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Investment Commentary - First Quarter 2019

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- U.S. stocks saw biggest quarterly gains since 2009
- Bonds rallied as longer-term interest rates fell
- 10-year treasury yields dropped below 3-month yields
- Growth slowed in the U.S. and abroad

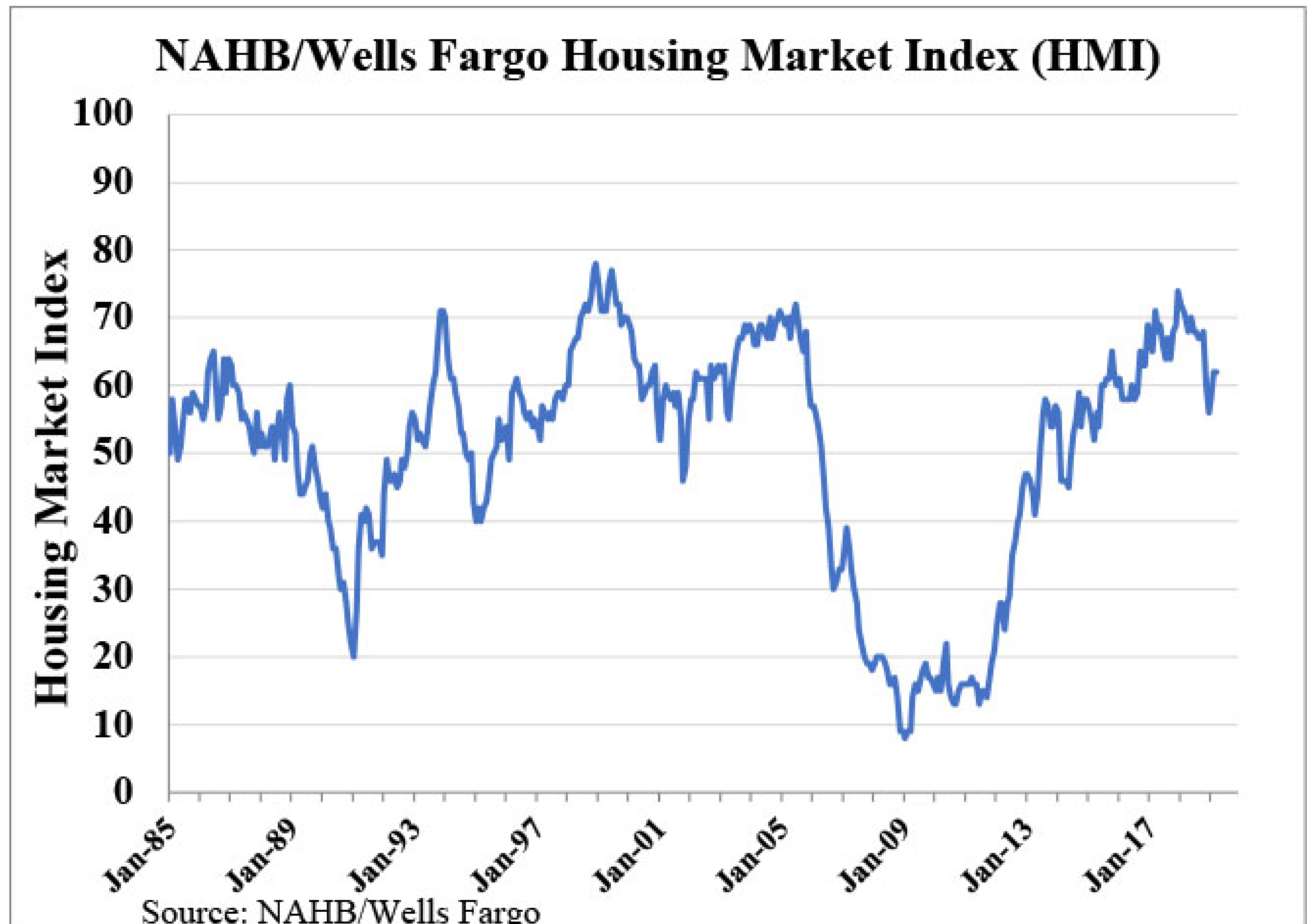
U.S. stocks surged higher during the first quarter. The S&P 500 had its best quarter since 2009, rebounding sharply to recoup almost all the declines from the closing months of 2018. Bonds also rallied. The yield on the 10-year treasury plunged to 2.41%, down nearly one percent from its peak last fall. A driver for both the stock and bond market rallies was the dovish U-turn made by the Federal Reserve (Fed). After raising rates in December and signaling more hikes to come, the Fed turned decidedly more accommodative at the beginning of the year, reducing expectations for additional rate hikes in the foreseeable future. The stock and bond markets cheered the Fed's new direction. It remains to be seen if the Federal Reserve's actions can extend the U.S. economic expansion or if the global slowdown will spread to the U.S. in the quarters ahead.

Economic Review & Outlook

After growing faster last year, the U.S. economy is expected to have slowed a bit in the first quarter. A Wall Street Journal survey of more than 60 economists predicts first quarter GDP

rose a mere 1.35%, representing the slowest quarterly growth rate for the U.S. economy since 2015.

This slowdowncan partially be blamed on fading benefits from the tax cuts enacted in 2018. Slowing growth in Europe and Asia is also a contributor. Additionally, the Fed's interest rate hikes last year increased the cost of large purchases such as homes and autos. The chart below represents the National Association of Home Builders Sentiment Index or

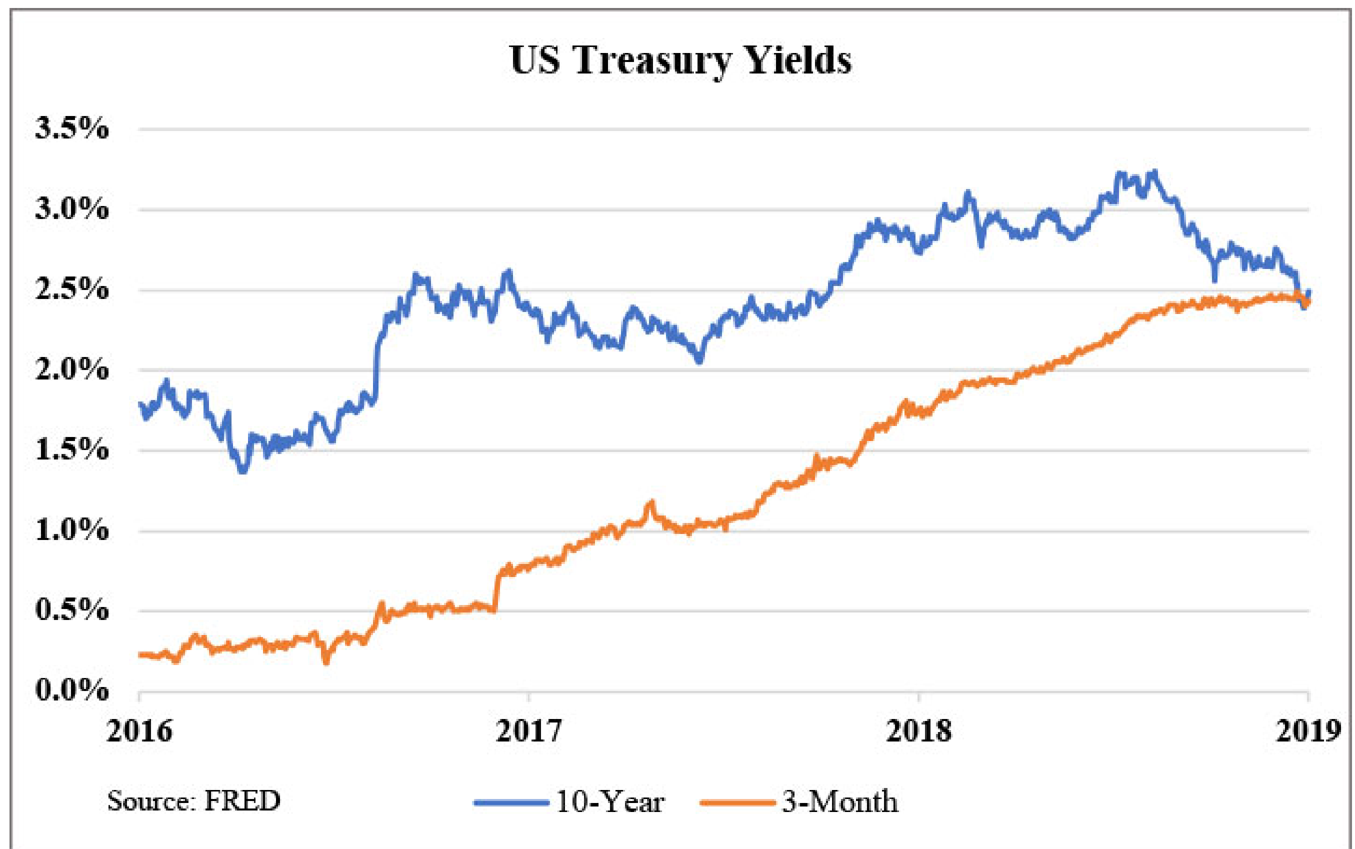


HMI (Housing Market Index). This is a gauge of homebuilding activity looking out three to six months. As shown, sentiment amongst homebuilders began to wane at the end of 2017 and throughout all of 2018. Home prices have risen sharply over the past couple of years, making affordability an issue for potential buyers. Higher interest rates also play a part as even a small increase, such as 0.5% or 1%, can result in dramatically higher monthly payments. As the Fed continued increasing interest rates last year, future home sales became more uncertain. Now, with Fed rate hikes seemingly on hold and mortgage rates lower, the housing market stands to benefit, as the recent pick up in the HMI shows.

A boost in the housing market would help because other indicators warn of slower growth ahead. One well known indicator of recessions is an inverted yield curve. An inverted yield curve is when long-term treasury bonds have a lower yield than short-term treasury bills. That's unusual because investors normally demand a higher interest rate to tie up their money up for longer. However, if investors believe interest rates will be lower in the future, they buy longer-term bonds to lock in a higher interest rate. This increases the demand for longer term bonds, pushing up their prices and lowering their yield. Investors anticipate lower yields if they believe the economy is heading into a recession and the Federal Reserve will be

lowering short-term interest rates as a result. An inversion of the yield curve has preceded seven of the last eight recessions. There is usually a 12-18 month lag between when the yield curve inverts and the start of a recession. Also, to be a reliable recession indicator, long-term rates need to remain below short-term rates for 3 months or more.

During the last few days of the quarter the yield curve briefly inverted. The 10-year treasury yield declined below the 3-month treasury yield (See chart below). Since then, the 10-year yield has risen and is again higher than the 3-month yield. So, for now this does not signal an impending recession, but it bears watching.



Bond Market Review & Outlook

As discussed above,the Federal Reserve did an about-face at the beginning of 2019, drastically reducing expectations for interest rate increases in coming quarters. Bonds benefited across the board as interest rates fell. The Barclays U.S. Aggregate Bond Index delivered a 2.9% return for the quarter. The Lipper Intermediate Term Municipal Fund Index rose 2.6%. The largest gains came from the credit sectors as credit spreads, or the difference in yields between treasuries and corporate bonds, narrowed. As a result, the Bloomberg Barclays US Credit Index returned 4.9%.

Credit spreads typically widen prior to sharp slowdowns in the economy as investors demand increased returns for a greater risk of bond default. The narrowing of credit spreads during the first quarter indicates that bond investors are not currently overly concerned about the economy slowing.

Alternatives & Hybrids Review & Outlook

Alternatives gained in the first quarter with the Morningstar Multi-Alternative Category rising

4.2%. Real estate, managed futures, broad commodities, and the market neutral Morningstar categories were all up for the quarter. Hybrid funds, which allocate across stocks, bonds, and other asset classes also rose. Within hybrid funds, the higher their allocation to stocks, the better their first quarter return. Given the strong stock market returns, alternatives that are less correlated to stocks and tend to be steadier in up and down markets, were up less. Of course, they were also down much less during the fourth quarter. While the steadier nature of some alternatives is less appreciated during sharp up markets like the first quarter, these strategies are very helpful when markets are rocky.

Stock Market Review & Outlook

Although investors may have been singing the blues at their holiday parties, the mood has changed for the better. After a blistering start to the year that saw indexes deliver their best January since 1987, stocks continued to rise in February and March, resulting in the sharpest quarterly gain since 2009. The large cap Dow Jones Industrial Average and S&P 500 Indexes returned 11.8% and 13.7%, respectively. The small cap Russell 2000 Index gained 14.6%. Growth stocks outperformed value. Although lagging the other broad markets, international stocks gained 10.0%, as measured by the MSCI EAFE Index.

While the quick recovery in the financial markets has calmed investor fears, the fourth quarter market decline was not a one-time event. From September 20th to December 24th, the S&P 500 dropped 19.4%. That was its largest decline in nearly 10 years. History shows that 20% drawdowns in the stock market typically occur every four to five years. The fact that we had our first one in ten years, and it lasted less than three months, suggests that investors should stay vigilant against another possible decline occurring sooner rather than later.

Conclusion

While there are always reasons to be cautious when it comes to forecasting economic growth, we remain optimistic regarding the long-term prospects for the U.S. economy. The unemployment rate has been in a steady downward trend for nearly a decade, suggesting the U.S. consumer has a reasonable level of confidence in job security at the moment. Further, the personal savings rate has been fairly consistent over the past decade, and at 6%, is more than double where it was before we entered the Great Recession in 2008. A strong job market and a higher savings rate, combined with continued technological innovation that should help keep a lid on inflation, is a recipe for economic prosperity. This provides a strong backdrop for the U.S. economy over the long-term, even though a recession is inevitable at some point. Investors who share this view should feel confident that even when a recession occurs, and their investment portfolio temporarily declines in value, a well-diversified portfolio should remain an excellent way to grow wealth over the long-term.

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