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INVESTMENT WATCH Q1 2019

FIRST QUARTER REVIEW

Financial markets got off to a strong start despite the partial government shutdown and concerns about slowing global economic growth. The S&P 500 index gained 13.6% for the quarter to close at 2,834. While this is still about 3.5% below the record high reached in September of last year, it is well above 2018's low of 2,351 recorded on December 24th. Despite investor concerns about economic growth, equity returns were led by more economically sensitive sectors such as information technology, industrials and consumer discretionary. Oil prices increased 32% during the quarter to $60.14 a barrel, and this helped energy sector stocks outperform the market. International equity markets also posted strong gains for the quarter, with the MSCI All-World (excluding U.S.) index gaining 10.4%. Interest rates declined during the quarter as the Fed reversed course on its outlook for interest rate increases. This, along with an increase in the global demand for yield, helped push the yield of the 10-year U.S. Treasury down from 2.68% to 2.44% by the end of the quarter.

THE FUNDAMENTAL DRIVERS OF ECONOMIC GROWTH ARE INTACT

As we enter the 10th year of this economic recovery, the U.S. economy remains on solid footing. While the economy experienced some weakness in the first quarter, the fundamental drivers of growth: a healthy consumer and positive business investment, remain. While much has been made about the length of the current economic expansion, it is important to note that expansions do not end after a pre-determined amount of time, nor do they end because of an inversion of the yield curve. Recessions are caused by imbalances in the economy or financial system, a Fed policy mistake or some other exogenous event. The fundamentals of the economy remain strong, and the financial system is healthy and significantly better capitalized than it was prior to the last recession. Finally, the recent shift by the Fed to a wait-and-see approach on future rate increases, significantly reduces the risk of a monetary policy error. Economic growth both in the U.S. and internationally, is likely to be slower than last year, but still positive. While some of the near-term risks have subsided, there are still potential risks to the economy including unfavorable trade policy, further weakening in China or Europe and geo-political tensions, but we believe the longer-term outlook remains positive.

Short-term Headwinds Impacted First Quarter Growth.

First quarter economic activity was slower than anticipated due to the partial federal government shutdown and a decline in consumer and business confidence. The government shutdown, which began in late December and lasted 35 days, had a direct impact on the pace of economic growth. In addition, the combination of the government shutdown and the equity sell-off in December led to a decline in consumer and business confidence that negatively impacted spending early in the quarter. Uncertainty about trade policy led corporations to be more cautious about capital spending. But, as the quarter wore on some of the short-term headwinds began to subside and we started to see signs of increased economic activity. We expect that economic growth in the quarter will be below the 2.2% pace of the fourth quarter, but the momentum in the later part of the quarter should lead to better growth throughout the year.

The Consumer Continues to Drive Growth.

The consumer remains the foundation of the economic expansion, with consumer spending accounting for about 70% of overall GDP growth. A key to continued spending is a healthy labor market. Even with the slower pace of economic activity in the first quarter, the U.S. added over 500,000 new jobs. Job gains in February were much lower than expected, but January and March both exceeded expectations. The unemployment rate of 3.8% is considered at or near full-employment, and as such we would expect that the pace of job gains will begin to slow going forward. Wages are increasing at a 3.2% annual pace and with increases in minimum wages, the largest gains are being seen by workers at the lower end of the pay scale. Consumer confidence is also a primary driver of activity and we did experience a dip in confidence early in the quarter, however, as the markets recovered, and government reopened, confidence began to increase, and consumer spending should reflect this going forward.

Business Investment Depends on Trade Clarity.

While consumer confidence bounced back, business confidence remained below recent highs. Business investment was positive last year, supported by the provisions of the Tax Cuts and Jobs Act, however, capital expenditures were not as consistent as hoped. Uncertainty about the outcome of trade deals with China, Europe, Mexico and Canada, created some caution on the part of corporate CEOs. Investments in technology and other productivity improving processes occurred, while some longer-term investments were put on hold. Clarity on trade, particularly with China, has the potential to lead to more sustained capital spending, which could provide a boost to economic growth in the second half of the year.

The Federal Reserve Reverses Course on Rate Increases.

During the second half of 2018, investors became increasingly worried that the Fed would raise rates too fast and too far, which could hurt economic growth. Activity in interest rate sensitive sectors such as housing and autos showed signs of slowing. The gap between the Fed's outlook for rates and the market's expectations led to increased market volatility in both equities and bonds. In January, the Fed, citing increased economic uncertainty due to outside factors such as trade uncertainty, slowing economic growth in China and Europe and the impact of the government shutdown, decided to pause its interest rate normalization program. The Fed's initial forecast was for 2-3 rate increases this year, but now it is expecting to hold the Federal Funds rate to a range of 2.25% to 2.5%. In addition, the Fed announced changes to its plan to reduce the size of its balance sheet. Beginning in September, they will stop the run-off of Treasury securities, but will continue to reduce exposure to mortgage securities, by reinvesting principal payments and maturities into Treasuries. Fed Chairmen Jay Powell indicated that the fundamentals of the economy remain positive, but the outside risks warrant a more cautious, wait-and-see approach to monetary policy. This change by the Fed reduced the risk of a policy error and helped to support the gains in the equity market.

Yield Curve Inversions can be Correlated with Recessions, but Do Not Cause Them.

A yield curve inversion occurs when the yield of short-term bonds exceeds the yield of long-term bonds. While the yield curve has been flattening for some time, recently we experienced a short-lived inversion of the curve. This has caused increased investor anxiety about the potential for a recession and added to market volatility. While most recessions are preceded by an inversion of the yield curve, recessions are not caused by yield curve inversions. We do not believe that the current shape of the yield curve is signaling the end of the economic expansion. By most measures monetary policy is neutral to accommodative, not restrictive. Long-term inflation expectations are still relatively low, and that has kept interest rates on long-term bonds from rising significantly. Long-term yields have also been affected by the global demand for yield. Currently more than 12 trillion in foreign government debt has negative yields, which significantly increases the attractiveness of U.S. debt and led to declines in U.S. yields. The outlook for economic growth remains positive and with the Fed now on hold, the factors that could lead to a recession are less evident.

IMPACT ON YOUR INVESTMENTS

We believe that the recent weakness in economic growth was attributable to short-term factors. We continue to expect that healthy consumer and business spending will support on-going positive economic growth, albeit at a slower pace than 2018. Corporate earnings are expected to increase this year and should provide upside potential for the equity market. Given some of the headwinds in the first quarter, we allowed cash balances to increase a bit during the quarter. As we identify attractive companies that will perform well in this environment, we expect to return to a more fully invested position. In the fixed income allocation, we continue to focus on building a ladder of high-quality corporate bonds that will mature over the next five years.

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