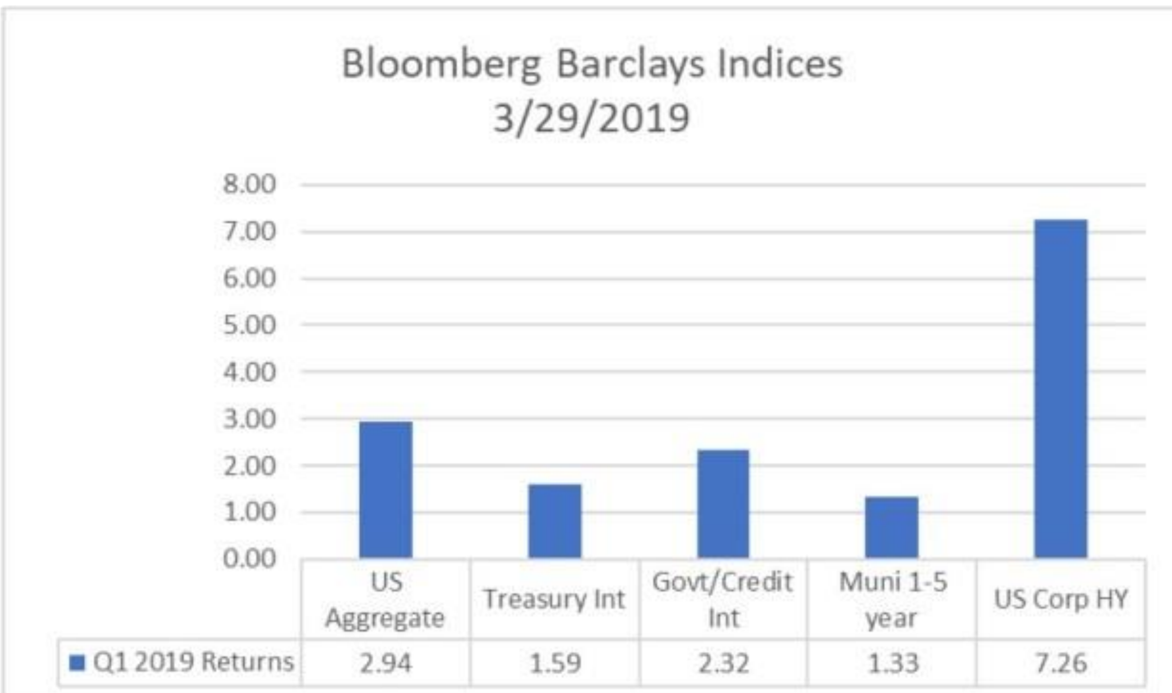
HIGHTOWER WESTCHESTER

Q1 2019 Market Commentary

The first quarter is over, and it was good for equity markets. Global stocks were up 11%, the best performance since 2010.[1] The U.S. and China led the way with the S&P 500 up 13% (best since 2009); China's CSI 300 surged 4% to close out the quarter and finished up 29% (best since 2014).1 Bonds also rallied. Now, raise your hand if you saw that coming? The correction last year was fueled by three primary fears: trade war, rising interest rates, and slowing earnings growth. So far this year, each of those fears have regressed. Significant progress has been made toward a trade agreement with China, the Federal Reserve ("Fed") changed course and no longer expects to raise rates in 2019, and earnings results have been solid.

The U.S. markets appear to be enjoying the Federal Reserve's 180-degree pivot on monetary policy. Following the March meeting, the Fed struck a much more dovish tone on interest rates and balance sheet management than expected, resulting in a major decline in U.S. Treasury rates and an inverted yield curve out to 7-year maturities. Many have interpreted an inverted curve (10-year less 3-month yield) as a sign of an impending recession. More bullish economists believe an inverted curve is just the market's way of signaling to the Fed that short-term interest rates are too high, and not necessarily that recession is around the corner. While we hesitate to say "it's different this time," it is worth verifying whether the conditions that historically lead to an inverted curve, and subsequent recession, are or aren't being repeated in this cycle as well. An examination of those conditions reveals substantial differences that could influence the severity of a downturn and may suggest that if a recession does unfold, it may be short-lived. The appearance of an inverted yield curve, because it is not accompanied by conditions that typically lead to recession, could produce a shallower downturn than is normally assumed with this yield curve condition.

Fixed income markets exhibited positive performance in the first quarter of 2019, as global growth slowdown fears appeared and world central banks, along with the U.S. Federal Reserve, signaled more accommodative policies. U.S. 10-year Treasury yields fell in the first quarter, reaching their lowest level since late 2017.[1] U.S. High Yield performed well given strong demand, light new issuance, the continuation of low default rates, and steady corporate earnings. Likewise, tax exempt municipal bonds had good performance in the first quarter with lower new issuance and strong mutual fund inflows. Following recent tax reforms which capped deductions of state and local taxes for many taxpayers in higher brackets, investors have poured money into the municipal markets to take advantage of the tax-free income. Below are some first quarter Bloomberg/Barclays index returns:



Source: FactSet[1]

On the bond side, the shape of the yield curve is relevant to how investors should be positioned. Right now, and for the last several quarters, we have been maintaining modestly shorter duration than normal because doing so generates similar yield with lower interest rate risk. The tradeoff is modestly less diversification benefit from bonds if recession hits, stocks sink and bonds rally.

Typically, the arrival of April signifies the green shoots associated with longer days and the sunnier skies of spring. The brackets frenzy of the March Madness ritual also helps usher in the second quarter of the year. Soon, the earnings season takes center stage and analysts and investors alike determine how they expect the rest of the year to unfold. The transition from one quarter to the next is usually fairly straightforward. This year, however, may prove exceedingly different as questions are abound over the strength of the global economy, specifically with the U.S. economy, under the microscope for signs of strength or weakness.

With that said, earnings growth was revised higher throughout the first quarter, finishing up 13%, the fifth straight quarter of double-digit growth.[1] However, with tax cuts now embedded in year-over-year numbers, estimates for the coming results suggest a flattening or decline. So far, companies issuing negative guidance have mostly not been punished severely by the market. It will be interesting to see how investors digest a full quarter of flat or negative growth, if it comes to pass.

Foreign stocks also did well in dollar terms, with the MSCI EAFE Index delivering a nearly 10% return and the MSCI Emerging Markets Index just on its heels at 9.92%.[1] Emerging markets struggled for most of 2018, but they seem to have shaken off their difficulties for the time being. Anticipated economic growth in emerging markets is twice of what is expected for the U.S. At the same time, valuation levels of emerging market equities are historically low relative to U.S. equities, and global political/economic developments seem aligned to promote tailwinds for emerging market investments. Even if the U.S. dollar does not weaken significantly, some emerging markets will benefit from China's growth acceleration.

Trade remains a big unknown. U.S. and Chinese officials are believed to be close to a deal and are said to be in the process of reviewing specific terms. Still, such negotiations are tricky and leaders from both sides are unpredictable. To be a positive, an agreement would need to be viewed as comprehensive and permanent. With widespread optimism for a resolution growing over the last couple of months, most of the upside may already be baked into stocks and risk from this issue may now be skewed to the downside.

United Kingdom ("UK") equities performed well over the quarter, despite ongoing Brexit-related uncertainty, and were in line with global equities. The deepening Brexit chaos in the UK Parliament has led many to conclude that Britain is likely to crash out of the European Union without a deal, perhaps as early as April 12. We know that not to be true now, as they have extended the deadline until October 31. It is possible that the UK enters into an endless sequence of "temporary" arrangements, similar to the EU's relationships with Norway and Switzerland.

Eurozone equities recovered well, supported by central banks stepping away from tighter monetary policy. However, worries over economic growth lingered throughout. Many say that the Eurozone's future is essentially tied to the future of Germany. And that future now looks dicey. For 20 years, Germany prospered thanks to labor market reforms, which held down wages, and welfare reforms, which pushed millions of unemployed into work. But the pool of surplus labor has run dry, real wages are rising, and German competitiveness is suffering. Germany needs to mobilize capital more effectively and with the current policy environment, this looks unlikely.

Finally, commodities performed well with continued advances in oil prices. Energy overall led the way as crude oil prices rebounded from a sell-off in the fourth quarter. Production cuts from OPEC and other oil producers, together with the implementation of U.S. sanctions on Venezuela, served to tighten supply. The industrial metals component also moved higher amid positive signs emanating from U.S.-China trade talks. By contrast, precious metals recorded a modest gain, supported by a small rise in gold prices. Real Estate Investment Trusts or REITs, both globally and domestically, were beneficiaries of lower interest rates.

Looking ahead, we view the outlook as balanced. Valuations are mixed. The forward price-to-earnings of the S&P 500 is approximately 17 times, which we consider neutral given existing low interest rates. However, other metrics such as price-to-sales or the value of the U.S. market compared to gross domestic product show stocks remain expensive. International stocks are trading at lower valuations and are compelling on this basis but as noted above, have their own list of risks.

The rapid correction and recovery whipsawed many who reacted emotionally. After almost no volatility in 2017, the recent choppiness is a good reminder that markets don't go in a straight line and strong up-and-down moves should both be expected and planned for. Those with a strategic plan were able to benefit from tax management and rebalancing and we believe remain likely to emerge from full market cycles successfully.

The current economic expansion has been longer than most, but also characterized by slower average growth. Ten years deep into a bull market feels to us to be the wrong time to be greedy. That said, we don't see any compelling reason to believe the U.S. economy can't continue to expand at a steady pace or anything suggesting that the short-term outlook for stocks carries more risk than normal. The challenge is to make the most of late-cycle returns while preparing for the inevitable downturn. It means relying on a structured and disciplined process. Ultimately, it's about adhering to a diversified approach as we navigate these increasingly volatile markets.

[1] *FactSet financial data and analytics. www.factset.com*