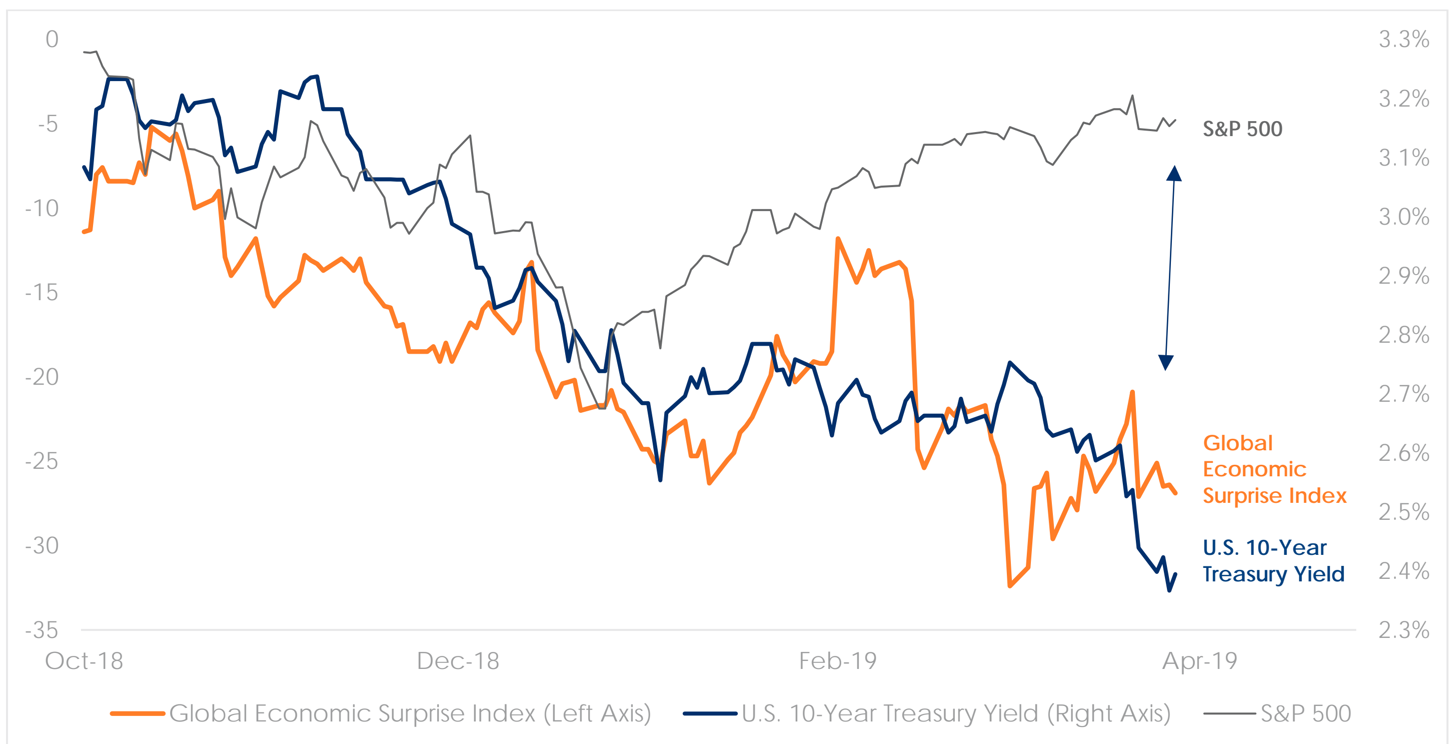
FIRST QUARTER 2019

Market Update

The first quarter of 2019 had little in common with the final quarter of 2018. The S&P 500 had its best first quarter since 1998, and nearly all asset classes saw strong returns despite declining global growth. Such positive performance came off an exceptionally volatile year. Perhaps one of the only similarities between the end of last year and beginning of this year is the level of market influence the Federal Reserve continues to have. The Fed's policy outlook changed dramatically over the course of just weeks.

What has been dubbed the "Powell Pivot" gave risk assets a tremendous boost and pushed interest rates to multi-year lows during the first quarter. The pivot also improved the chances of a U.S. economic "soft landing," or the current economic expansion enduring for a few more years. In fact, in July 2019, the current expansion will become the longest on record. We thought "Goldilocks" conditions were a distant memory, but the Fed resurrected them by backing off its decisions to continue raising rates and to continue shrinking its balance sheet.

First Quarter 2019: Dovish Fed Sends Stocks Higher, But Interest Rates Follow Economic Growth Lower



Source: Bloomberg

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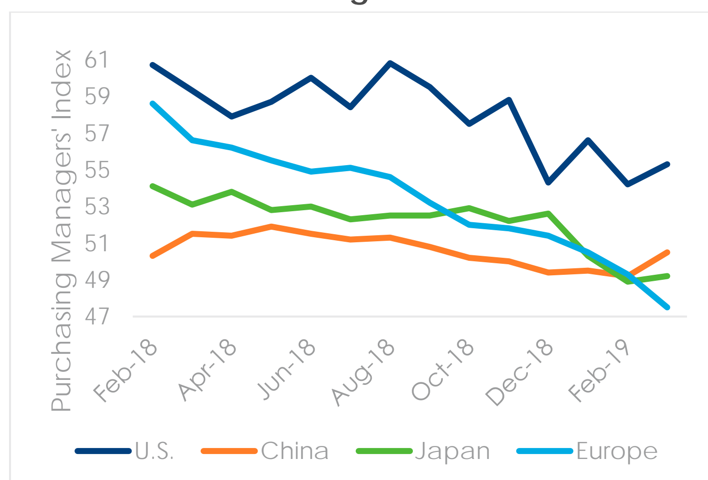
The first quarter saw global growth disappointments and downgrades

Global equity and risk markets rallied in the first quarter despite an abundance of headlines highlighting disappointing economic data and a weakening global growth outlook. The slowdown has been most severe in Europe, and within export and manufacturing-oriented sectors. Brexit uncertainty has been an overhang, and Italy entered recession at the end of 2018. Germany is struggling with anemic growth and a deep slump in its manufacturing industries. It is no surprise then that one of Germany's key trading partners, China, is also in the midst of a cyclical growth slowdown.

Global Manufacturing Indices



Source: Bloomberg

The U.S. is faring better than other developed nations but has not been immune to the global growth slowdown. First quarter U.S. GDP forecasts have been reduced from 2% at the beginning of the year to 1.5%, though some economists are expecting growth below 1%. Consensus estimates are for a rebound in Q2 to 2.6% and 2.4% growth for full year 2019, supported by a strong labor market and steady consumer spending. Job growth rebounded in March with the U.S. economy adding almost 200,000 jobs.

The Federal Reserve and other central banks turned dovish

Economic growth received significant attention in the first quarter, but it was central bank policy and the return of "lower for longer" interest rates that drove the tremendous equity and corporate bond rally. The Fed that investors took cues from in the fourth quarter was drastically different from the Fed of early 2019, prompting a turnaround from the sharp sell-off at the end of 2018. Since the turn of a new calendar year, Fed Chair Powell has continuously stressed "patience" in determining future monetary policy and has said that the Fed is cognizant of risks to the global growth outlook.

A Tale of Two Feds

	4Q 2018	*1Q 2019*
Guidance on interest rate hikes	Two in 2019	Zero in 2019
Balance sheet run-off	On "autopilot," run-off will continue and shrink balance sheet to ~$2.5 trillion by 2022	Run-off will end this September with balance sheet at ~$3.7 trillion
Outlook	"Risks to the economic outlook are roughly balanced"	"The committee will be patient," "economic activity has slowed"

Source: Bloomberg

Foreign central banks have echoed similar sentiment as the Fed. The European Central Bank announced it would revive its Targeted Long-Term Refinancing Operations to encourage bank lending and provided guidance that rates would be lower for an extended period of time. Because of a more accommodative stance from global central banks and muted growth and inflation, global government bond yields plummeted in the first quarter, and both Germany's and Japan's 10-year yield fell below zero.

Global Government Bond Yields

	12/31/18	3/31/19	Change
U.S. 2-year Treasury yield	2.49%	2.23%	-26 bps
U.S. 5-year Treasury yield	2.51%	2.20%	-31 bps
U.S. 10-year Treasury yield	2.68%	2.39%	-29 bps
U.S. 30-year Treasury yield	3.01%	2.82%	-19 bps
Japan 10-year yield	0.00%	-0.06%	-6 bps
Germany 10-year yield	0.24%	-0.07%	-31 bps
Italy 10-year yield	2.74%	2.47%	-27 bps

Source: Bloomberg

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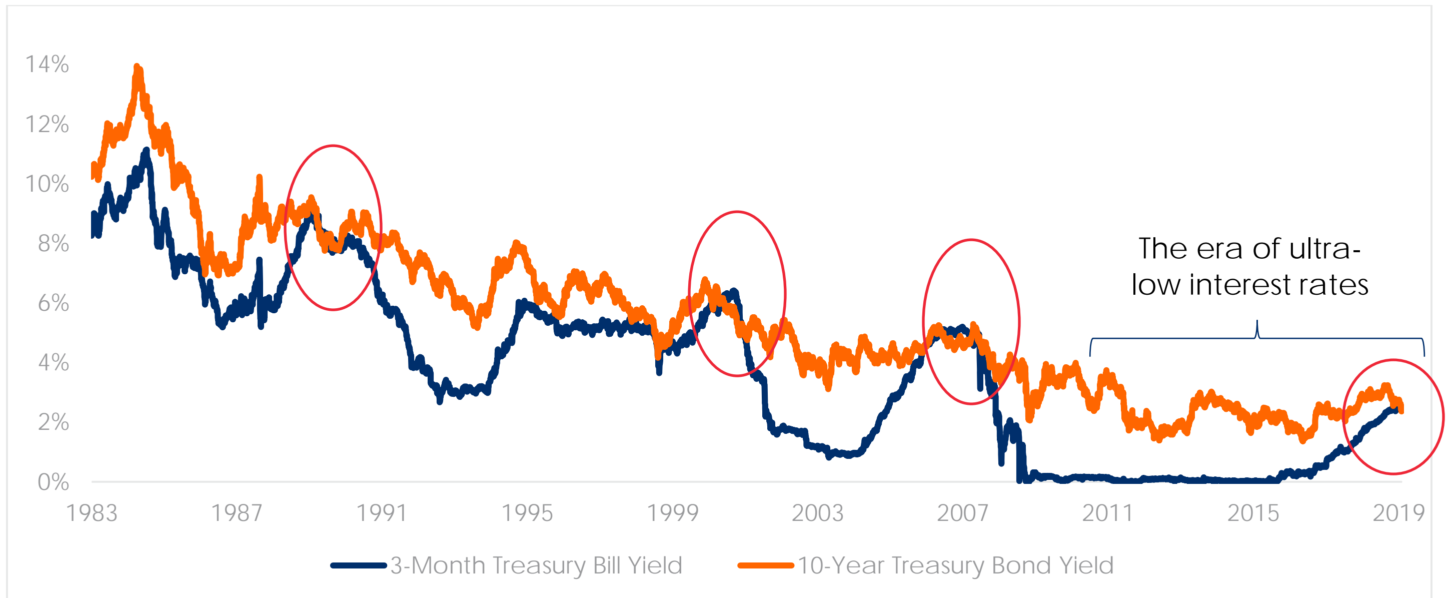
What does inversion of the Treasury curve really mean?

Despite the Fed's dovishness improving the prospects for the current U.S. economic expansion, there is one indicator that has received significant attention due to it often being viewed as a leading indicator of recession: the slope of the yield curve. In March, the 10-year Treasury bond yield fell below the 3-month Treasury bill yield for the first time since 2006.

3-Month and 10-Year Treasury Yields



Source: Bloomberg

We believe there are a few important points to consider on yield curve inversion. The first is the actual cause of the inversion. According to Bloomberg[1], material curve inversions that preceded the financial crisis and dot-com bubble resulted when both short-term and long-term yields are rising, but the former climb by more than the latter. This time around is a bit different with long-term yields falling faster than those at the front end.

Why did 10-year Treasury yields fall so fast? Foreign investors who are faced with negative or near zero yields on 10-year debt in their respective countries (Germany and Japan), have bought Treasurys whose ~2.5% yield looks pretty attractive on a relative basis. The dynamic of ultra-low interest rates and extraordinary monetary policy has been absent from previous cycles. Therefore, distortions due to unconventional monetary policy make the current inverted yield curve a less reliable recession indicator.

The second point is that yield curve inversion has historically been a long and highly variable leading indicator of recession. According to Bank of America, when the curve has inverted, the average time to the next recession is 27 months, but with a range of 9-66 months. Equities also tend to post above-average returns following curve inversion and until the beginning of a recession.

What to watch for in the second quarter: green shoots in global growth and corporate earnings

As global growth estimates came down in the first quarter, so did corporate earnings estimates. U.S. first-quarter corporate earnings-per-share growth is expected to slow considerably from last year when companies benefited from a large windfall due to U.S. tax reform. Current estimates are for S&P 500 first quarter earnings per share to decline 4% over last year, which would mark the first such decline since the second quarter of 2016. For the full year, analysts expect earnings per share growth of ~4%. Company guidance, especially as it relates to foreign markets and China will be of particular interest. With the Fed on the sidelines and given such a strong first quarter, we believe earnings growth will be key to future equity returns.

[1] *Bloomberg: Treasuries Throw Investors a Curve, But This Time Is Different; March 29, 2019.*

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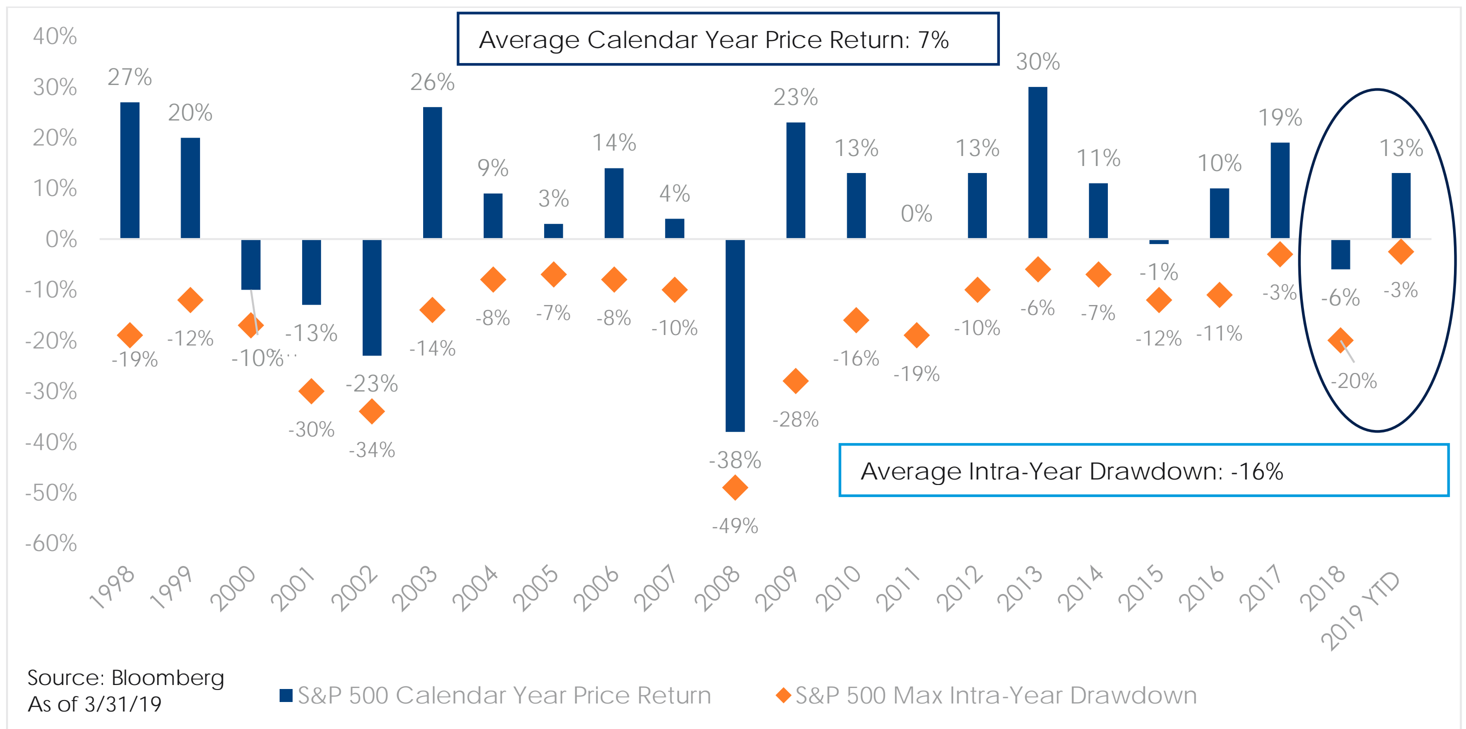
In addition to corporate earnings, we welcome signs of stabilization in global growth. Stimulus should benefit China's economy and provide broader support to emerging markets and Europe towards the second half of the year. Recent manufacturing data indicates green shoots might already be emerging and that global growth could be coming off a cyclical trough in the first quarter. China and U.S. manufacturing PMIs rebounded in March, driven by an improvement in new orders, though European data remains underwhelming. We are also encouraged by the White House's decision to delay additional tariffs on China and recent progress in negotiations, and believe the potential for a trade deal appears to be improving. Nevertheless, following a trade agreement with China, there is a risk that trade tensions with Europe could escalate at a time when Europe's economy is already somewhat fragile. President Trump recently threatened tariffs on $11 billion of goods imported from Europe.

A reminder that volatility is normal in the context of history

We continue to believe that risks of imminent recession are low. The U.S. economic cycle is maturing, but as former Fed Chair Yellen has said, economic expansions do not simply die of old age. However, increased volatility is expected at this stage of the cycle and bull market. Looking back over the last twenty years, where the average S&P 500 drawdown was 16%, volatility is quite normal and in some ways healthy. Many periods of elevated volatility prove to be great buying opportunities as in the case of fourth quarter 2018. We would not discount U.S. politics as a potential source of volatility in 2019. U.S. national debt recently hit an all-time high of $22 trillion, and action on the debt ceiling by Congress will likely be needed this coming fall, creating the set up for another potential "fiscal cliff" and more political discord in Washington.

We hope investors continue to see more "Goldilocks" and less volatility in the second quarter, and we believe that the U.S. economy can "land softly." However, a soft landing is dependent on several factors, including the Fed remaining on the sidelines, continued trade war de-escalation, and stabilization in economic and corporate earnings growth. Stay tuned for an update on these and other top-of-mind topics this summer in our second quarter 2019 report.

Cliff Noreen and Kelly Kowalski



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