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INVESTMENT COUNSEL

2019 SPRING INVESTMENT OUTLOOK

The stock market's worst December since 1946 and third worst fourth quarter since that same year has quickly flipped to a V-shaped recovery during the first quarter of 2019. The S&P 500 came within 2.5% of its September high before a late March selloff and is off to its best calendar year start since 1987. The bearish sentiment that pervaded the capital markets at the end of 2018 has been lifted by the change of heart of Federal Reserve policymakers in response to the December equity market volatility as well as the continued slowing of both U.S. and global economic data. The Bloomberg global GDP tracker for the first quarter of 2019 based upon the recurring economic data (a model which explains about 75% of the variation of government GDP data when it is eventually released) has dropped to just 2.1% growth on a qtr/qtr annualized basis, a meaningful slowdown from the 4% rate of growth that existed when 2018 commenced. While some of this deceleration can be attributed to the impact of tariffs and trade dispute with China, the extent of the global slowdown has surprised most economists.

The bond market has been less sanguine than the stock market throughout the first quarter regarding this step-down in growth as interest rates have fallen. The 10-year Treasury is down nearly 80 bps to 2.44% and some parts of the yield curve are already inverted. Despite its shorter maturity, an investor can currently earn more in a 6-month Treasury at 2.46% annualized compared to the 2.22% offered by a 5-year note. Such an inversion implies a greater risk of recession and could be telegraphing a potential interest rate "cut" will occur sooner than most expect. Both survey and financial market measures of inflation expectations are also substantially lower since autumn and well short of the Fed's explicit 2% goal. These signals indicate a more somber attitude toward economic fundamentals by bond investors, thus the diverging pattern of lower interest rates and higher stock prices to start the year is unlikely to persist for too long.

The market P/E ratio has risen back to its 5-year average of 16.6x with the recovery in stock prices, an expensive proposition in the context of a longer history and an uncertain corporate profit backdrop. Quality stocks with strong balance sheets are at even a greater premium, trading well above 20x earnings on average and at a relative valuation gap near the 95th percentile when compared to firms with weaker financials over the past 40 years.

2019 YTD Total Returns

	3/22/19	% Change
Dow 30 Industrials	25,502	+10.0%
S&P 500	2,801	+12.3%
NASDAQ Composite	7,643	+15.5%
MSCI All Country World Index ex-USA	281	+10.4%

Outlook

The old adage "don't fight the Fed" has reverberated throughout the financial markets to start the year as the de facto global central bank has quickly course-corrected its monetary policy following the fourth quarter turmoil. Such a shift has occurred on both of its policy levers. In early October Chairman Powell indicated in a speech that the Federal Reserve was "a long way" from getting its key fed funds rate to a neutral level (where inflation is contained and growth is consistent), implying more rate hikes were on the way. Then at the mid-December FOMC meeting Mr. Powell indicated the unwinding of the Fed's balance sheet "was not creating significant problems" and would continue on "auto-pilot." This communication led to a swift stock market sell-off, widening of credit spreads, and strengthening of the dollar to end the year. Such tightening of financial conditions was akin to additional interest rate hikes, negatively impacting business and consumer sentiment, and forcing the central bank to quickly reverse course in early January.

Mr. Powell said the central bank will now be "patient" in its approach to monetary policy at a roundtable discussion with former Fed chairpersons in early January and the FOMC committee re-affirmed this approach in its latest policy statement on March 20th. In fact, the latest median expectation of the committee is for no interest rate hikes in 2019 from the current 2.375% level compared to an assumption of two increases as recently as December. Such a shift is now in line with current market expectations according to fed funds futures, which are pricing in no rate hikes this year and an increasing probability of a rate cut by year-end. The Fed has also moved away from its previous notion regarding the balance sheet runoff of the government bonds it holds and now intends to slow the reduction in May and conclude it in September. By the end of 2019 the balance sheet is expected to hold about $3.5 trillion of assets, approximately 17% of GDP. This is about a $1 trillion reduction overall and a decline from peak levels of 25.2% of GDP in late 2014 at the conclusion of QE3.

Although the Federal Reserve balance sheet is multiples larger compared to prior economic cycles it is a fraction relative to the Bank of Japan (BOJ). The BOJ currently holds more than $5 trillion of assets, which is more than 100% of that country's nominal GDP, and it owns close to half of all Japanese government debt (vs. the Fed holding just 10% of U.S. debt). Core inflation in Japan has averaged only 0.3% over the past 12 months despite the size of the central bank's balance sheet and stimulus. It is facing similar challenges that many other large developed economies will experience in the coming years and decades including unfavorable demographics, high levels of social spending, high debt levels, and the impact of technology. Such headwinds could prevent broad interest rates from returning to pre-crisis norms and force central banks to use their balance sheets to even greater degrees in future crises. Central bankers will likely be forced to prove that they can create and sustain higher levels of inflation than we've experienced over the past 10 years before the negative ramifications of such policies become an issue.

Other global central banks have in essence been leading the Fed to its latest monetary accommodation. The Bank of China loosened policy throughout 2018 as its economy continues to slow on an organic basis, with the U.S. trade dispute not helping matters. The European Central Bank (ECB) has pledged to keep interest rates at current record-low levels at least through the end of the year and has revived some of its crises-era targeted lending tools to encourage banks to lend. The Euro area is expected to grow just 1.1% this year and is intricately linked to China via its various export industries. Germany has the greatest fiscal cushion to stimulate the region to a greater degree but challenging politics and intransigence throughout the region make it likely that governments do nothing on the fiscal front despite the slowdown. Brexit will also continue to be a near term risk as well since a compromise remains out of sight. These are several reasons why the Euro area remains stuck with negative interest rates.

China is perhaps the biggest catalyst that could impact equities in the near term. In fact, one-third of 186 fund managers polled in a recent Bank of America survey said slower growth in China is the biggest tail risk at the moment (followed by trade war risks and a corporate credit crunch). China GDP grew at a 28-year low of 6.6% in 2018 and the government continues to move the bar lower to a target range of 6.0%-6.5% for 2019. China's exports and imports have both declined about 5% y/y on average over the past three months and export orders (for future shipment) fell at the fastest pace in February since the global financial crisis.

As a result Chinese authorities will almost triple fiscal stimulus in 2019 to 3% of GDP compared to the levels of 2017, comprised of both tax cuts and spending. Monetary policy has also been loosened and Chinese banks are being encouraged to increase lending, especially to the private sector. Recent data shows credit growth gaining some traction and some economic activity bottoming, which is why local Chinese stock markets have been among the strongest to start the year. But the government is unlikely to engage in the flood-like stimulus as it has in years past due to heightened financial risk, thus we expect the result from the various measures implemented to be less immediate and less impactful this time around. We also doubt that private sector confidence and activity in China will snap-back to prior high levels as President Xi has prioritized government policies towards state-owned enterprises since coming to office.

Global stock markets are also up to start the year on the hopes that the U.S. trade dispute with China will be resolved via a comprehensive agreement. Sentiment around this prospect improved in the first quarter but recent press reports in late March indicate getting a longer term comprehensive deal that both sides trust could prove difficult. China is reportedly walking back some key concessions and President Trump has indicated that tariffs will remain in place for a substantial period of time to ensure the new trade terms are enforced. If a deal is reached it could be met by a "sell the news" reaction from the stock market. Some permanent damage to global trade has probably already occurred on the margin and failure to come to terms could make the economic fundamentals even more precarious.

The U.S. economy continues to be driven by the consumer as well as corporate investment in software and equipment. Housing-related activity is lagging and is contributing much less to the economy compared to previous cycles but the recent decline in mortgage rates should help support the market as the spring selling season begins. Although the February employment report was much weaker than expected, such a data point was unconfirmed by other surveys but certainly bears watching in the months ahead. Wage growth continues to rise, which helps support spending, and job prospects still seem abundant for those individuals with the proper technical skills.

In the meantime, public equity investors are celebrating the Federal Reserve's new tone. Some of the price appreciation can be ascribed to lower inflation and the decline in interest rates, which have historically been associated with higher valuations. However, further gains from current levels will be more dependent upon corporate profit growth expectations, which have been falling since November. Full year earnings are expected to be up 3-4% in 2019 for the S&P 500. However, first quarter profits are forecasted to decline 2-3% with the strong U.S. dollar continuing to be a partial headwind for many multinationals. Index earnings are estimated to be up just slightly through the first three quarters only to be saved by the strong 9-10% fourth quarter growth, as forecasted by Wall Street. Whether fourth quarter strength predicted by Wall Street comes through remains to be seen.

Investment Conclusion

One investment premise that has held true throughout history has been that starting valuations are critical to an investor's future total return, thus the currently high P/E ratio of the stock market implies gains over the coming decade could be well below the double digit returns experienced during the post-WWII era. High quality equities are trading at an even greater premium to the overall market and fundamental growth is slowing, thus we are favoring capital protection at this moment versus chasing returns as many on Wall Street are espousing. Income from dividends, bonds, and money market instruments is essential to sustaining spending plans (for those clients taking distributions) and lowering overall portfolio volatility. Gold-related investments could also come into favor considering the shift in monetary policy that appears to be underway.

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