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FIRST QUARTER 2019 MARKET RECAP

Global Financial Markets Rally After Fed Reversal And Progress Towards a U.S.-China Trade Deal

The Markets Love me, the Markets Love me not, the Markets Love me…

The U.S. Federal Reserve ("Fed") did it again. It surprised the financial markets by backing off plans for additional short-term interest rate increases and announcing an early end to "normalizing" its balance sheet holdings of Treasury bonds. Instead of triggering a near bear market in U.S. stocks this time, the Fed's unexpected "dovish" turn sparked a rally in both stocks and bonds in 1Q 2019. Meanwhile, additional progress was made towards a comprehensive U.S.-China trade deal and the United Kingdom's "Brexit" out of the European Union has turned into a "Brextension." There was even a yield curve "inversion" during the quarter as we explain in more detail below.

With much of the expected return in U.S. stocks for 2019 pulled forward into the first quarter, foreign equities are poised to takeover market leadership over the course of this year. Meanwhile, the prospect that the Fed has reached the end of monetary policy tightening signals the U.S. economy is getting even closer to the end of its current growth cycle and this probability warrants maintaining a conservative position within fixed income. Economic growth cycles end with a recession and recessions tend to precede or occur at the beginning of structural bear markets (more on this below). Exposure to asset classes outside of traditional stocks and bonds, namely real assets and alternatives, and tactical opportunities should help to enhance the return potential of client portfolios while reducing overall volatility.

Robust Rebound in U.S. Stock Prices

The S&P 500 rose 13.7% during first quarter 2019. The key factors that nearly caused a bear market in U.S. stocks in Q4 2018, namely U.S. Fed monetary policy and U.S.-China trade relations, helped propel U.S. stocks to their best three-month start since 1998 as we witnessed a reversal in Fed policy and progress on trade negotiations between the U.S. and China. Also notable last quarter, the “bull” market in U.S. stocks hit its tenth anniversary, making it the longest stretch of positive returns in history. A “bull” market is a period of time for which asset prices consistently rise without falling 20% or more. Within the S&P 500, Technology (+19.9%), Real Estate (+17.5%), and Industrials (+17.2%) led all sectors over the first quarter while Healthcare (+6.6%), Financials (+8.6%), and Materials (+10.3%) lagged the overall market. Growth-oriented stocks, which tend to represent shares of more economically-sensitive companies, outperformed rising 15.0% while defensively-oriented, value stocks that typically pay a dividend were up 12.2%.

With the Exception of China, Foreign Stocks Lagged

The MSCI EAFE Index (“Europe, Australia-Asia, and Far East”), which measures the U.S. dollar-denominated return of large company stocks in developed, foreign markets outside of the U.S. and Canada, increased 10.0% during first quarter 2019. Developed international stocks underperformed U.S. stocks last year and in 1Q 2019 due in large part to disappointing economic data, especially in Europe and Japan, and increasing uncertainty over Brexit negotiations. Brexit is the term used for the United Kingdom’s exit from the European Union (“EU”). The MSCI Emerging Markets Index rose 9.9% on a U.S. dollar basis in the first quarter of 2019. Chinese stocks, which account for roughly 33% of the index, drove U.S. dollar denominated emerging market equity returns during the quarter rising 24.9%. The sharp rebound in Chinese stock prices, after declining by 26.7% in 2018, was the result of increasing expectations for both a U.S.-China trade deal over the coming months and new expansionary policy out of the Chinese central government. Moderating U.S. dollar strength and a 27.1% rise in oil prices also helped to stabilize emerging market stock sentiment.

Real assets, or physical assets that have tangible value and provide relatively stable income, continued to deliver a differentiated source of returns relative to traditional stocks and bonds. As was the case last quarter, global real estate and global infrastructure assets outperformed U.S. stocks and investment grade bonds, rising 17.1% and 15.6% respectively during 1Q 2019. U.S. midstream energy assets (i.e. domestic gas/oil pipelines and storage facilities) also outperformed U.S. stocks and bonds in the first quarter increasing 16.8%. U.S. midstream energy benefited from positive sentiment related to rising energy costs as well as increased investor interest, especially among private equity investors. Alternatives assets, or assets/strategies with low correlation (i.e. relationship) to other asset classes, rose 3.2% last quarter.

Broadly Positive Fixed Income Results

U.S. fixed income, or U.S. investment grade bonds of all types, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, rose 2.9% during 1Q 2019. Investment grade corporate bonds were especially strong with the Bank of America/Merrill Lynch US Corporate Bond Index rising 5.0% during the quarter. U.S. Treasury bonds and mortgage backed securities ("MBS") modestly underperformed the broader investment grade bond market with the Bloomberg Barclays Aggregate Treasury Index and the Bank of America/Merrill Lynch US MBS Index increasing 2.1% and 2.3% respectively last quarter. While national municipal bonds, as measured by the S&P National Municipal Bond Index, nominally trailed U.S. investment grade bonds during the quarter (+2.79%), they still offer attractive tax-equivalent yields of 2.8%-3.4% for higher tax earners relative to taxable bonds (2.8% for the Bloomberg Barclays U.S. Aggregate Bond Index).

U.S. investment grade bonds benefited from the Fed's unexpected "dovish" turn as the U.S. central bank reversed near-term plans for additional monetary policy tightening (the Fed is now in a "wait and see" mode). At its March Federal Open Market Committee ("FOMC") meeting, Fed Chairman Jerome Powell cited growing global risks, a slowing U.S. economy, and muted inflationary pressures as reasons for foregoing additional hikes to its target for the federal funds rate (the overnight rate at which domestic banks and other depository institutions lend reserve balances to each other). The Fed also announced an earlier-than-anticipated slowdown in its balance sheet "normalization" program (also known as "quantitative tightening"). Rather than continuing to redeem its substantial Treasury bond holdings in perpetuity, the Fed now expects to end the "run-off" of these securities in September, which would reduce the overall size of its bond holdings from a peak level of $4.5 trillion in October 2017 to $3.5 trillion. The Fed's change in policy stance last quarter drove the yield on the 10-year Treasury bond down 28 basis points from 2.69% on 12/31/18 to 2.41% on 3/31/19.

Corporate bonds managed to outpace Treasury bonds in 1Q 2019 as they benefited from both the decline in rates (bond prices move inversely with bond yields) and tightening credit spreads. A credit spread is the yield difference between a non-Treasury bond and an equivalent maturity Treasury bond. This spread measures the additional yield demanded by investors over Treasury bonds for assuming the risk of a potential credit agency downgrade and/or issuer default (Treasuries are considered the closest proxy to a risk-free bond). Narrower credit spreads signal a higher risk tolerance among investors (since they are not demanding less additional yield to own a riskier bond) while wider spreads suggest a lower risk tolerance (investors want more additional yield to own a riskier bond).

The Bloomberg Barclays International Aggregate Bond Index, which measures the U.S. dollar denominated results of international (non-U.S), developed market, investment grade (IG) bonds of all types, increased 1.5% last quarter. International, developed market, IG bonds lagged the performance of their US counterparts due to continued highly accommodative monetary policies abroad suppressing overall yields. Emerging market (EM) bonds once again outperform U.S. IG bonds in U.S. dollar terms with the Bloomberg Emerging Markets Aggregate Bond Index rising 5.9% in first quarter 2019. The continued inflow of investor money into these assets reflects both a desire among investors to obtain higher yields given accommodative central bank monetary policy globally as well as a more favorable view over growth prospects within the emerging markets, especially China.

A Yield Curve Inverted. What Does This Mean?

Between March 22 and March 29 the closely followed 3-month/10-year Treasury yield curve inverted. The 3-month/10-year yield curve charts the spread between the 3-month Treasury bill yield (short-term rates) and the 10-year Treasury bond yield (long-term rates) over time. Normally, the yield curve is upward sloping, meaning short-term interest rates (i.e. yields) are typically lower than long-term interest rates. This is because investors demand a premium for having their rates fixed for longer periods of time. When a yield curve inverts, prevailing short-term interest rates are higher than long-term rates. This phenomenon is mostly observed in the later stages of an economic cycle and may serve as a signal that the financial markets expect the Fed to lower interest rates in the future to combat a near-term recession. In fact, the 3-month/10-year Treasury yield curve has preceded each of the last 7 recessions dating back to 1970, and recessions typically occur just prior to or at the beginning of structural bear markets in stocks. A structural bear market is when an index, such as the S&P 500, declines 20% or more in value over a period of at least 12 months.

So what does this mean? While an inverted 3-month/10-year yield curve remains one of the most reliable leading indicators of an upcoming recession, it can occur multiple times prior to a recession with instances of an inversion happening several years in advance of a recession. It is also important to keep in mind that U.S. interest rates are artificially low due to unprecedented Federal Reserve monetary policy actions since the 2008 financial crisis. Heightened demand for U.S. bonds have further suppressed longer term yields as even more aggressive central bank accommodation outside of the U.S. (namely in Japan and Europe) have maintained the attractiveness of U.S. Treasury bonds given their higher yields to other sovereign bonds, including some that have negative yields. Meanwhile, the Fed has been raising short-term yields given its view that the U.S. economy is healthy and no longer in need of unconventionally low short-term interest rates. Considering the Fed has been raising short-term rates from artificially low levels and central banks outside of the U.S. continue to depress long-term rates, this inversion simply confirms the U.S. economy is in its late cycle and a recession is not imminent. Not only do trends in key economic measures such as consumer spending and unemployment support this view, but the strategists we speak with generally do not expect the next U.S. recession to occur for at least another 12 to 18 months.

Expectation for U.S. Equities Going Forward

As mentioned above, we are of the view that the U.S. is firmly set in the late phase of its current growth cycle and a recession is unlikely to occur over the near-term. The slowdown in U.S. growth should not have been a surprise to anyone given the 4Q 2018 government shutdown and the waning effects of the tax cuts in early 2018. Slowing U.S. economic growth combined with continued tame inflation data may be smoke screens for the primary reason why Fed monetary policy has become less restrictive. All indications both from the media and our market consultants point to meaningful progress being made towards a comprehensive trade agreement between the U.S. and China. By bolstering the economic situation in the U.S., the Fed is enabling the government to consummate an ultimate trade deal from a position of strength, especially ahead of an exogenous risk to market sentiment stemming from a potential hard Brexit.

As discussed in last quarter's market commentary, we stopped reducing exposure to U.S. stocks given the near bear market in the S&P 500 and indications that the U.S. stock swoon was overdone. Instead, we let the first quarter rebound in U.S. stock prices take our clients' exposure back to levels deemed appropriate given prevailing market valuations and the stage of the U.S. economic expansion. Furthermore, much of the expected return we anticipated occurring over the course of 2019 was realized last quarter. With U.S. stock valuations generally in line with historical levels, we see less impetus for further expansion in market "multiples" going forward. With that said, the potential approval of an infrastructure bill later this year would meaningfully push-out the timing of a U.S. recession while reinvigorating economic corporate earnings growth. Retrofitting a deteriorating U.S. infrastructure is one of a select list of fiscal policies both democrats and republicans agree on especially ahead of the 2020 elections. For these reasons, we generally advocate maintaining meaningful exposure to U.S. stocks but at approximately half the levels we would typically recommend.

Foreign Equities Still Primed to Take Over Market Leadership

Political uncertainties (primarily Brexit) and concerns over Chinese economic growth have weighed on economic activity within Europe and Japan. This uncertainty has stifled sentiment, which has led to slower-than-expected economic activity over the course of 2018 as many businesses and consumers have delayed expenditures or have pursued contingency plans to limit financial exposures. Even though economic growth has downshifted in Europe and Japan, it has not stalled, and valuations in international developed markets have become even more compelling. The current discount international developed market stocks are trading at compared to both U.S. stocks and historical levels means much of the bad news is already reflected in their valuations. We expect investor sentiment towards international developed market stocks to improve and for these assets to begin an extended period of outperforming U.S. stocks as stabilization in economic growth becomes more obvious, especially as China reinvigorates its economy over the course of this year (both Europe and Japan are major exporters to China).

We anticipate evidence of an orderly Brexit will serve as an additional trigger for a change in sentiment towards international developed stocks. At the end of the day, both the United Kingdom (U.K.) and the EU want to avoid a "hard Brexit" where the U.K. leaves the European Union without a withdrawal deal in place given the economic consequences to both economies. Ultimately, we see the EU granting the U.K. yet another extension after which both parties consummate a "soft" Brexit. Such a deal would involve the U.K. no longer contributing $65 billion per year to the EU budget, the U.K. losing passport rights to the EU while also negotiating a "pay to play" trading relationship, and an Irish backstop (i.e. a scheme to maintain an open border between Northern Ireland and the Republic of Ireland).

We continue to view emerging markets (EM) as the most compelling mid-to-long term opportunity within equities. The economic growth slowdown in China coupled with the U.S.-China trade dispute led to a prolonged drawdown in valuations last year. However, signs of progress towards a U.S.-China trade deal led to a sharp recovery in Chinese stocks last quarter. The recovery in the broader EM stock universe, though, has languished due in large part to concerns over moderating Chinese economic growth (China as major import market for most key EM economies).

China's economic slowdown is a byproduct of its efforts to "de-risk" its financial system as it continues its transition from an industrial-based exporter to a consumer-driven economy thus the central government is managing short-term growth trends to ensure longer-term viability of its economy. After letting annual growth in gross domestic product ("GDP" or the value of economic activity within a country or the sum of the market values of all goods and services produced in an economy) fall close to levels not seen since the global financial crisis, we are seeing firmer signs that China is more aggressively easing monetary policy and beginning to inject fiscal stimulus into its economy. These measures are expected to improve corporate earnings growth both in China and the Asia-Pacific region. An improving earnings outlook combined with relatively attractive valuations, should drive higher demand for these assets, thus valuations, over the mid-term. Longer-term, emerging markets stocks will benefit from positive secular growth tailwinds driven by favorable demographics and rising incomes.

Owning Real Assets, Tactical Opportunities, and Alternatives Make Sense

Real assets remain an important portfolio "diversifier" due to their defensive attributes. Not only do they provide a hedge against an unanticipated rise in inflation, but their relatively stable income streams reduce the inherent volatility of client portfolios. Within real assets, we continue to advocate investment in midstream energy (oil and gas) companies given the robust outlook for distributable cash flows over the next few years. We also view investments in global real estate and infrastructure as viable proxies for a portion of fixed income assets as a means to lower client exposures to interest rate volatility and credit risk.

We maintain our positive view on the healthcare sector since this sector is relatively insulated from changes in the economic cycle. Healthcare is also supported by strong long-term secular trends, namely aging demographics and constant innovation. Concerns over efforts to repeal the Affordable Care Act ("ACA" or "Obamacare") and potential price controls are overdone. Specialists we consult with expect the latest district court ruling to overturn Obamacare will get reversed on appeal, as has been the fate of all prior district rulings. Even if this ruling was upheld both on appeal and at the Supreme Court, the sector's underlying growth tailwinds remain intact and the industry's breadth of opportunities still allow active managers to generate outsized returns over time.

Sticking with the theme of investing in sectors with less exposure to the business cycle, we maintain our positive view on the consumer staples sector. Like healthcare, this sector is comprised of companies whose earnings tend to be derived from more "inelastic" goods and services. In other words, these companies tend to experience lower sales and earnings variability to changes in the underlying economic environment (e.g. the U.S. falling into recession). Companies within the consumer staples generally pay higher dividends compared to the broader market, which further helps to reduce the overall volatility of these stocks.

Last quarter, we began modifying the composition of many of our clients' technology holdings to be less sensitive to changes in the economic environment. This involved shifting a portion of exposure out of more traditional technology companies, such as semiconductor equipment manufacturers, that tend to be more sensitive to changes in the economy, and into the broader communication services sector. Much like healthcare and consumer staples, the communication services provides active managers the capability to become more defensive in their positioning by investing in telecommunications companies, which tend to outperform the broader market during weak economic environments. Like the biotech sector within healthcare, the communication services sector also includes internet companies and other constantly innovating subsectors that reduce the overall sensitivity of our clients' stock holdings to the business cycle.

We continue to monitor the burgeoning global movement towards regulating the protection and privacy of personal data. Currently, the U.S. does not have a federal framework for regulating this data, but it is just a matter of time before a bill is introduced given strong bipartisan support over this issue. Last May, the EU began enforcing its General Data Protection Regulations and the impact of the technology industry as result of these new rules remains unclear. We will consider adjusting client exposure to technology sector investments if this law or any proposed legislation in the U.S. materially impact the expected long-term growth profile of this sector.

Like exposure to real assets, alternatives strategies remain an important means to reduce overall portfolio volatility without having to take on additional interest rate risk or credit exposure. These investment strategies tend to have both very low correlations to traditional stocks and bonds and differentiated return streams. This means the strategies within this asset class have the ability to "zig" while other assets "zag" due to their low relationship with the broader financial markets. The managers we use within alternative strategies include underlying strategies that have the potential to generate positive returns when the broader markets decline.

Investment Grade or Bust

Our view on fixed income has not changed. We continue to recommend holding onto a globally diversified mix of investment grade bonds with lower overall sensitivity to interest rate movements and changes in the credit environment. Investors are still not being adequately compensated for taking excessive interest rate risk within bonds since global yields remain at historically low levels. The U.S. economy is also in the late phase of its business cycle, which reduces the attractiveness of maintaining excessive credit exposure. We prefer to take more credit risk early in a business cycle when underlying economic conditions are improving and the risk of defaults are declining. We emphasize exposure to structured notes (predominately mortgage backed securities, as well as other asset backed securities and commercial mortgages) since these bonds provide the opportunity to own high quality assets with lower correlations to interest rate changes. We also recommend exposure to emerging market bonds, as this sector is one of the few areas within fixed income to offer attractive long-term, risk-adjusted, return opportunities that are supported by robust secular tailwinds.

The primary reason for maintaining meaningful exposure to fixed income is to reduce the fluctuation of portfolio returns, especially during tenuous market environments. The equity sector remains the primary means by which we advocate assuming risk to generate returns since these assets still provide the potential to deliver much higher upside. Combining stocks with predominately high quality bonds, real assets, and alternative strategies diversifies risk while improving the return potential of client portfolios through more efficient compounding of returns over time.

A Well-Diversified Portfolio Makes Sense

In an environment of constantly changing interest rate expectations and political uncertainty, owning a conservatively positioned, well-diversified portfolio makes sense. While a U.S. recession does not appear likely in 2019, current stock valuations and low interest rates, warrant more thoughtful asset class positioning. Emphasizing sectors with the best risk-adjusted return profiles and owning asset classes that can dampen volatility while providing differentiated sources of upside helps portfolios generate more predictable return patterns over time.

We invite you to visit our new website at www.ginsburgadvisors.com. Here you will learn more about our services, value proposition, and our team. The site also has a useful "Resources" section where you can access our previous market commentaries, watch informative videos, download our latest staff contact list, and access useful financial calculators and web links. Please be sure to check the site periodically, as we will be updating the functionality of the site to include a client portal and other useful applications.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

This information is compiled and written by Ginsburg Financial Advisors.

Unless otherwise noted, financial data are as of March 31, 2019

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

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