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MARKET UPDATE
MARCH 26, 2019

Following a sharp correction during the fourth quarter of last year, equity markets have staged an impressive rebound to start the year. From our perspective, the selling looked overdone in late 2018 and we thought a market rebound appeared likely. The steep bounce back which started on December 26th likely caught some investors (who ran for cover) by surprise. Heading into 2019, we did not believe a recession appeared likely over the next few quarters. Therefore, as we wrote in our November and December, 2018 market updates, we remained mostly invested and did not try and time the market (which involves selling and then trying to figure out when to get back into the market). So far this has turned out to be the appropriate strategy to follow.

Over the near term, we would not be surprised to see a period of consolidation or some modest profit taking after the market's recent move higher. In terms of global asset allocation, we remain overweight U.S. versus foreign markets (as we have for a number of years), favor growth versus value (a trend that remains largely in place) and large cap versus small cap (to hopefully maintain more stability due to the length of the current economic expansion).

Around the world economic data has been weak in recent months (more on that below). The ECB has taken notice and recently lowered its estimated GDP growth rate this year from 1.9% to 1.1%. The central bank in China has forecast growth of 6 to 6.5% in 2019 (although we have a hard time believing that forecast). Here in the U.S., the Federal Reserve bank recently lowered its estimated GDP forecast for 2019 from 2.3% to 2.1%. During the first quarter, it appears that weak global economic growth overseas has finally caught up with the U.S (the partial government shutdown probably played a role as well). On a more positive note the

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unemployment rate remains below 4%, wage growth is currently at a cycle high of 3.3%, and weekly jobless claims remain near multi-decade lows. Consumer confidence also remains not too far below recent cycle highs.

One thing that caught our attention last week is that the yield curve (i.e. the difference between 3-month Treasury Bills and 10-Year Treasury Note Yields) inverted for the first time since 2007. At least historically, this trend (if sustained for a period of time) has been an indicator that a recession may lie ahead over the next 12-24 months. This development is likely to raise the level of uncertainty in financial markets over the near term. From our perspective, we think it's important to point out that the recent decline in U.S. 10 Year Yields has likely (at least in part) been caused by weak growth overseas (for example, German 10 year Bund yields recently fell below 0%) along with actions taken by central banks around the world to keep rates low and help stimulate growth. From our perspective, U.S. growth appears weak in early 2019 but should start to bounce back somewhat in coming months.

Equity market valuation levels for the S & P 500 are currently trading at about 16x estimated forward 12-month estimated earnings. This is no longer cheap (compared with late 2018 valuation levels) but is also not overly expensive (considering interest rates and inflation remain at fairly low levels). Further market gains this year will be dependent on a pickup in earnings, increased CEO and CFO confidence that leads to a pickup in capital equipment spending, continued strength in the U.S. consumer, along with signs that global growth will start to show signs of improvement.

A trade deal with China (still in the works) could provide a boost as investors start to think about what could go right in the global economy instead of what might go wrong. While a market pullback could occur at any time, we believe that equity markets are likely to grind their way somewhat higher over the next 6-12 months. Growth has clearly slowed this year compared with 2018 (whether you look at corporate profits, industrial production, GDP etc…) which likely means that investors should prepare for somewhat higher volatility. However, at least for now, we reiterate our opinion that we think the odds of a recession in 2019 currently remains a low probability. We can't say the same for some European countries.

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The first quarter of 2019 looks like somewhat of an air pocket for economic growth. For reference, the widely followed Atlanta Fed GDP Now tracker currently forecasts first quarter GDP growth of around 1.2%. Estimates from Factset (which polls a wide range of economists each month) is somewhat better and currently stands at 1.7%. Following a weak start to the year, growth appears likely to bounce back during the second quarter, with full year 2019 growth likely ending the year around somewhere in a range of approximately 2.0% - 2.5%.

As we said, U.S. economic growth has been mixed to start the year due to: 1) the government shutdown (that has now ended); 2) weak growth overseas; 3) lower earnings expectations and 4) concerns about the trade conflict with China. Looking at the jobs picture, the increase of only 20,000 in payrolls last month has raised fears that job growth and consumer spending may be starting to slow. However, given that weekly jobless claims remain at historically low levels, other hiring surveys remain pretty healthy, and the Federal Reserve Bank now plans to keep rates on hold for a while, we believe it is too soon to sound the alarm bells just yet. Given the recent volatility across a range of economic data, we think it makes sense to take a multi-month view of the job market. Looking back over the past three months, for example, the average monthly job gain has been 186,000 per month. We think this is probably more representative of the underlying health of U.S. labor markets.

Similar to last month's weak jobs report, the December 2018 retail sales reports was extremely weak. The January retail sales report bounced back (although it didn't recapture all of the sales lost during the prior month). Looking at the health of the U.S. consumer, with wages rising (up 3.3% on a year over year basis), job openings near all-time highs (based on the JOLTS jobs report from the Bureau of Labor Statistics) and consumer confidence at pretty healthy levels, we believe that consumer spending should continue to grow at a moderate rate in 2019. For reference, the JOLTS jobs report measures the number of job openings and people who leave their current job for new jobs each month. If equity markets fall sharply, oil prices spike higher, a trade deal with China falls through or the economy slows sharply, that could certainly put a dent in the level of consumer spending later this year.

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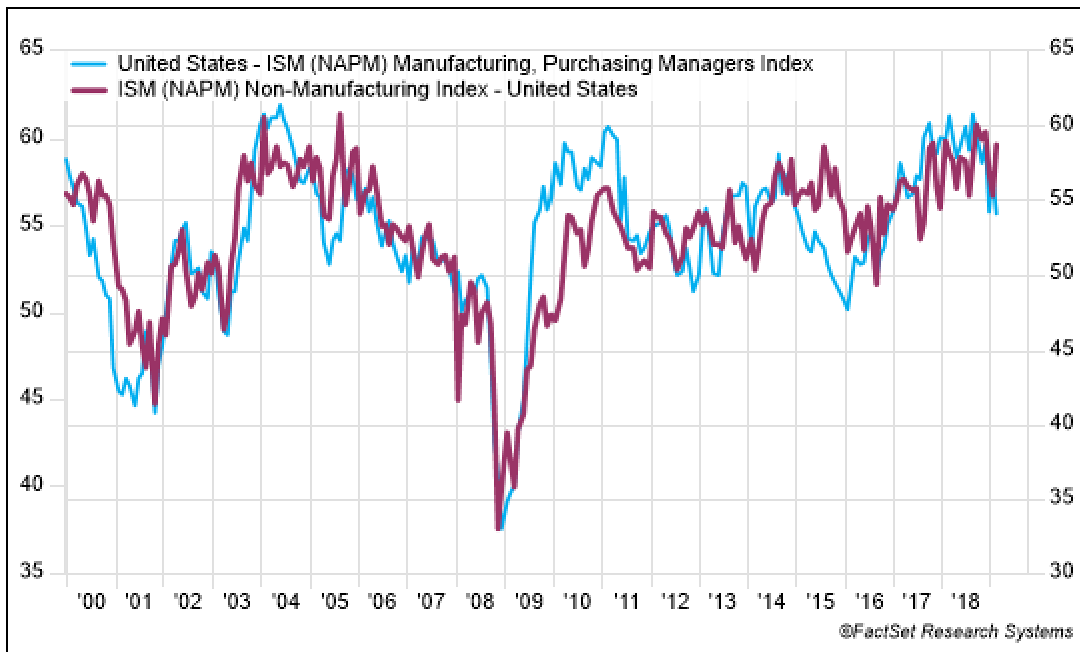
Each month we monitor the level of the ISM Manufacturing Index and the ISM Services Index. Together, these two indices provide a timely read on the state of the country's manufacturing and services industries (see chart below – source: Factset). Note, the blue line is the ISM Manufacturing Index and the purple line is the ISM Services Index.

As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. Last month the ISM Manufacturing Index fell to 54.2 (versus 56.6 the prior month). On the other hand, the ISM Services Index rose to a reading of 59.7 (versus 56.7 the prior month). While manufacturing activity has slowed over the past several months (likely reflecting weaker growth overseas and uncertainty among corporate executives due to rising trade tension with China), manufacturing activity remains positive. The ISM Services Index, on the other hand, rose to a three-month high last month and remains close to one of the highest readings of the current expansion.

One of the areas that weakened in 2018 was the housing market. While housing data did not collapse, it certainly slowed. Housing activity was likely held back by millennials (who have high levels of student debt), high prices across a number of geographic areas and mortgage rates that rose during parts of last year. It's hard to say the trend has turned positive again. However, we have recently started to see some signs of improvement. For example, the NAHB Home Builders Survey has recently improved from a level of 56 to 62 over



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the past two months, home mortgage applications have started to rise, housing starts recently rose to a four-month high of 1.23 million units and existing homes sales rose sharply last month. In what could be somewhat of a strange development (since housing typically does better earlier in an economic cycle), housing activity may provide a lift for the economy later this year now that the Federal Reserve Bank has signaled it plans to keep rates on hold in 2019.

Overseas

Overseas, economic data has been fairly weak over the past several months. According to the latest estimates from Factset, GDP growth in Germany, Japan, and China are currently forecast to rise 1.3%, 0.9% and 6.2% respectively in 2019 compared with average growth rates of 2.1%, 1.1% and 6.7% over the past three years. To cite just a few statistics, year over year exports fell 20.7% last month in China, industrial production has fallen in four of the past five months in Germany and the monthly Tankan Survey in Japan (which measures the quarterly outlook for large business activity) has slowed in three of the past four quarters. On a more positive note, central banks around the world have taken notice of the global slowdown and plan to remain accommodative or provide additional stimulus in order to boost economic growth.

In Europe, after ending their multi-year bond buying programs, the ECB had previously indicated that the next step would be to gradually start raising short term rates. However, in a reversal, the central bank recently announced that it would start up a previous lending program aimed at providing additional liquidity for banks. In China, the central bank has cut reserve requirements twice in recent months and has pumped additional money into the economy this year to help boost growth. There are some early signs that a possible pick-up in growth may develop over the next several quarters. However, there is still plenty to be concerned about. We will be watching "leading" economic signals like money supply growth, business and consumer confidence levels and the direction of key commodities like copper to help judge the outlook for global growth as we head through the year.

The bottom line is that in early 2019, it looks like the U.S. has finally joined the global slowdown. However, it's important to keep this weakness in perspective. In the U.S., growth appears likely to rebound after a weak start to the year. Overseas, economic growth

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remains quite weak (across multiple countries) although we are starting to see some early signs of a possible rebound in economic growth. Equity markets in many parts of the world have rallied in early 2019, possibly ahead of a pickup in global growth later this year. Much will depend on the outcome of trade talks with China, which is something we expect to hear more about over the next 2-3 months.

The Fed

Following the Fed's dovish turn earlier this year, central bankers met for the second time this year on March 19/20. At its latest meeting, Fed Chairman Powell signaled that future rate hikes appear unlikely for the rest of 2019. To us, the central bank thus appears unlikely to choke off economic growth and prematurely end the current expansion. After evaluating incoming domestic (and global) economic data over the next few quarters, the central bank will be in a better position to decide on what to do next. We think it is too soon to sound the all clear and believe that another rate hike (some time in 2020) is still a possibility if U.S. economic conditions and global growth show signs of improving. Conversely, the next move by the Fed might also be to cut rates at some point if the economy slows further. At least right now, we see no change in Fed policy over the next several months.

Earnings

Turning to the picture for corporate profits, the forecast for first quarter earnings per share (EPS) has declined by 6.7% since December 31, 2018. This percentage decline is larger than the 5-year average of -3.2% and the 10-year average of -3.7%. Because of the net downward revisions to EPS, first quarter earnings are now forecast to decline -3.7% year over year (compared to estimated EPS growth of +2.8% back on December 31, 2018). If -3.6% is the actual decline for the quarter, it will mark the first year-over-year decline in EPS since the second quarter of 2016.

Looking at future quarters, analysts currently see year over year EPS growth of +0.1% for the second quarter of 2019, +1.8% growth for the third quarter of this year and a rebound to +8.1% growth for the fourth quarter of this year. On an annual basis, EPS for the S & P 500 are currently forecast to rise from $162 per share last year to $169 (up 3.8% year over year) per share in 2019 and $188 per share in

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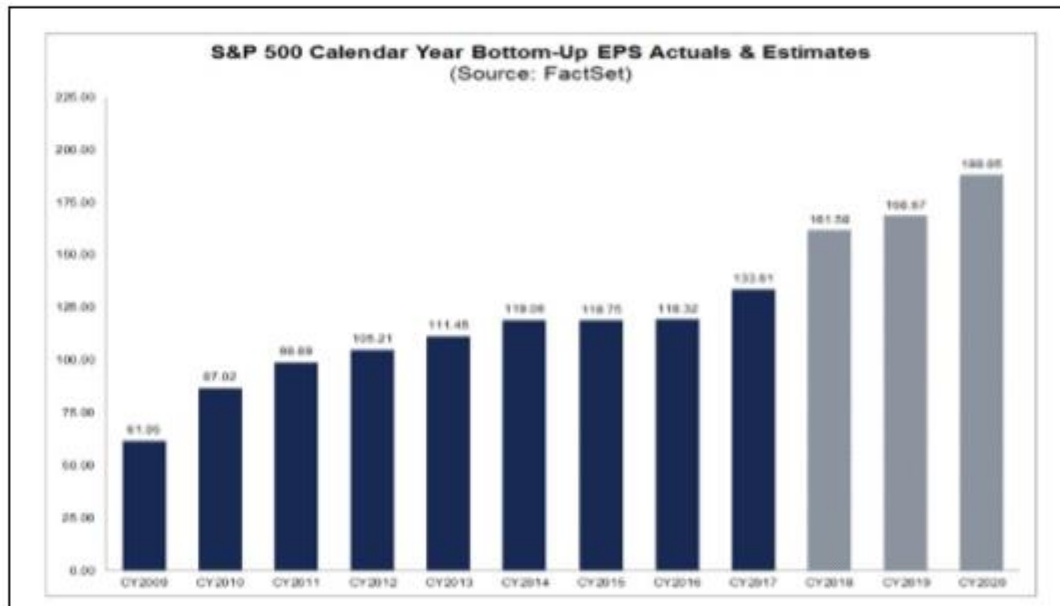
2020 (up 11.6% year over year) – see chart below (source: Factset).

In addition, we think it's important to make a distinction between a temporary slowdown in corporate profits and a deeper more protracted downturn in profits. In the post WWII period, there have been 14 earnings recessions i.e. periods when earnings have been negative on a year over year basis for two or more quarters (source: Blackstone). In the six periods when the economy did not end up in recession, corporate stock prices were higher 12 months later (rising by more than 10% on a year over year basis). However, in the eight times when a recession developed, stock prices fell an average of 0.4% over the next 12 months. At this point, we believe that corporate profits are experiencing a temporary growth slowdown, but this is something we will be watching as we head through the year.

Reading the Tea Leaves

As mentioned earlier, after a weak fourth quarter last year, equity markets have staged a solid rebound to start the new year. On a positive note, various parts of the market that were weak in 2018 (for example semiconductor stocks, energy companies and emerging markets) have all demonstrated signs of improvement so far in 2019. Other areas of the market that have demonstrated signs of improvement include copper prices and credit spreads (which are both economically sensitive).



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On the other side of the coin, falling government bond yields are an indication that bond investors remain wary about the outlook for the economy and the markets. The yield on the U.S. 10 Year Treasury bond closed last year at 2.68%, fell to a low of 2.54% on January 4th and rose to a high of 2.77% on March 4, 2019. As of the close on March 22nd, the yield on the U.S. 10 Year Bond fell to a new low of 2.44%. Around the world, there is now $11 trillion in debt obligations with negative yields (representing about 20% of government debt obligations - source: Bloomberg). If the global economy was really on solid footing, it seems that bond yields would be rising as investors price in a more positive economic outlook. The bottom line is that in recent weeks, the market has been sending mixed signals. Ultimately, we believe that the macroeconomic backdrop is likely to remain supportive for U.S. stocks in 2019. However, it may take more time before we get a clearer picture regarding the outlook for the economy and the markets.

A Little Bit of Market History

When you combine the returns from January and February, this represents the 6th best start to a year dating back to 1925 (source: Blackrock). Interestingly, in the 55 years when January and February are both positive, returns for the remainder of the full year were negative just 8 times or 15% of the time. Conversely, in the 38 years when January and February were both negative, equity market returns for the remainder of the year were down 17 times or 45% of the time. Thus, at least based on past historical returns, the positive start to this year appears to bode well for the remainder of 2019.

Finally (something we have commented on before), in the post WWII period, equity markets have never been down in the 12-month period following midterm elections. The track record is 18 for 18 with equity markets posting an average gain of 14.5%. It's hard to come up with a good explanation for this impressive track record, but I think the reason is that in the third year of the election cycle, the president takes steps to boost the economy (prior to the next election) and this provides a positive tailwind for equity markets. We acknowledge that every period is different and we believe that economic fundamentals are what really matter most. However, it is still reassuring to know.

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Summary

Equity markets have started the new year on more positive footing after a turbulent fourth quarter last year. We remain moderately constructive (but not exuberant) in our outlook for equity markets for the balance of this year. A combination of low to mid-single digit earnings growth, low inflation and interest rates, reasonable valuation levels, positive GDP growth and a healthy consumer should help provide a tailwind for equity markets in 2019. After a strong start to the year, we expect more muted returns from here along with periods of higher volatility from time to time. In terms of allocation, we still favor the U.S. versus overseas (note: we recently discussed adding to our foreign holdings but decided against it at this time), growth versus value and large caps versus small caps (although we continue to maintain a small amount of exposure to small cap stocks).

We still see a number of risks that include weak economic growth in many parts of the world (Europe, China, Japan etc…), tariff/trade issues with China, geopolitical concerns in various regions of the world and questions about the outlook for corporate earnings. It will be hard for corporate profits to grow too much faster in the current environment given that approximately 1/3 of profits come from overseas. A lot is riding on current trade negotiations with China. Both countries have a reason to try and work out a successful trade pact (to help boost growth). While momentum seems to be building towards a trade deal over the next several months, a lot of work still needs to be done before both parties sign off on a final agreement. Looking out further, another concern is how we deal with the $22 trillion (and rising) deficit facing our country. We have never faced deficits this high before. At this stage of the economic expansion, we are probably late cycle. However, this fact alone does not mean that the end of the expansion is right around the corner.

As always, we welcome any comments you may have.

Respectfully,

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Data Source: FactSet

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