Review & Outlook – 1Q 2019

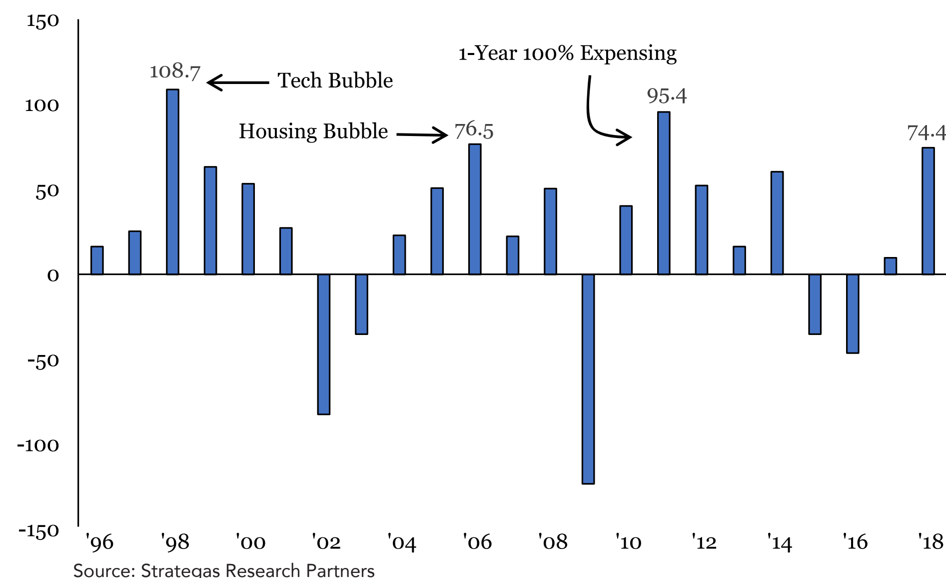
Optimism returned to the markets during the first quarter, following the broad selloff and negative sentiment that struck investors at the close of 2018. The rebound generated the highest quarterly returns in a decade, with the S&P 500 delivering a 13.7% total return year to date and 17.2% since the previous low on 12/24. Global equities participated as well, with developed markets returning 10.0% and emerging markets returning 9.9% year to date. The sharp recovery emphasizes the importance of remaining invested. Being uninvested during the three best trading days of the quarter would have resulted in U.S. equity returns of just 6.6%, which is consistent with the poor historical performance for investors who attempt to time the markets.

Perhaps the most influential source contributing to the strong Q1 equity performance was the Fed's language implying a pause in rate hikes for 2019. Coming into the year, the market was expecting 2-3 rate hikes. Currently, the expectation is zero as Fed officials attempt to avoid raising rates too high and causing a recession. Through the first quarter, yields have fallen across nearly all maturities with a notable inversion in the 10-year/3-month Treasury towards the end of March. While this does not necessarily imply a looming recession, it may push the Fed to reverse course and cut short-term rates to stimulate growth.

Despite the partial inversion of the yield curve, underlying fundamentals in the U.S. economy remain strong with GDP estimated to have grown 2.9% in 2018. The U.S. consumer, which comprises approximately 70% of the GDP figure, has been healthy amidst low unemployment, wage gains, strong personal balance sheets, and strong levels of spending. However, most major economies are expected to experience lower GDP growth this year resulting from tighter financial conditions in the U.S. and trade tensions. The Fed recently cut 2019 growth to 2.1% from 2.3% and the IMF has revised global growth estimates down from 3.7% to 3.5% with further reductions expected.

A recovery in business sentiment and expansion in capital expenditure will be key readings to monitor for signs of a continued U.S. economic expansion. While shareholders have been rewarded through share buyback programs and increased dividends, reinvestment of capital into fixed assets has been lagging. Large capital expenditure programs are generally undertaken when corporations need increased capacity and feel comfortable with the economic outlook. Many executives were cautious in 2018 given the trade uncertainty that weighed on the economy. Increased capital spending will important to generate productivity gains that will help extend the current bull market.

Along with slowing growth, the primary risks within the international markets include global trade policy and Brexit. As negotiations have progressed over the past month, the U.S. and China have suspended new tariffs and existing tariffs will likely be reduced or eliminated once an agreement is in place. Both sides are incentivized to reach a deal, considering lower GDP growth rates and uncertainty weighing on productivity gains through capital expansion. Resolution of trade disputes, including those with Europe and the United States-Mexico-Canada Agreement (USMCA), will be a primary focus to bolster the economy heading into the 2020 presidential election. Britain exiting the European Union without an agreement would cause the most disruption. Given the small size of the U.K. equity market relative to the world (4.5%) and the risks already priced into British stocks, the long-term impact on global markets should be limited despite potential short-term volatility.



Source: Strategas Research Partners

Developed economies worldwide are slowing and governments and central banks are beginning to respond with stimulus measures. The European Central Bank has indicated they will keep rates unchanged at least through 2019 with additional stimulus measures coming in September. Similarly, the Bank of Japan will likely continue monetary stimulus considering below target inflation and a planned October increase in the consumption tax that may reduce consumer spending. The U.S. economy and markets are not immune international developments. As the U.S. approaches the all-time highs that were set in September despite these growing economic risks, it is important to remain committed to core principles while eliminating emotions from investment decision-making. With risks and headwinds aplenty across the globe, volatility will likely return in the months ahead and create opportunities for patient long-term investors. Our focus will be to remain broadly diversified with an emphasis on quality as we navigate the current period of slowing economic growth.