Insights: April 2019

Market Overview and Performance

With the third positive monthly return in a row coming at the conclusion of March, US equities have now largely reversed the precipitous drop that occurred during the final three months of 2018. Given the overall market sentiment at the end of last year, the likelihood of this result would have been viewed as virtually impossible. In reality, although the S&P 500 tumbled within a hair's breadth of a 20 percent decline which traditionally signals a Bear market, by the end of March, the Index stood just 3 percent below the all-time high reached in early October. As we have written about consistently since the sell-off began, the main motivator was merely sentiment. Very little had fundamentally changed during either the three quick months down or mirror reversal back up. Howard Silverblatt at S&P Global summed up this psychology well in his recent note stating, "The bar talk's change from "here comes the bear" in December 2018, to "I'm buying at the bar" in March 2019 can largely be attributed to perception….The prior perception was that markets were headed down due to higher interest rates, slower earnings, slower economic growth, tariffs, and the potential return of a European recession. The new perception was of low interest rates, high single-digit growth for earnings (which became acceptable), economic growth in the 3% area (more minus than plus), and that trade issues would eventually be settled with an acceptable agreement growth emerged." We cannot argue with his assessment. Attention will now turn toward earnings with a general optimism that this will provide the next impetus to keep the positive momentum flowing. Given the extreme fourth quarter negativity being extrapolated into 2019, this may prove to be a comfortably low bar to beat. As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.94	**13.65**
Russell 2000 Index	**-2.09**	**14.58**
MSCI EAFE Index	0.63	9.98
MSCI Emerging Markets Index	0.84	9.92
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**1.92**	**2.94**
Barclay's U.S. Aggregate Credit Index	**4.33**	**7.86**
Barclay's U.S. Aggregate Corporate High Yield Index	0.94	7.26
Barclay's Municipal Bond Index	1.58	2.90
Macro Measures		
Gold	-1.34	1.34
Crude Oil	**5.10**	**32.44**
CBOE Volatility Index	**-7.24**	**-46.07**
USD Dollar Index	1.16	1.15

Current Theme – Positive Three Month Start to the Year has Largely Reversed the Declines of Late 2018

Trade War Headline Fatigue has Generally Resolved Itself into an Outlook that "Something" Will get Done – Market Focus Returns to Fundamentals (Earnings and Growth Trends) for Signs of the Path Forward

While the last 6 months have been difficult for many to stomach, it was in fact merely a brief period of equity price volatility. When one considers a longer term perspective, you can see that the S&P 500 has now eclipsed the high from January 2018 and on a total return basis (price change + dividends), the Index is now back to record high levels last seen in October.

On a Total Return Basis, S&P 500 Back at All-Time High

Source: Topdown Charts; Thomson Reuters Datastream

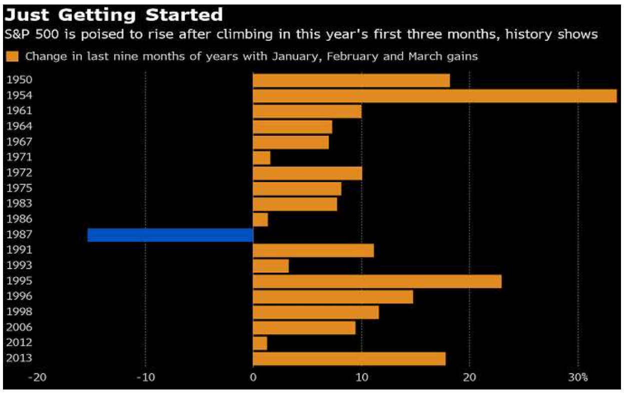
Now to be fair, it has taken a remarkably consistent run of +23 percent to climb back from the low reached on December 24th. But for most non-professional investors, the wildly pessimistic sentiment that took hold at the end of 2018 seems a bit curious since their portfolio values are now back to previous peaks.

Current Path Mirrors Prior Recoveries Post -20% Declines

Source: FMRCo; Bloomberg; Haver Analytics; Facset

In fact, as seen in the previous chart, the path of the current recovery is right on track with the experiences of 1994, 1998 and 2011 when the market declined by -20 percent outside of a recessionary period.

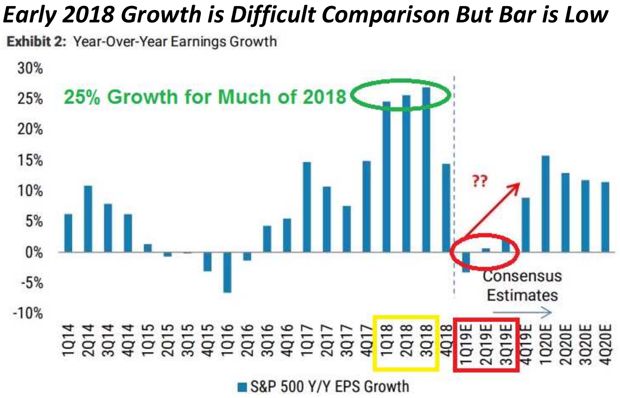
If 1st 3 Months All Positive, Next 9 Higher 18 of 19 Times



Source: Bloomberg

Something perhaps more surprising is what history tells us about a year that starts off with three straight positive months. According to Bloomberg and LPL Research, since 1950 there have been 19 such occasions. In 18 of those years, the ensuing 9 months have produced positive returns as well with an average advance of 9.5 percent over the nine-month period. Of course, history provides no guarantee, but that is a powerful pattern. So, if we start with the assumption that the Q1 recovery was based off the realization that the global economy wasn't quite as bad as feared, what will fuel these next 9 months? Certainly, earnings will play a key role here. Now, part of the concern during the drawdown was the notion that we were facing an earnings "recession". Considering the chart below, we find this to be an unlikely outcome.

Early 2018 Growth is Difficult Comparison But Bar is Low



Source: Morgan Stanley

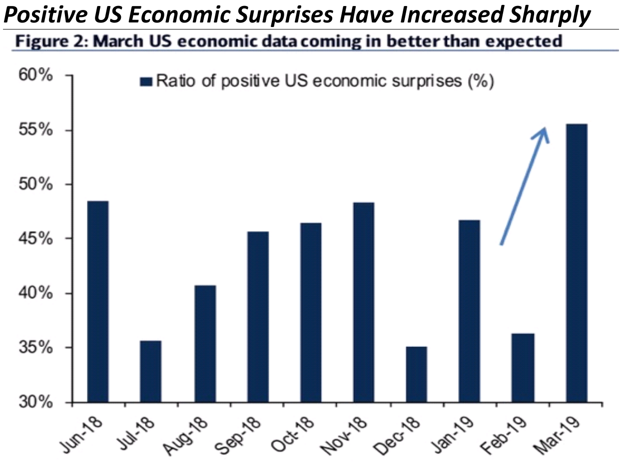
Notice that Q1, Q2 and Q3 of 2018 all displayed earnings growth of roughly 25% largely due to the introduction of a corporate tax reduction. That inflated level of growth makes for a difficult year over year comparison in 2019. However, as the previous chart highlights, estimates for Q1 2019 have gone from +4.3 percent to -3.5 percent, an almost -8 percent swing which is more than twice the historical average of revisions. In short, the negativity of late 2018 has been extrapolated out into 2019 and appears overdone.

Equities Historically Return +3% During Earnings Season

Source: Haver; Factset; Deutsche Bank Asset Allocation

That means that expectations for the current earnings season are now very low and have a reasonable chance of being exceeded. That would be a positive for the market, and as the above chart shows, historically, an advance of +3 percent for the S&P 500 would not be unusual. We are also seeing additional positive surprises across a wide range of varied economic data in the US at a rate not seen in quite some time.

Positive US Economic Surprises Have Increased Sharply



Source: BofA Merrill Lynch Global Research

Other present trends also contrast the "recession like slowdown" narrative. The chart below shows us that Commercial and Industrial Loans – i.e, business loans, are climbing at a brisk pace of 11 percent after a period of decline from 2015 until early 2018. This does not happen in a severely contractionary environment. Banks simply would not be putting their capital at risk if they did not see potential upside to their investment in the current climate.

Business Loan Growth Rebounded; Now Growing at 11%

Source: Daily Shot; St Louis Federal Reserve

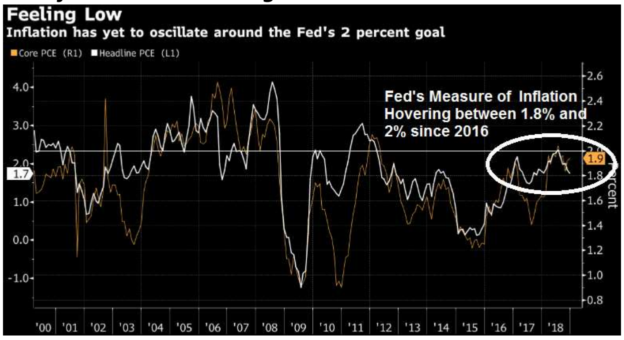
The labor market, which has been so consistent that it almost goes unnoticed, also continues to provide positive surprises. Jobless claims are now at their lowest level in 50 years. A strong labor market helps instill confidence among the US consumer which in turn provides a "cushion" to absorb short term patches of weakness like we saw in the fourth quarter of 2018. It is a key component of the US Federal Reserve's dual mandate of managing "maximum employment" and "stable prices", or inflation in other words. With respect to the labor market, the Fed has certainly accomplished its mission for the time being.

Labor Market Solid: Jobless Claims Lowest Since 1969

Source: Bloomberg

And inflation, as measured by the Fed's preferred indicator of personal consumption expenditures (PCE) has been very close to their desired target of 2 percent since 2016. All combined, these factors would suggest that the Fed has guided the economy into what's commonly referred to as a "Goldilocks" economy, or one that is "just right" – not too hot, not too cold.

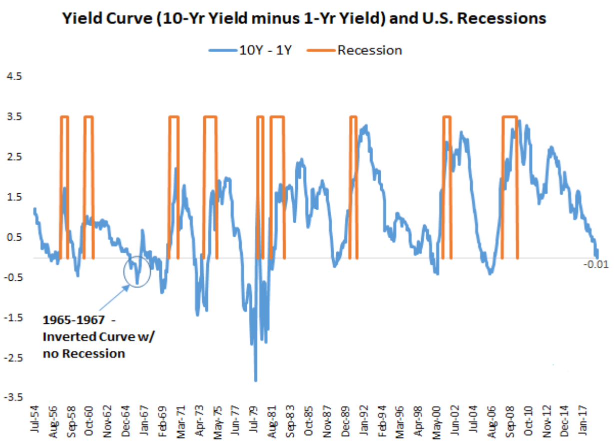
US Inflation Close to Target at 1.8% to 2% Since 2016



Source: Bloomberg

Chairman Jerome Powell seems to be in agreement stating in late March that, "It may be some time before the outlook for jobs and inflation calls clearly for a change in policy." So all clear, full steam ahead, right? Not quite says the bond market. In March, we saw a further deterioration in the yield curve with several portions of the shorter term curve in particular, inverting. Historically, this suggests that investors view the oncoming environment as a challenging one with declining or even negative growth. It has been a very reliable indicator of oncoming recessions in modern market periods as one can clearly see in the track record since the 1950's illustrated in the chart below.

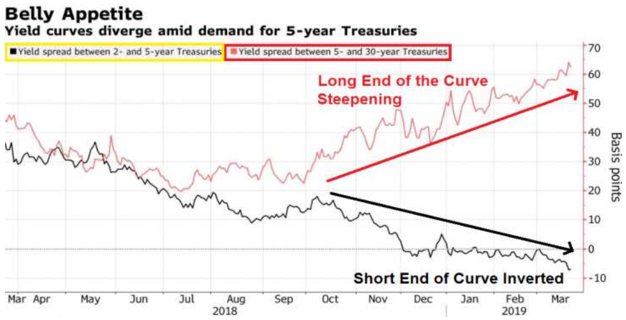
Shorter End Portions of the Yield Curve Inverted in March



Source: Pension Advisors

As we have written about for much of the last year, this is a legitimate warning sign that should be heeded given that the bond market is traditionally the first to sense instability. However, there are nuances here. Yes, several portions of the yield curve have inverted, but it is important to focus on exactly where in the curve this is taking place and what the drivers are.

Short End of Curve Inverting, But Long End is Steepening

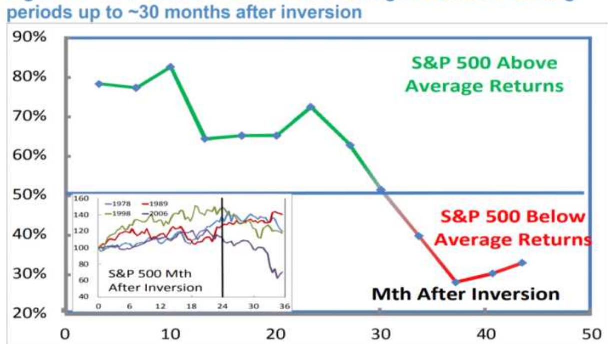


Source: Bloomberg, Mohamed El-Erian

As the chart above highlights, the inversion we are seeing is in the short end, in this case, the yield spread between 3 and 5 year treasuries. This is basically what is controlled by the Fed who has now said that rate hikes are on pause. Conversely, the longer end of the curve, the yield spread between 5 and 30 year treasuries in this chart, is actually steepening. This portion of the curve is essentially controlled by the free market. In other words, it is difficult to make the blanket statement that any one measure of inversion in the curve will automatically lead to a recession. Additionally, as JP Morgan found, historically, stocks can continue to provide above average returns for as long as 30 months after the first signs of inversion in the curve.

S&P Historically Still Solid 30 Months after Inversion

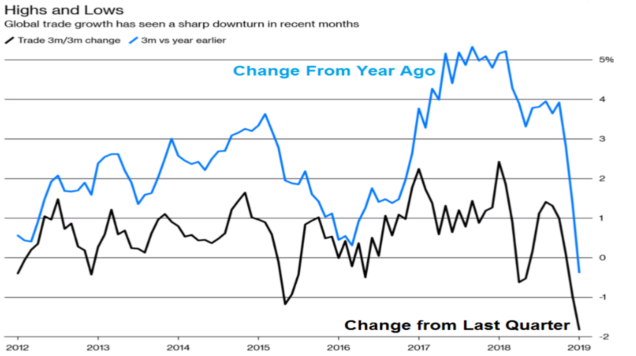
Figure 2: The market delivered above average returns for holding periods up to ~30 months after inversion



Source: JP Morgan

The more pressing concern is the continued negative impact on global trade resulting from the ongoing trade dispute and tariffs between the US and China.

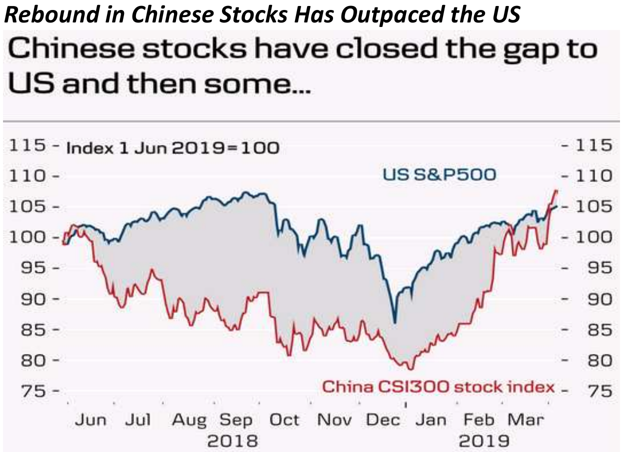
Neg. Trends in Global Trade Remain a Primary Concern



Source: CFB World Trade Monitor; Daily Shot

As the chart above clearly illustrates, there is a very real price being paid by the entire globe as talks drag on. Global trade growth is now negative on both a quarter over quarter and year over year basis. This has not occurred in quite some time and could turn into a self-fulfilling prophecy of global weakness as participants potentially pull back on business investment. Fortunately, we are seeing several signs that the Chinese economy in particular is rebounding from the 2018 slowdown. This is important because China plays a key role in the global supply chain. First, from a sentiment perspective, flows have poured back into Chinese stocks. In fact, the recovery in Chinese stocks has outpaced that of US stocks since the December low. This is an important indication of investor confidence in the future outlook of the Chinese economy and risk assets in general.

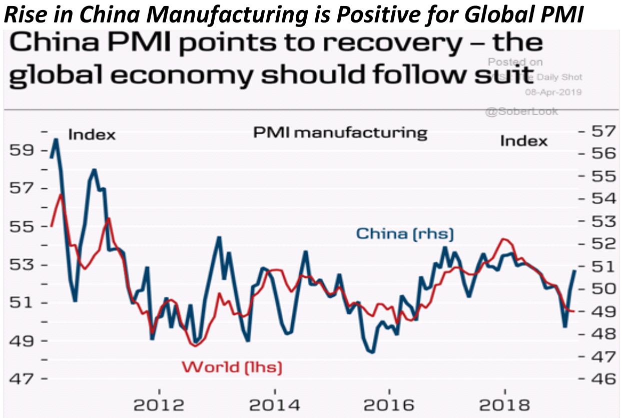
Rebound in Chinese Stocks Has Outpaced the US



Source: MacroBond Financial; Bloomberg

Second, from a more fundamental perspective, Chinese manufacturing data has demonstrated a significant recovery since the end of 2018. Loan data from China also reflects a similar positive trajectory. As the chart below demonstrates, China PMI is very tightly correlated with global manufacturing.

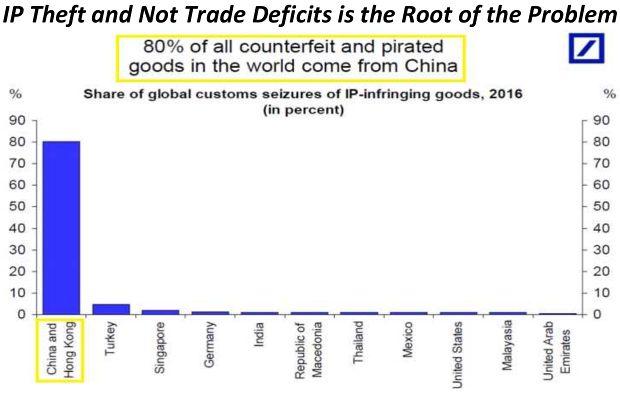
Rise in China Manufacturing is Positive for Global PMI



Source: MacroBond Financial; Bloomberg

As MarcoBond Financial indicates in the title of their chart, the assumption is clearly that as the environment in China improves so will the rest of the global economy. In short, we are seeing multiple sources of evidence that the soft data we saw developing in the last three months of 2018 is not in fact pointing to a drastic reduction in growth trends for 2019. With the environment looking much more solid in the eyes of many, a resolution to the trade issues between the US and China would only help to unlock the "friction" that has been introduced into the system via tariffs. As the chart below shows, a simple agreement tied to the trade deficit would not address the root problem, but it would undoubtedly be viewed by investors as a positive development.

IP Theft and Not Trade Deficits is the Root of the Problem



Source: Deutsche Bank

Going Forward

As we have discussed over the recent months, the sentiment driven market sell-off did not alter the fundamental dynamics of the global economy. It is fortunate that this was a very brief episode of negative perception since a poor outlook can begin impacting investment spending if left unchecked. This vicious cycle of a belief in weakness causing behaviors that result in actual weakness seems to have abated for the time being. As we have written, the major concerns and tail risk events for 2019 have been largely articulated by market participants. As such, we are constructive on the near-term outlook for risk assets. However, there is strong evidence that 2019 may prove more challenging as both the US and global growth rates are normalizing. However, a resolution of trade disputes combined with the abrupt pivot by the Fed to an extremely dovish stance toward interest rate policy, could clearly lead to a more bullish shift as the year progresses.

With that outlook in mind, we would emphasize the technology, financial and industrials sectors as we look out toward the remainder of the year. We view the 4th quarter declines as a benefit to the technology sector in 2019 as valuations and earnings expectations were both notably reduced. Financial names are very reasonably priced after substantially underperforming the S&P 500 Index for much of 2018 and trailing thus far in 2019. We feel that this is overdone, and with many valuation metrics reaching multiyear lows, several quality large cap names are attractive in our view. The industrial sector stands to benefit from a likely positive outcome to the trade disputes which have handicapped global growth. In fact, the mere messaging of progress and a reduction in “recession fears” has proved enough to push the sector almost 20 percent higher year to date.

After sharp declines at the end of last year, small and mid-cap stocks remain attractive in our view despite outperforming their large cap counterparts by a wide margin thus far in 2019. These companies are generally less impacted by trade tariffs, making them a good counterbalance to companies exposed to the global supply chain. As of writing, the Russell 2000 Index was up 16.6 percent year to date and the Midcap Index was up 17.4 percent - both ahead of the S&P 500.

With the recent weakness in the US, equity markets outside of the US are even more compelling in our view. Non-US markets remain much more accommodative in their monetary policy endeavors. Importantly, valuations are substantially lower than the US – at multi-decade lows in some cases. This, combined with the fact that growth rates outside of the US are expected to outpace those anticipated domestically, make non-US markets attractive. We have favored emerging markets equites for quite some time. The asset class suffered in 2018 from both a strong US dollar and trade tensions. However, their valuation and growth levels are compelling, and PMIs (a reflection of economic health) across emerging markets as a group are now expected to exceed developed markets for the first time in many years.

The flattening yield curve is far and away the biggest fundamental concern to many investors. While this trend has moderated somewhat, concerns over a dramatic slowdown in growth and even a recession sometime in the near future are still top of mind for many. We have written about these concerns for quite some time and are also wary to a certain degree. However, at this time, we do not see the eminent worries as valid. The data simply does not support that scenario just yet. For our fixed income exposure, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value.

Although gold trailed other assets for the first 9 months of 2018, the metal proved its merit as a diversifier within a portfolio during the sell-off, climbing over 7 percent while the S&P 500 fell by almost 20 percent during the fourth quarter decline.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.