MARKET UPDATE
FEBRUARY 12, 2019

We are pleased to report that at least so far, 2019 is off to a very positive start. The gains so far this year have erased all of the losses from 2018 (in the U.S. as of 2/11/19). As we have stressed over the past three decades that trying to time the market (i.e. pick the best individual days, weeks or even months) is extremely difficult. Since markets can, and in this particular case did, turn around quickly, having the right asset allocation and appropriate level of risk in your investment portfolio are the most important things to focus on in helping you achieve your term investment objectives over time.

Looking at returns so far this year, several of last year's laggards such as overseas markets, small capitalization stocks and Master Limited Partnerships (for example) have gone from being a headwind to a tailwind. This helps support the case that when building client portfolios, it's important to be diversified. Over time, our strategy has been to maintain at least some exposure to a wide range of investment categories. Having said this, based on our global investment outlook, we will tend to overweight or underweight various parts of the market investments that we believe look more or less attractive. Right now, we continue to favor large capitalization over small capitalization stocks, growth versus value and the U.S. versus overseas markets.

THE FEDERAL RESERVE

In January the central bank held its first meeting of 2019 and while rates were held steady (as expected), the central bank made news by changing its stance on monetary policy. Just last October, Jerome Powell and members of the central bank stated that they were far from the "neutral rate" and that further rate hikes were likely in 2019. These comments helped contribute to the correction in financial markets during the fourth quarter last year. After a pickup in market volatility combined with weakness in the global economy, the central bank blinked.

Following their first meeting earlier this year, the central bank stated that "In light of global economic and financial developments and muted inflation pressures, the committee will be "patient" as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." Decoding this, they left the door open to either raising rates again down the road (should additional rate hikes be warranted) or reducing rates in the future if that is the policy needed to help support the economy. This represents a major change in policy and at least for now, removes one of the major hurdles facing the economy and financial markets.

Recent Economic Data

It has been our viewpoint that the risk of recession is fairly low in 2019. While some U.S. economic data has slowed in recent months (for example housing related data), reports on employment and manufacturing indicate the economy is off to a solid start in early 2019. The monthly jobs report was released on February 1st, 2019 and indicated another solid rise in employment. Payrolls increased by 304,000 (versus estimates of an increase of 165,000 and a 3-year average of 204,000), the unemployment rate rose 0.1% from 3.9% to 4.0% (as more workers re-entered the labor force) and average hourly earnings rose 0.1% month over month (up 3.2% year over year). Importantly, payrolls have now increased for a record 100 straight months. This is important because consumers represent about 70% of the economy. Therefore, we continue to keep an eye on job growth, wages and consumer confidence. At this stage in the economic cycle, it's only fair to assume that job growth should start to slow as an increasing number of people are now part of the labor force. At least so far, signs continue to point to a continuation in job growth, which should help support additional growth in consumer spending. One caveat is that the economy cannot just rely on the consumer. It will be important to see a sustained pickup in business equipment spending in the quarters ahead.

Another widely watched economic report we wanted to touch on is the ISM Manufacturing Index. The January ISM Manufacturing Index was also released on February 1st and came in at 56.6, better than the consensus estimate of 54.2 (and last month's reading of 54.1). For reference, a reading above 50 indicates expansion while a reading below 50 indicates contraction. Among the highlights from last month's report, new orders were notably stronger at 58.2 versus 51.3 in December and the production component bounced back and registered 60.5 compared with 54.1 last month. Employment remained pretty much unchanged at 55.5 versus 56.0 the prior month. Given ongoing concerns regarding trade/tariffs with China, the recent government shutdown and increased volatility in financial markets last quarter, continued growth in employment along with the bounce back in manufacturing activity last month, is encouraging.

MARKET TECHNICALS

We spend most of our time looking at market fundamentals (i.e. factors like sales, earnings, corporate profits, interest rates, inflation etc…) but also keep an eye on market technicals. Over the past few weeks, we have started to see some signs of improvement in market technicals. For example, the percent of stocks trading at 52-week highs, the percent of stocks above their 50-day moving average and the market's advance/decline line have all shown signs of improvement so far this year. We believe this is encouraging and at least historically, has pointed to some additional market gains looking ahead over the next 6-12 months. The next hurdle for the market will be to rise back above its 200-day moving average in the days ahead. We wouldn't be surprised to see a bit of profit taking (after the market's recent advance) or choppiness over the next several weeks (ahead of the March, 2019 U.S./China trade and Brexit deadlines), but overall we are mostly encouraged by recent improvement in market technicals.

OVERSEAS GROWTH

Economic growth overseas has been a source of concern in recent months. For example, Italian GDP has been negative for two straight quarters, the German Purchasing Managers Index has been below 50 for two straight months and data out of China has remained weak. In Europe, Brexit talks between the UK and Europe remain an overhang with no real solution at least so far. One positive note is that the unemployment rate for the Eurozone peaked at 13.2% in 2013 and has continued to decline over the past several years (currently standing at 7.9%).

The European Central Bank (ECB) had previously indicated that after they ended asset purchases, the next step would be to slowly start raising short-term rates later this year. However, with economic data weak across Europe, we may actually see more government stimulus before the ECB ultimately starts raising rates. In China, the central bank has cut reserve requirements twice in recent months, has provided additional liquidity for small businesses and is looking for ways to stimulate the economy (while not adding to already high debt levels). Looking around the world, economic growth outside the United States remains weak (but still mostly positive).

It's hard to see the U.S. continuing to remain strong indefinitely while the rest of the world is slowing. In terms of our global allocation, we currently have about 15% exposure to non-U.S. markets. As a reminder, for several years we had almost no foreign exposure (note: the 15% foreign exposure in our models right now is considerably below the approximately 50% exposure to overseas markets currently in the MSCI All Country World Index). The reason we have some exposure to foreign markets is because overseas markets have more attractive valuation levels, greater monetary accommodation, and higher dividend yields. Looking ahead (which is our job as your investment advisor), we believe the multi-year outlook for overseas markets looks attractive. However, at least for now, U.S. markets appear more stable. Thus, we continue to overweight U.S. markets in our portfolios but maintain a small amount of exposure to overseas markets.

China Trade Talks

Along with Fed policy, China trade talks remain our biggest concern in 2019. Recent press reports suggest that trade negotiations with China are making progress although the final outcome is still highly uncertain. The United States is asking China to change the fundamental way they engage in trade - which currently includes forced intellectual property transfers, 50/50 joint ventures with U.S. companies and high tariffs on U.S. goods sold overseas. For now, we are hopeful that both sides will avoid further escalation in tariffs as they continue to negotiate a longer-term agreement.

At their meeting in Argentina last November (at the G20 Summit), the two sides agreed to a 90-day cooling off period during which trade negotiations would continue to take place. A trade delegation from China met with U.S. officials at the White House over the past few weeks. Soon, U.S. Trade representative Lighthizer and Treasury Secretary Mnuchin are expected to travel to China to have more trade talks (ahead of a possible trip by the President over the next several weeks). Both China and the United States have an interest in trying to come to an agreement to help stabilize financial markets and boost economic growth. The million-dollar question is: Will China and the United States both agree to new trade terms that have so far alluded both sides?

Summary

In summary, after a volatile fourth quarter last year, financial markets appear to be on more solid footing to start the new year. Global equity markets are rebounding, credit markets are performing better and there is a sense that the current economic expansion may have longer to run. With the Fed on hold for now, this removes one big risk for investors to worry about. Trade/tariff talks with China remain the other big outstanding issue that will need to be resolved for investors and corporate CEO's to feel more positive in their outlook for the economy as we head through 2019. While this year is off to a positive start across most asset categories, investors should be aware that volatility is likely to remain somewhat elevated. Market valuation levels are no longer cheap (trading at about 16x forward 12-month earnings estimates) so if a few things do not go right, equity markets could move lower and possibly re-test prior 2018 lows.

In terms of the big picture, job growth remains positive, wages are rising, the yield curve (the difference between short-term and long-term treasury yields) remains positive, the Monthly

Leading Economic Index (although it has slowed somewhat) remains positive and consumer and business confidence (off recent highs) also remains constructive. While the U.S. consumer (approximately 70% of the economy) remains on fairly positive footing in early 2019, we would like to see a more pronounced pick up in business spending to help boost productivity and economic growth this year. The one area of the economy that has clearly slowed in recent months is the housing sector. Overseas, growth remains a concern and this is something we will be monitoring in the year ahead.

In the U.S., corporate profits (for the S & P 500) were forecast to grow 20.3% in 2018 (we acknowledge this is backward looking) followed by growth of 5.3% in 2019 (negative EPS growth is currently forecast for the first quarter of 2019) and 11.3% in 2020. Over time, stock prices tend to follow the direction of corporate profits. Therefore, corporate profit trends will be important to monitor in the quarters ahead. GDP was forecast to rise 2.9% in 2018. However, as the 2017 tax cuts start to fade somewhat, GDP growth is currently forecast to register around 2.5% in 2019 and 1.8% in 2020. While we may be in the later stages of the current expansion, our outlook over the next few quarters remains one of continued moderate economic growth (although slower than in 2018). Based on currently available information, we do not believe the end of the current cycle is right around the corner.

As always, we welcome any comments you may have.

Respectfully,

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Disclaimer:

S & P 500 - The *S&P 500 Index* tracks the performance of 500 large capitalization companies that trade on either the NYSE or NASDAQ Market.

VIX Volatility Index – The VIX Index is a gauge of equity market volatility.

Data Source: Factset

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