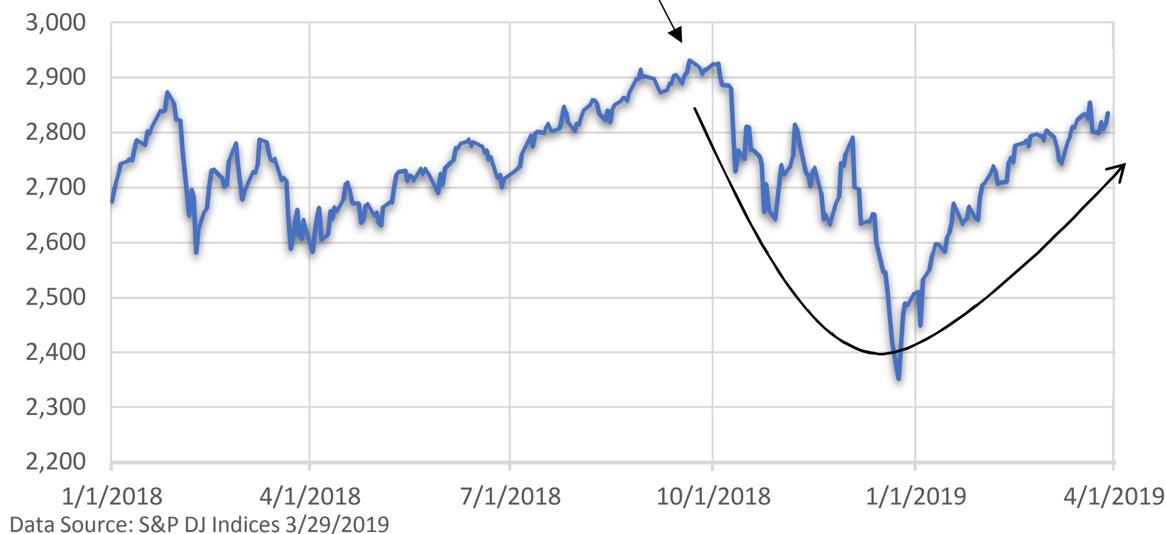
April 2019

Quarterly Market Insights

A Strong Start to the Year

The first quarter feels as if it was the mirror image of the final quarter of 2018. Economic conditions are far from robust, but investors have jumped back into stocks, brushing aside fresh concerns. In fact, the S&P 500 Index turned in its best quarter since the third quarter of 2009.



The Federal Reserve's newfound flexibility has played a big role in supporting the market, in our view. In December, the Fed (i.e. the Federal Reserve) was talking about two rate hikes this year. That has changed. They are no longer on rate-hike autopilot. Instead, they are carefully looking at the economic data as they contemplate their next move.

Crosscurrents have developed at home and the global economy has slowed. We are seeing it in the trade data and specific sectors of the economy, including housing and autos.

The latest Fed forecast now projects no rate hikes this year. On the other hand, Federal Reserve Chairman Powell pushed back against talk of a 2019 rate cut at his March press conference.

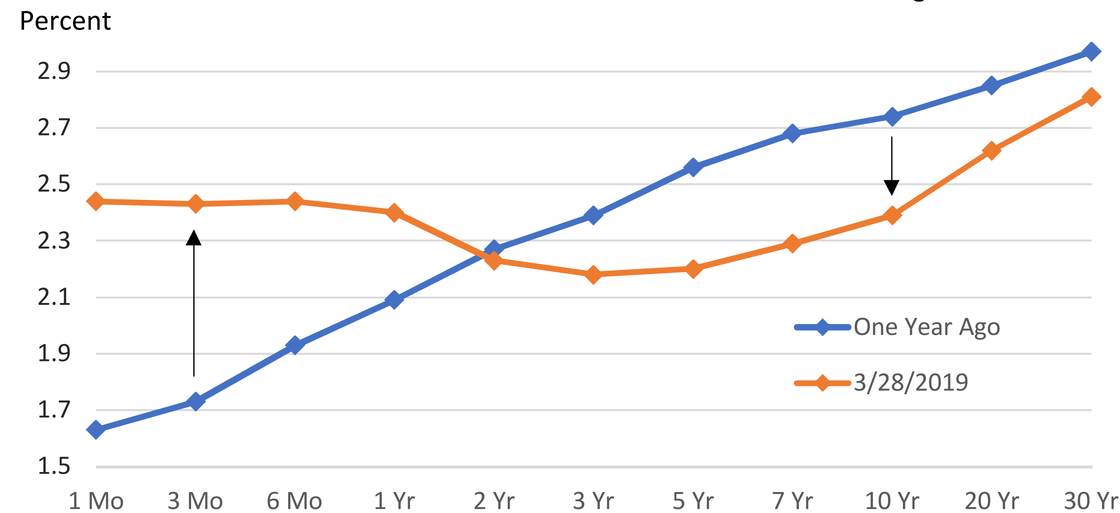
Cautious optimism about a U.S.-China trade agreement has also lent support. Despite favorable headlines, the two economic powers have yet to conclude an agreement that opens Chinese markets to U.S. goods, protects intellectual property of U.S. companies, and prohibits forced technology transfers. Most reports suggest the enforcement mechanism of any deal has been the sticking point.

Yielding to the Curve

While the data is not pointing to an economic contraction, the economy has entered into a slower level of growth. Coupled with slower economic growth around the globe, we witnessed an **inversion** of the yield curve for the first time in over a decade.

What is the yield curve? The yield curve plots the yields of a similar type of bond (such as Treasuries) over various maturities. It is illustrated in Figure 2.

A year ago (3/29/18) the curve was "normally" sloped – longer maturities offered a **higher** yield than shorter term ones. Today, we see a "kink" in the curve. As of 3/28/19, the 10-year Treasury note yielded **less** than the 3-month T-bill.



Why do we care? An inverted yield curve may restrict bank lending, but by itself, it does not cause a recession. Instead, it is the bond market's signal that short-term interest rates may eventually fall in response to an economy that is expected to weaken.

Why is this important: the 10-year/3-month has inverted prior to each of the last seven recessions. Additionally, on average a recession has occurred 11 months after the inversion of the 10-year/3-month T-bill. While an inversion does not guarantee a recession, it is something that we are closely watching (in addition to slowing earnings).

That's the Bad News – Any Good News?

While the 10-year/3-month yield spread inverted, not all signs point to a recession.

1. The Conference Board's Leading Economic Index® (LEI) has been flat since October, but it has not turned lower. Historically, it declines in front of recessions, with an average lead time of 7 to 20 months. That is quite a range and highlights the difficulty in predicting and timing a recession. This one indicator is not currently indicating a recessionary signal.

2. During the last seven recessions, the 10-year/2-year Treasury yields (vs. the 10-year/3-month spread mentioned earlier) inverted an average of 20 months before a recession. The spread has yet to invert in this economic expansion.

3. Low yields around the world may be encouraging bond purchases in the U.S. which could be artificially pushing U.S. yields lower. At a minimum, we have a distorted bond market due to the unprecedented activity of central banks around the world which can lead to strange outcomes.

4. Today, the Fed is on hold. Moreover, financial conditions have eased in the first quarter and yet, banks are still lending which is a good thing for liquidity and growth.

5. Finally, the steep drop in longer-term Treasury yields has pushed mortgages rates down sharply. In October, the average 30-year fixed rate mortgage was approaching **5.00%**, according to Freddie Mac's weekly survey. As of March 28, the weekly survey placed the average rate closer to **4.00%**. These lower rates add support to the struggling housing market.

Index	March Return*		2019 Q1 Return %*
S&P 500 (large)	+1.94%		+13.65%
S&P 400 (midsize)	-0.57%		+14.49%
Russell 2000 (small)	-2.09%		+14.58%
MSCI EAFE (intl.)	+0.63%		+9.98%
Bond Yields	**March 29 Yield & Qtr. Change**		**Yield a/o Dec 31, 2018**
3-month T-bill	2.40%	(-0.05%)	2.45%
2-year Treasury	2.27%	(-0.21%)	2.48%
10-year Treasury	2.41%	(-0.28%)	2.69%
30-year Treasury	2.81%	(-0.21%)	3.02%
Commodities	**Mar 29 Price & Qtr. Change**		**Year end 2018**
Oil per barrel	$60.14	(+$14.73)	$45.41
Gold per ounce	$1,295.40	(+$16.40)	$1,279.00

**Stock indices include reinvested dividends and are NOT annualized*

Where Do We Go from Here?

Let's not dismiss what has happened to the yield curve. We have been in a long-running economic expansion and U.S. growth has been slowing. But other warning signals aren't pointing to a contraction. Throw the government shutdown into the mix and the economic numbers for the first quarter are unlikely to deliver impressive results.

Historically, we have seen a bounce in the second quarter. The St. Louis Fed notes that in recent decades, Q1 GDP has been "substantially weaker than growth in other quarters."

Recessions have typically been preceded by major economic imbalances, such as a housing or stock market bubble, or a sharp rise in inflation that forces the Federal Reserve to aggressively respond with rate hikes. For the most part, these conditions are currently not present, lessening odds that a near-term recession is lurking. Further, recent market action has been impressive. It's not as if we haven't seen some volatility, but year-to-date performance is not suggesting an economic contraction is imminent.

Bottom Line: Do not react to day-to-day movements in the market. Instead, construct a portfolio that is well diversified and tailored to your unique situation and financial plan.

Final Thoughts

We are very proud to announce that we have two additional owners at Hopwood Financial: Kevin Galvin and Eric Randolph. Both Kevin and Eric are important members of the team and by adding them as shareholders, it shows our commitment to building the firm for the long term. Please congratulate them if you have an opportunity.

In addition, Joni Alt was recognized at the recent Schwab annual convention for advisors. She was filmed and received much press explaining what being an advisor means to her and the responsibility that it brings to serve her clients. We are very proud of Joni and encourage you to view the video on our website at www.hopwoodfinancial.com under the *Resources* tab and *In The News*.

Thank you for your business.

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