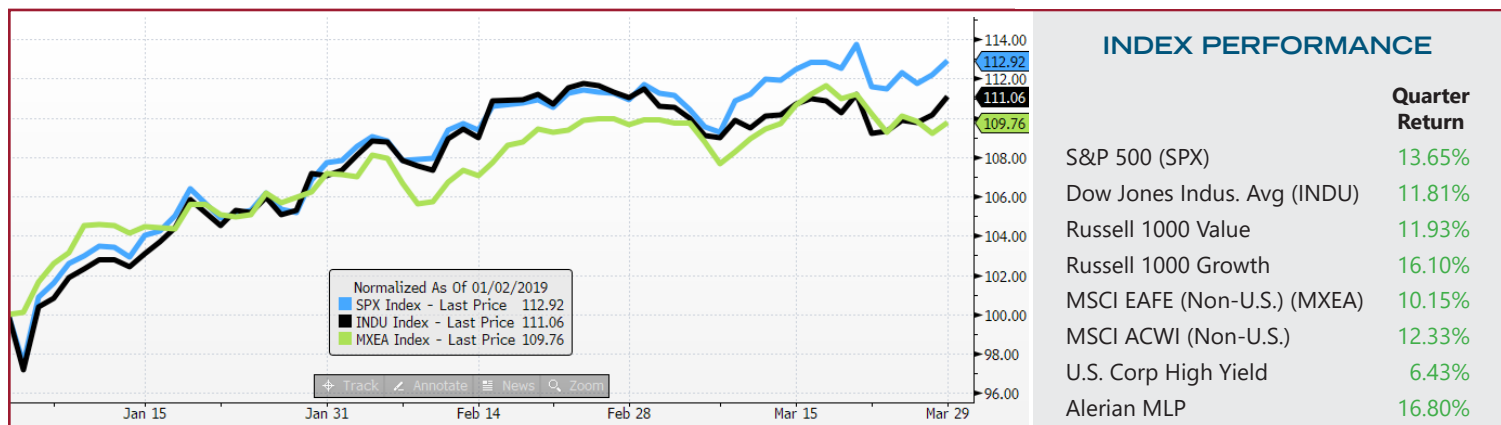




# Q2 2019 Quarterly Newsletter

## IS IT THE FED OR THE YIELD CURVE?

 **Chart 1.** Index Performance Q1 2019



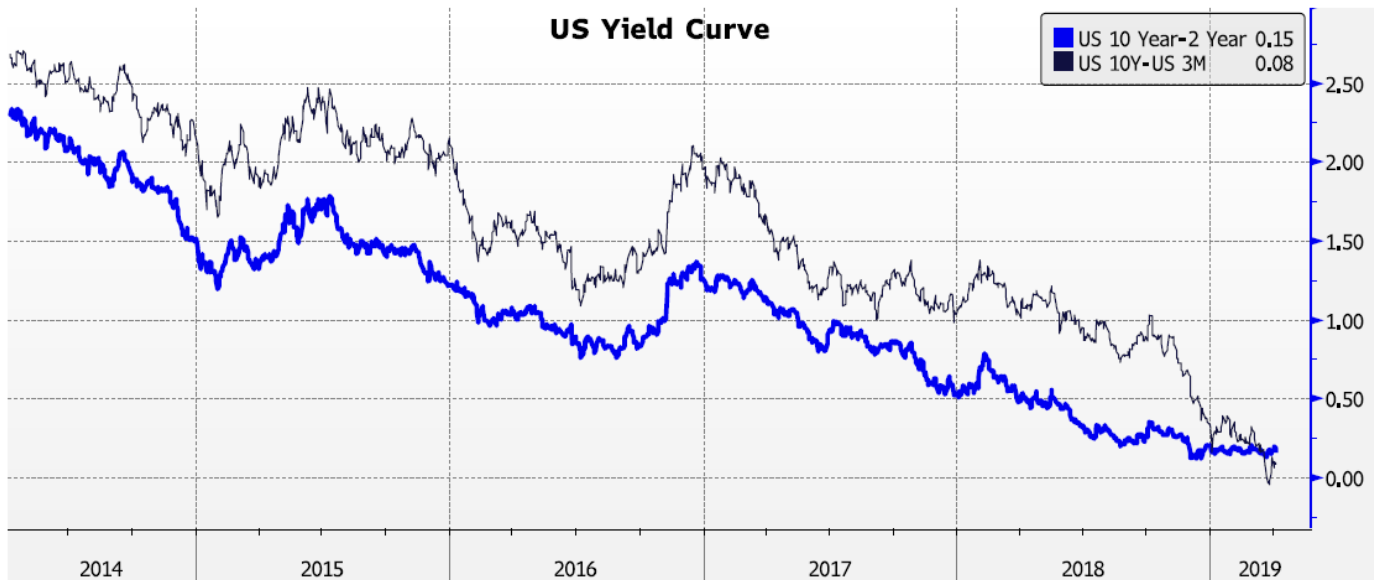
Source: 2019 Bloomberg Finance L.P.

On the heels of a very challenging fourth quarter in 2018, the first quarter of this year has indeed roared back with the S&P 500, along with other major indices (domestic and non-U.S.) posting record performance, and furthering the case for market bulls that the global economy remains in growth mode, albeit slower by GDP standards. The current bull market is now officially the longest bull market in history, and with that notoriety comes the onset of market participants debating the longevity and potential for this market cycle to fizzle in a slow burn, or collapse in grand fashion. At the heart of the matter, in our opinion, is growth of the global economy and of course the inherent struggle between the Federal Reserve (Fed) and the market. Both play a key role in the economy, and this is particularly evident when we take a closer look at the Fed and interest rates.

There has been plenty of news headlines and commentary on yield curve inversion, and the implications of such an inversion on equity and fixed income markets, particularly because the recent 10-Year Treasury Bill/3-Month Treasury Bill (T-Bill) curve inverted during the quarter, albeit for a short period of time (See Chart 2 on Page 2). Although yield curve inversion has historically been one of the most reliable predictors of a recession, and frankly the closest thing we have to a sure thing, we have only seen an inversion eight times since 1967. In our opinion, this is not a very statistically robust sample. Add to this the fact that once the yield curve inverts, the timing of the recession is far less predictable. Some recessions have occurred within 11 months, while in other periods,

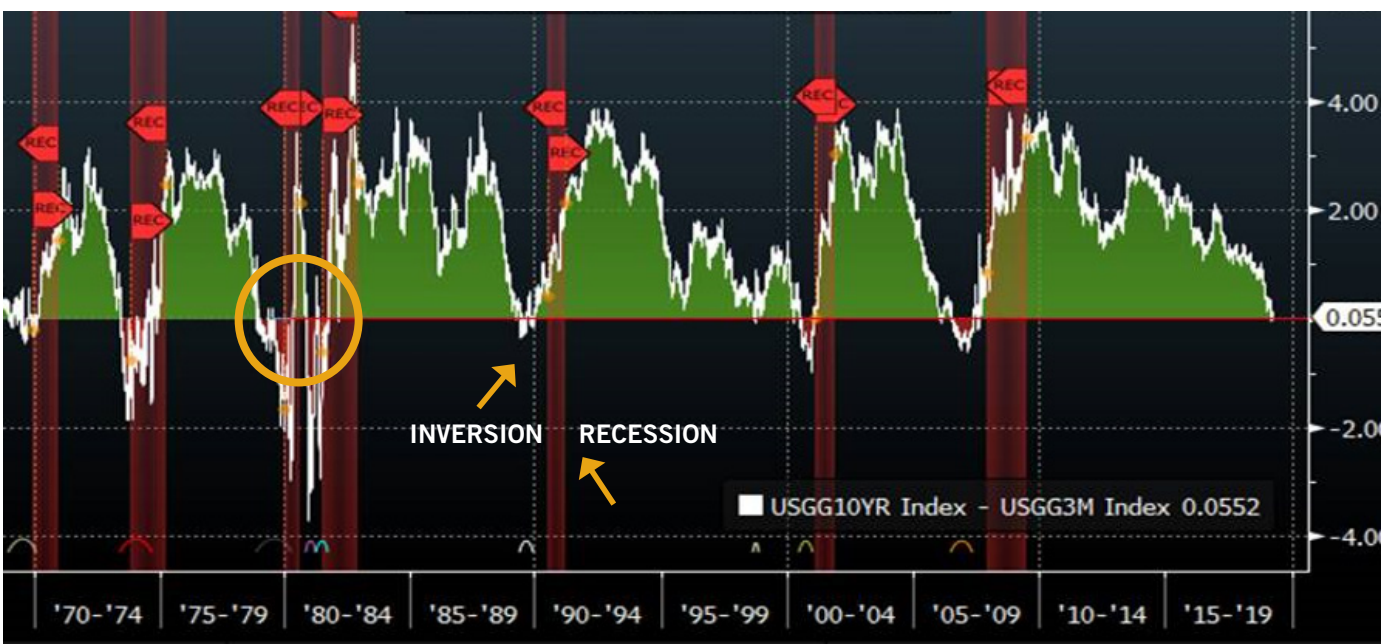
the recession did not occur until 24 months later, if at all (See Chart 3). Indeed, these recessions have transpired during very different economic backdrops and regimes, including the Financial Crisis. We think a very important issue to consider is the fact that each inversion has been accompanied by a Fed-tightening cycle, although every inversion has not led to a recession (80s and 90s).

Chart 3



Source: 2019 Bloomberg Finance L.P.

Chart 2



Source: 2019 Bloomberg Finance L.P.

## YIELD CURVE

An inversion of the yield curve is a complex issue, and one that we monitor as part of our investment process and mosaic approach to research, with both the 10-Year / 3-Month T-Bill and the 10-Year / 2-Year T-Bill under the proverbial macro-economic spotlight. With dialogue and conversation taking such a focused look at this market dynamic, we pose the question and ask, “is it the Fed or the Yield curve?”

We believe it is more about the yield curve and the inversion is merely a derivative of market expectations related to the economic environment and the Fed-tightening cycle. Consider, the Fed controls the front-end of the yield curve (short-term rates), and “The Market” controls the longer end of the curve, which responds to market participants voting with their dollars on the perceived direction of the economy, interest rates, etc. The inverted yield curve simply tells us “The Market” thinks the Fed is wrong about the future direction of the economy. “The Market” believes the Fed is overshooting the prediction on future inflation and economic growth, and market participants are voting for less inflation and growth, therefore driving down rates on the long end of the curve.

Of course, we are very interested in how this plays out. If we examine the current Fed Dot Plot, none of the 17 Fed board members believe that rates will be cut this year, while six of the 17 think we will get one more rate increase. In fact, just as Spring has arrived around the country and we are seeing vegetation emerge from dormancy, we think we are seeing “green-shoots” in the economy as of this writing. And if the economy continues to advance, and the brief period of weakness we experienced during the 4th quarter of 2018 was just a pause, then we could very well see one more rate increase. We believe the 10-year rates will then follow, and the current expansion will be back on track. All that said, we are proactively monitoring very closely the metrics that we think could signal further weakness and recession down the road.

## MARKET SIGNALS

Signals that could change our perspective and stance on the market, along with our belief of an impending recession would include the following factors, sourced from Cornerstone Macro:

- **PMI's below 50** – PMI has historically been a solid indicator of market expansion and contraction. A range above 50 indicates an economy that is expanding, while a number below 50 would indicate contraction. Current PMI is 55.3%, and has been relatively range bound for some time, representing a robust economy.
- **A Fed rate cut** – While many have speculated that the Fed has reached “neutral” or may even have one more rate increase, some have said the Fed's next move may in fact be a rate cut. Such a move would surely increase the level of market angst as it would leave investors asking the question, “what does the Fed know that we do not?”
- **EPS growth** – We continue to monitor EPS growth the closest, and believe the overarching story is mostly about growth in earnings and the economy.

## EARNINGS ESTIMATES AND THE ECONOMY - OUTLOOK

One major factor Market Bears have cited is the brutal cutting of earnings estimates for the S&P 500 since the beginning of this year. In Chart 4, we can see that this longer-term trend has recently begun to reverse. According to Bloomberg, the per share estimate has jumped by \$1.04 for 2020. If this trend continues, the “green shoots” and other positive indicators will continue to grow in our opinion, and may perhaps peak in 2020 (see Table 1).

 Chart 4



Source: 2019 Bloomberg Finance L.P.

 Table 1

	BEST EPS	GROWTH %
2019	\$166.57	9.51%
2020	\$186.19	11.78%
2021	\$203.84	9.48%

Source: 2019 Bloomberg Finance L.P.

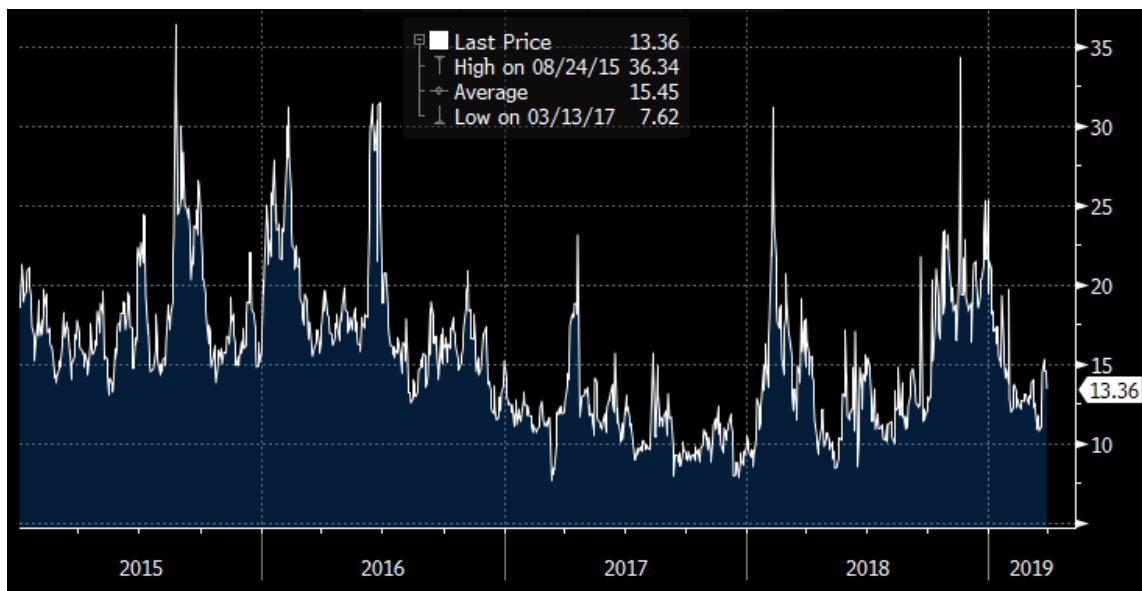
## INTERNATIONAL

International markets similarly rebounded sharply in the first quarter after concerns of a global slowdown looked to be overblown. Markets posted their best quarterly gains in years with the following notable indexes finishing in the green.

- Shanghai Composite: +23.94% (Best 1Q since 2009)
- Hang Seng: +14.35% (Best 1Q since 1993)
- Nikkei 225: +6.81%
- TAIEX: +9.40% (Best 1Q since 2012)
- MSCI EAFE: +10.63% (Best 1Q since 2012)

Despite the solid returns to start the year, volatility will likely play a role in the international space in 2019. Last year the VXEFA (Vix for emerging markets) averaged 14.83%, while in the 1Q of 2019 the average was slightly lower at 14.16%. Even with the average VXEFA level staying fairly consistent, we have already started to see some overhangs that persisted in Q4 2019 dissipate over the first three months of the year, helping to alleviate fears in global markets for the time being. (see Chart 5 on Page 5)

Chart 5



Source: 2019 Bloomberg Finance L.P.

While a permanent resolution has not been agreed upon between the U.S. and China on the trade front, the prospect of a deal appears more promising than it did at the end of 2018. The so-called “90 Day Window” has come and gone, with President Trump agreeing to delay the increase on tariffs as talks continue to progress. However, the President has made it perfectly clear he would not hesitate to switch his stance should discussions deteriorate. The most uncertain aspect to the extension continues to be a final date on when tariffs could increase, and what “progress” looks like as it remains arbitrary to U.S. negotiators. Even with the prospect for higher tariff’s in the future, markets seem to be ignoring the potential for increased tensions.

Most recently we have seen Emerging Market (EM) PMI increase above the key level of 50, increasing to 50.6 and slightly outpacing developed markets. More specifically, the Caixin China manufacturing PMI rose into expansionary territory for the first time in four months, bolstering equity performance.

While sentiment did improve, certain overhangs still persist which could change the narrative given further developments, including:

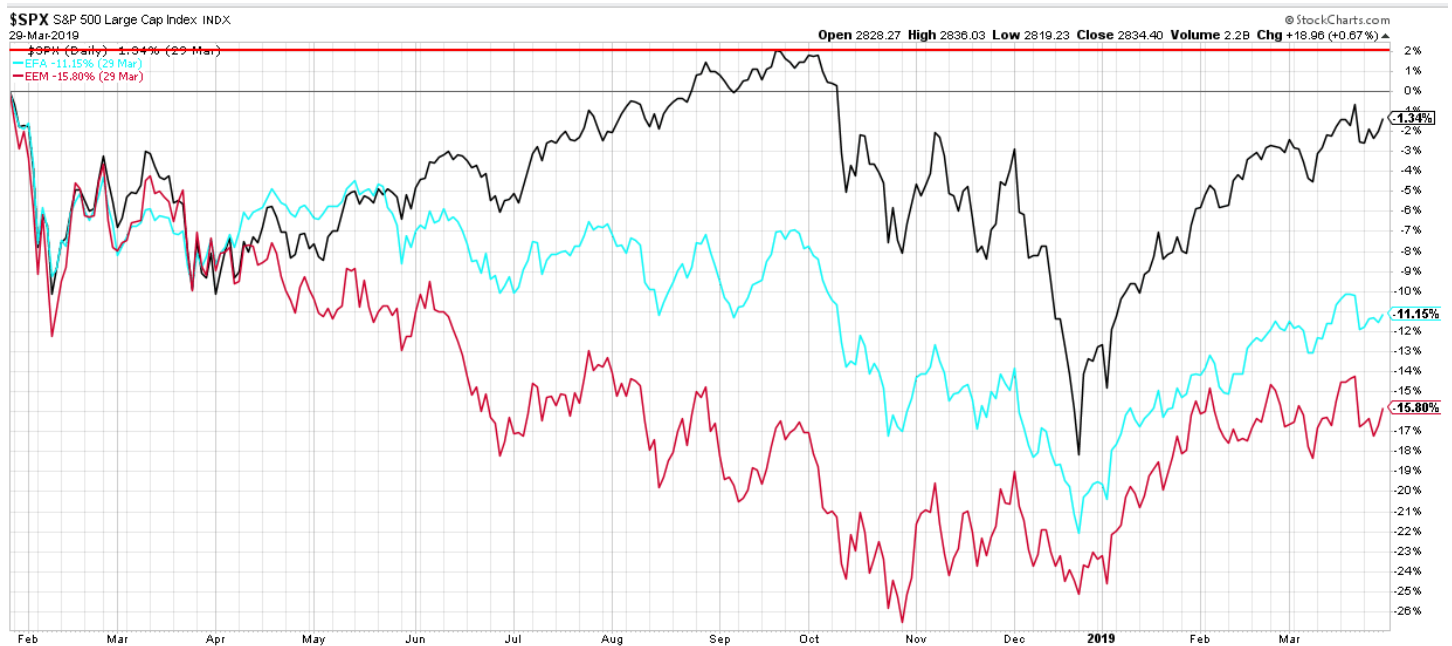
- **Weaker European Data** – PMI in many countries remain in contraction territory and jobless data in core countries remain at multi-year highs.
- **Brexit** – Prime Minister May continues to push for resolution to accomplish the goals of Brexit, however as we have seen, this is a complex issue and pleasing all parties is proving near impossible.

## ASSET ALLOCATION VIEW

During the first quarter of 2019 we saw the markets move to “risk on” mode. However, in Chart 6 below, we can see that from the synchronized global market peak in January of 2018, the S&P 500 is only about back to that peak, with global markets trailing far behind.

As discussed earlier, there are currently various crosscurrents across economies and markets. While we remain cautiously optimistic, we will be looking to see if the U.S. large cap market can break to new highs in the 2nd quarter, and if other markets will follow. If this does not occur, there is an increased chance markets could revisit some level of prior lows. Therefore, we remain constructive on both the equity and fixed income markets, but cautiously so.

 Chart 6



Source: ©StockCharts.com

 **ALLOCATION INSIGHT**

Current global market conditions factor into, and have the following implications for asset allocation:

**General Allocation** – As the markets have largely recovered from the December lows, we continue to recommend a slightly defensive position as we monitor how markets respond to the recent period of economic pause, and more difficult domestic earnings comps for the next couple quarters. We believe that the Fed is on hold for now, and will be data-driven such that its next rate move could be in either direction in concert with the everchanging economic environment. In the face of a flat U.S. yield curve and fairly valued equity markets, we expect continued volatility in all asset classes to be a likely scenario.

**Equity Allocation** - We continue to monitor financial conditions and market returns to determine our optimal asset allocation. Relative to benchmarks, we are neutral equities relative to fixed income, moderately overweight U.S. equities, and slightly overweight small/mid-cap equities. As valuations have become more favorable, we are considering additional exposure to developed international, while remaining underweight compared to U.S. equities. We also maintain a neutral weighting on emerging markets based on favorable valuations and improving growth prospects in many of these markets.

**Fixed Income Allocation** – We continue to recommend a modest underweight in duration, and a cautious exposure to credit spreads. In light of the current flatness of the yield curve, we do not like the risk/reward prospects of holding longer maturities. In practice, this means exposure to areas such as short-term and high-quality floating-rate securities are preferable. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

**THANK YOU!**

**Investment Committee**

## IMPORTANT INFORMATION

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).



## IMPORTANT INFORMATION

### CHARTS

<sup>1</sup> 2019 Bloomberg Finance L.P.

<sup>2</sup> 2019 Bloomberg Finance L.P.

<sup>3</sup> 2019 Bloomberg Finance L.P.

<sup>4</sup> 2019 Bloomberg Finance L.P.

<sup>5</sup> 2019 Bloomberg Finance L.P.

<sup>6</sup> ©StockCharts.com

### TABLE

<sup>1</sup> 2019 Bloomberg Finance L.P.