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SECOND QUARTER 2019

Q1 Market Update

(values as of 3/31/2019)

U.S. Stock Indices

S&P 500	2,834 (+13.07%)
Dow Jones	25,929 (+11.15%)
Nasdaq	7,729 (+16.49%)
Russell 2000	1,540 (+14.18%)

Global Stock Indices

FTSE (London)	7,279 (+8.19%)
DAX (Germany)	11,526 (+9.16%)
CAC (France)	5,351 (+13.10%)
Nikkei (Japan)	21,206 (+5.95%)
Emerging Mkts	1,058.13 (+9.57%)

Bond Indices (Bloomberg)

U.S. Gov't.	2,264.52 (+2.11%)
U.S. Corporate	2,974.53 (+5.14%)
U.S. Hi-Yield	2,047.94 (+7.26%)
Eurozone	261.79 (+2.53%)
Emerging Mkts	1,127.21 (+5.43%)

Commodities

Gold (per oz)	1,292 (+0.76%)
Silver (per oz)	15.13 (-1.99%)
Oil (WTI, barrel)	60.19 (+33.31%)

Fixed Income Yields

U.S. 2-Year Treasury	2.27%
U.S. 10-Year Treasury	2.41%
U.S. 30-Year Treasury	2.81%
U.S. High-Yield Index	6.29%

Currency Exchange Rates

Euro/Dollar	1.12
Pound/Dollar	1.30
Dollar/Yen	110.99

On Yield Curves and Recessions

Over the past few weeks, an increasing number of market-focused articles and analyses have begun to discuss the U.S. Treasury yield curve, which was recently described by CNBC as "one of the most reliable recession indicators in the market". And indeed, the yield curve's history of predictions is an impressive one: each of the last 9 U.S. economic recessions (dating back to 1955) has been preceded by an inverted yield curve. That said, not all yield curve inversions are created equal, and like any market or economic indicator, the devil is often in the details.

We'll take some time to consider the specifics of yield curve analysis, and what we should be looking out for over the next few months in the bond market, stock market, and the broader economy.

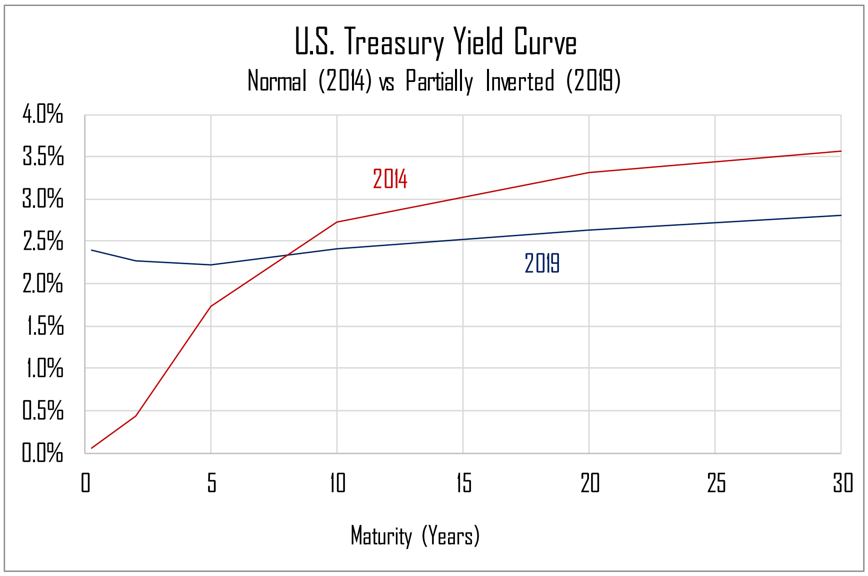
What is an inverted yield curve?

The yield curve is conceptually one of the simplest economic measures, merely plotting the current market interest rates at various maturities. In a "normal" economy, the yield curve tends to be upward sloping: shorter-term bonds have lower rates (yields), while longer-term bonds have higher yields. The higher yields on the longer-term bonds are usually assumed to compensate investors for a variety of additional risks compounded over the longer time horizons—uncertainty about future paths of inflation, economic growth, and broader interest rate trends, not to mention liquidity concerns for investors who are (at least theoretically) tying up their money for longer terms. But as economic cycles mature, the yield curve often begins to flatten, either because of direct Federal Reserve policy (usually an intentional increase in shorter-term rates in order to slow inflation in a booming economy), or simply due to changing investor preferences as risky assets rise to higher and higher valuations.

Eventually, a flattening yield curve can give way to an inverted yield curve, in which shorter-term bonds carry higher rates than longer-term bonds. The inverted yield curve can often send a warning signal to companies and market participants, but it also impacts investor behavior in a way that can create a self-fulfilling prophecy: if "risk-free" short-term Treasury bonds are paying higher rates than their riskier (longer-term and/or corporate) alternatives, then the benefits of lending money at longer terms (to companies and other borrowers who might need that money) are relatively weak. A decrease in investor risk appetite can then have impacts throughout the economy, as lending and borrowing patterns adjust to the changing interest rate environment.

The yield curve and the economy

While it's hard to argue with an economic indicator that has a 9-for-9 record in predicting a recession, a few caveats must first be mentioned and considered. First, not all yield curve inversions look exactly alike: the shape of the curve can matter, and the degree to which the inversion has occurred can also be relevant. If shorter-term rates are only higher than longer-term rates by a fraction of a percent, that probably won't have nearly as large an impact as an environment in which the gap between short and long-term rates is large, perhaps as much as a full percentage point or more. In addition, it is often possible for a portion of the yield curve to invert, without a "full" inversion. That is, in fact, the situation that currently exists in the bond market: Treasury bonds with maturities from 3 months out to 10 years are essentially flat (with a slight negative slope), but 30-year bonds still yield more than 10-year bonds, and 10-year bonds also yield more than their 2-year counterparts. The current situation, then, is best described as a partially inverted yield curve, and a very mild inversion at that. At least at the moment, there's no need for any investor panic.



Even if the yield curve were fully (and significantly) inverted, though, the effects on the economy could still be muted, and at least delayed. Even during its period of perfect recession predictions, the average lag between a yield curve inversion and a stock market peak has been 8 months, with an average lag of 14 months before the onset of the ensuing recession.

The market and the economy

In any case, it's important to mention that confusing the economy for the stock market is one of the most common investor errors. Even a booming economy can yield tepid stock market returns, while one in recession can still experience stock market gains. The two will normally track together over longer time horizons, but in the short-term, a lot of noise can enter the equation. Just in the last two years, we saw this dynamic at work in real time. In 2017, GDP grew by a relatively tepid 2.3%, but the S&P 500 grew by 19%. Last year, GDP growth accelerated to as high as 4.2% in the second quarter, but the market struggled, ending the year with a 6.2% loss.

Similar (but more dramatic) dynamics were at play leading into both the dot-com crash and the financial crisis that marked our most recent recessions; in 2000 and 2007, the stock market peaked (and swiftly declined) long before the economy was officially in recession. In both cases, there's a strong case to be made that the cause-and-effect actually operated in the opposite direction: it was the stock market that caused (or exacerbated) the downswing in the economy, and not the other way around.

All of these dynamics point to a strategy of being proactive with portfolio construction and rebalancing, rather than reactive; if you wait until the economy and market are flashing red warning signals, the time for action has usually passed, and corrective measures can become counter-productive. Therefore, we typically recommend continuing to rebalance portfolios regularly, keeping a portion of assets in safer investments at all times (in order to have the ability to respond to opportunities if and when risk asset prices correct), and minimizing our exposure to any one aspect or area of the global economic cycle.

Stock prices are generally forward-looking, and they take into account a wide array of economic variables and considerations. Yes, economic indicators (and overall economic growth trajectories) have a significant impact on corporate earnings, but they are far from the only factor at play. Geopolitical factors (think trade), tax policy, laws and regulations regarding corporate financing strategies, labor-versus-capital tradeoffs (think minimum wage policies), and other factors can all have an impact on the share of economic growth that generates corporate profitability and subsequent stock market gains. Focusing on just one factor (or economic indicator) at the exclusion of all others is rarely rewarded.

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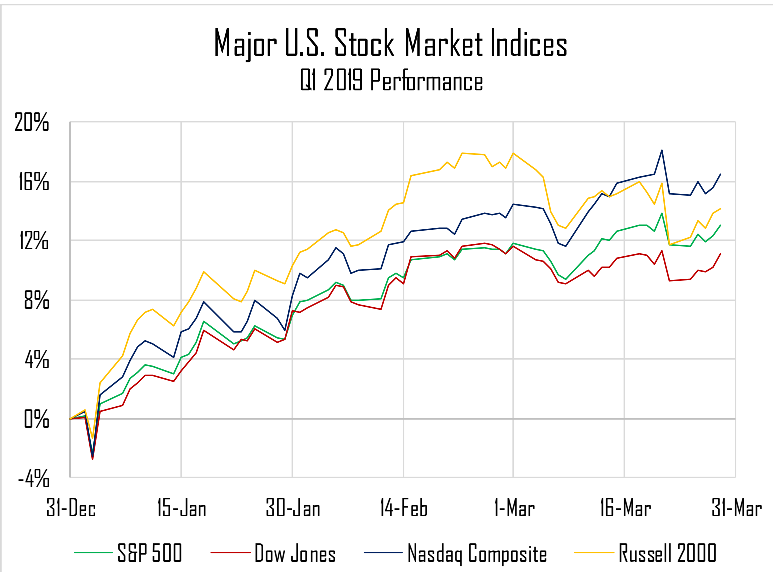
THE MARKET LOSSES FROM Q4 2018 WERE LARGELY REVERSED IN Q1 2019

Equity Overview – Domestic Equity Markets

2018 ended on a rough note for the markets, as rising bond yields finally took their toll, leading 93% of global asset classes to finish the year in negative territory. The fourth quarter was particularly rough for the markets, as a steady parade of negative headlines caused the major stock indices to slide by 15-20% in rapid fashion.

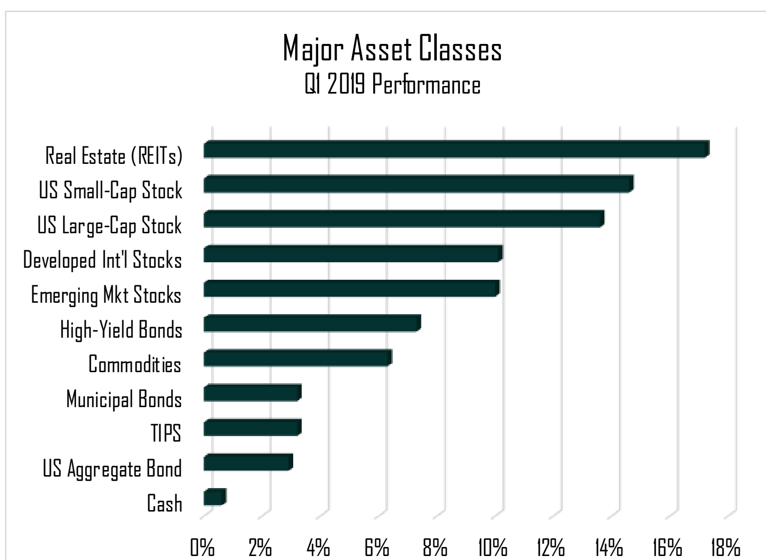


But as 2019 dawned, the slew of macroeconomic concerns that had begun to spook the market—and the broader economy—began to ease, one by one. First, the Federal government shutdown, which had begun during the holiday season and dragged on amid increasingly acrimonious negotiations, was lifted in late January, just in time for tax filing season. Soon after, the Federal Reserve—which had seemingly triggered a December selloff with another quarter-point increase in short-term interest rates—signaled a willingness to slow down their rate-hiking cycle, and to adopt a more neutral or accommodative monetary policy stance. Finally, with a deadline looming in the U.S.-China trade and tariff negotiations, President Trump and his Chinese counterpart Xi Jinping appeared to be approaching a thaw in their frosty relationship, a development that would generally be viewed as excellent news for the export-dependent sectors of the U.S. economy.

The removal (or at least easing) of those three concerns sparked a swift reversal in risk assets, as most U.S. indices essentially reversed their Q4 losses. The S&P 500 gained nearly 15% in Q1, pulling the index to within 4% of its all-time highs, marked back in September. With interest rates of most long-dated maturities gradually creeping lower, total returns for bond investments were also significantly positive for the first time in several quarters, providing more good news for investors in diversified portfolios.

The easing interest rate environment has also been positive for the real estate sector, as REITs were among the strongest performers to start the year, posting gains of nearly 20% as an asset class. Rates for 30-year mortgages are back down near (or even slightly below) 4% in most areas, after having peaked near 5% in late 2018. That rate decline should be good news for property values, which had begun to stagnate as mortgage rates rose.

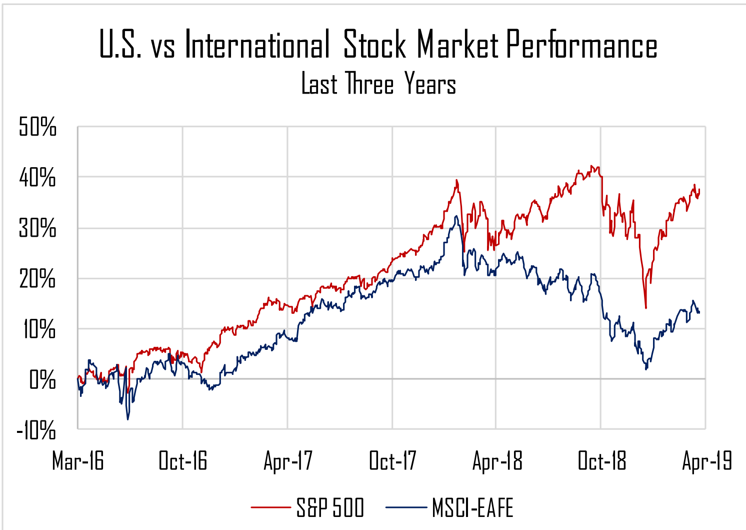
This economic recovery and market cycle is mature by nearly any measure, and many headline risks remain. As we begin to head into the usually duller summer months, eyes will surely remain fixated on the yield curve, but for now, lower long-term rates have provided some room for equity markets to run.



With Brexit Negotiations Still Ongoing, International Investments Lag

Brexit Negotiations Extended, But Still No End In Sight – International Markets

With the negative economic headlines in the U.S. largely easing during the first quarter, there is only one obvious macro concern hanging over the market, but it happens to be a big one. The Brexit negotiations continue to drag on in Europe, and while an agreement has been reached to extend the deadline for the U.K.'s exit date from April 12th until October 31st, there doesn't seem to be much evidence of any actual progress toward an acceptable solution. In the meantime, an intermediate deadline of June 30th looms, since a new session of European Parliament convenes on July 1st, and some progress update will certainly be required by then.



To date, the consternation about the European stalemate has mostly manifested itself via tepid global market returns (international markets once again lagged U.S. markets in Q1), but a particularly sloppy Brexit will almost certainly have implications for all major global economies and markets. For Europe itself, though, exhaustion seems to be setting in, and Brexit may in fact be setting up similarly to the U.S. stock market environment leading up to the 2016 Presidential election: any outcome, even a "bad" outcome, could be cheered by the markets, simply due to the removal of long-standing uncertainty. One way or another, international businesses and investors just want to know what their new reality is, and how best to respond to it. Until then, nobody seems willing to stick their neck out to take outsized investment risks.

Tax Refunds Are Coming in Light – Tax Policy

As the first Tax Day under the rules established by the Republican-led tax reform law (officially the Tax Cuts and Jobs Act of 2017) approaches, a number of taxpayers who may have expected increased tax refunds are disappointed to find that their expectations are incorrect, and that their refunds are in fact in line with prior years. According to IRS Commissioner Charles Rettig, the average refund on early 2018 tax returns is running almost exactly in line with 2017: a total of approximately 65 million refunds totaling $191 billion have been issued, yielding an average refund of $2,833, a small decline from last year's $2,864. Taxpayers who were hoping for an extra-large check from Uncle Sam to help fund their summer vacations have been dismayed, and some anger has begun to simmer in certain circles.

Of course, the lack of growth in tax refunds does not mean that the tax cut has not benefited individual taxpayers—on the contrary, the vast majority of filers did owe (and pay) less total tax on their incomes in 2018 as compared to 2017. However, most payroll providers (and software services) were able to adjust their assumptions in advance, causing most employees to have fewer taxes withheld from their regular paycheck. Therefore, even though tax refunds have not grown, taxpayers did get to keep more of their income in 2018—it's just that in all likelihood, they've already spent their tax cut savings, and they won't be getting any additional benefit come tax time.

That dynamic shouldn't matter much for the broader economy, but for any economists who were expecting a giant surge in consumer spending during tax season as refunds were processed, chances are that no such bump will be forthcoming, and that 2019 will look very much like prior years when it comes to the impact of tax season.