Economic & Market Commentary

The past six months was a period of extremes for financial markets around the globe. U.S. stocks ended 2018 in the red, as they experienced their worst year since 2008. Negative volatility was also felt globally and across most other asset classes as bonds and commodities suffered similarly. Financial asset weakness was primarily caused by rising interest rates and fear that the Federal Reserve would continue to tighten monetary policy, driving the U.S. economy into an economic contraction. Then, in late January, the Fed reversed course coming to the stock market's rescue. Fed Chairman Powell executed a perfect pivot saying that the central bank would be patient before raising rates further, and flexible in the pace of balance sheet reduction, implying few additional rate increases in the following 12 months, and to some introducing the possibility of a rate cut. These actions reduced investors' fears of an economic slowdown, which had dampened the prior quarter's returns. Interest rates declined (bond prices rose) and commodities rallied. The 10 year Treasury bond that had traded at 3.25% in October declined to the 2.4% area. Markets were off to the races with stocks experiencing mid-teen gains, both here and internationally. In the first quarter, the S&P 500's total return increased 13.6%, bond returns were positive across the yield curve, and oil, which had declined from $75 a barrel to the low $40s in the fourth quarter, climbed back to around $60 per barrel. U.S. stocks experienced their best three month gain in a decade.

The character of the equity market also felt like it was about to shift, as value started the quarter ahead of growth. This reversed in the final two months, and growth outpaced value for the full quarter. Small and mid-cap issues slightly outperformed large cap, as investors took on more risk after the Fed pivot. Six of the eleven S&P 500 sectors outgained the full index, which was a slightly broader performance than in the recent past. Technology, Industrials, Energy and Consumer Discretionary were the standouts, with all sectors nicely in positive territory. Once again the FAANGs (Facebook, Apple, Amazon, Netflix, Google) and Microsoft played a starring role. All were ahead of the index, except Google, which was slightly behind. Combined they contributed just under 25% of the S&P 500 gain; significant, but not as dominant as in prior periods.

As this is written, U.S. equities have recouped close to all of their peak-to-trough loss that occurred in October-December last year and our clients' portfolios have rebounded nicely. The domestic economy continues to look okay. We have believed the U.S. is in a 2% growth environment – slower than last year's 3%, which was aided by tax cuts and better global growth. This year's first quarter is expected to produce a GDP gain of 1.5 – 2.0%, with some modest pick up as the year unfolds. Earnings estimates and guidance have been coming down, as companies have pre-announced with caution, which could lead to some unpleasant stock market surprises. The risks enumerated in prior letters are still out there: Brexit, China, Euro softness are still unresolved, and could have a negative impact on U.S. progress. Domestic growth is slow enough that increases in wages or other costs could have a leveraged impact on corporate income statements. With the equity market regaining much of the ground lost off its October peak, the S&P 500 is now valued at more than 17x this year's estimated earnings. This level of valuation is neither outlandishly expensive, nor does it represent compelling value.

When compared to its most commonly used valuation metrics, the aggregate equity market is at the upper end of its normal valuation range. About the only metric against which the market looks cheap is interest rates. We have had low interest rates for the better part of this past decade. Interest rates are typically the comparator used by investors to determine a required rate of return of return from an investment, and therefore the discount rate used in determining appropriate present value. The lower the rate, the lower the required return and the lower the discount rate. This implies a higher current price for the asset involved.

Many economic observers expect interest rates to increase over the next few years. U.S. economic activity has been good, so the demand for money should increase. The Federal Reserve Board had indicated a policy of normalizing (raising) rates, and normalizing (reducing) the size of its balance sheet. In addition, the demands from government (to pay for tax cuts and fiscal programs) are high. All those factors would normally lead to increasing rates, but that has not happened. And now the Fed has pivoted, indicating a reduced pace of Fed Funds rate increases and balance sheet reduction. What was expected to be a case of “Quantitative Tightening” has reverted back to the policy of “Quantitative Easing.” This has coincided with the emergence of a new school of economic theory – Modern Monetary Theory (MMT). In simple form, believers in MMT say deficits don’t matter and governments should issue debt, without concern, as long as there is unused capacity in the economy to absorb all this liquidity.

Excess liquidity has existed in the U.S. and globally for the better part of the past decade. Savings rates are high, asset prices are high, consumers are spending, and corporations are wary of making capital commitments in the uncertain world. Recent policy pronouncements by the Fed have reduced the fear of the removal of liquidity. So it seems the outlook for low interest rates could be intact for some time. This set of circumstances is a departure from the belief of many economic observers. These factors need to be watched with open eyes to see how they develop. In the meantime, our policy is to stay the course as the U.S. economy continues to grow, employment and wages are going up, inflation is moderate, and consumer and business confidence remains strong.

Fixed Income

During the first three months of 2019, there was a dramatic departure from the market volatility and uncertainty that closed out 2018. The fixed income markets rallied and provided great returns, as three unique themes played out during this period. The Bloomberg Barclays Aggregate Bond Index returned 2.94%, after finishing flat for all of 2018. The Bloomberg Barclays U.S. Corporate Index returned 5.14%. Treasury yields for maturities under one year declined between 3-20 basis points. At the same time, yields for Treasuries between 2-30 year maturities fell between 20-29 basis points. This resulted in a relatively flat yield curve, as the curve shifted down.

As mentioned, there were three unique themes that occurred during the quarter. As the year started, investors were worried that the Federal Reserve would raise interest rates too fast and slow the economy too quickly.

In the first week of January, Chairman Jerome Powell told a conference of economists that the Fed would be flexible in deciding to increase rates. During a two week period, Treasury markets reacted from pricing in rate increases, to pricing in a Fed rate pause, to pricing in rate decreases. This accommodative tone permeated the markets and fueled a rally in the quarter, as stimulus from the tax cuts has faded.

The March Federal Open Market Committee meeting minutes indicated that the Fed would be responsive to data analysis and determine rate adjustments based upon this analysis. In essence, the Fed does not have conclusive data to determine a direction at this point in time.

The second unique theme that took place this quarter was an inversion of the yield curve. For a very short period of time and for the first time since it preceded the Great Recession, the 10 year Treasury yield was lower than the three month Treasury bill. However, the Fed's analysis has shown that inversion of the 10yr-2yr part of the Treasury curve has historically been the most predictive of a future recession and this did not actually occur in the first quarter. Yield curve inversions following quantitative easing and quantitative tightening may not be predictive of a future recession, as the yield curve has not normalized following the post-financial crisis intervention.

The third unique theme of the quarter is taking place overseas. As stimulus is fading in the U.S., it is increasing elsewhere. The global weakness is fostering accommodative monetary policies by many central banks. The EU is clearly committed to such a policy and China's stimulus policy is carrying over from 2018 to well into 2019.

In conclusion, inflation is low. The Federal Reserve is neutral on rate hikes and worries are rising about the strength of the economy. This pushed bond prices up and fueled a great rally to start the year.

We continue to position our fixed income portfolios shorter in duration to their benchmarks. We expect the Federal Reserve to continue to pause on raising interest rates. This scenario should bode well for short and intermediate range maturities. We plan to maintain an overweight in corporate exposure in our institutional portfolios, as we see continued value in this space and healthy corporate earnings.