EQUITY MARKET UPDATE

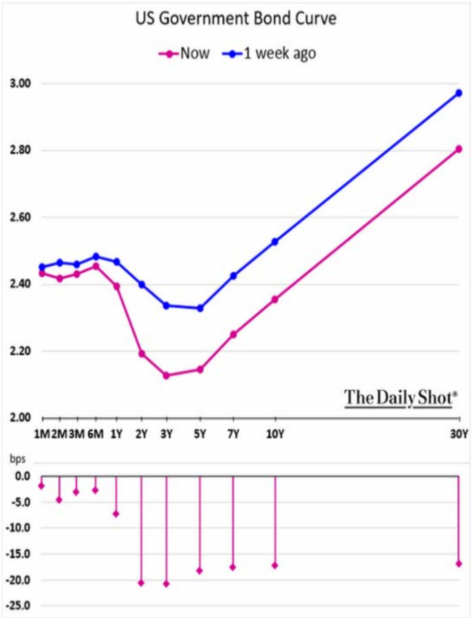
As of 03/31/19 | Volume 8, Issue 3 | FFTAM.com

Stocks had their best quarterly start to a year since 1991 and are currently sitting near the all-time highs. The rally has been aided by soft, but stabilizing, global economic data, easing trade tensions between the US and China, and monetary accommodation from the global central banks. As the second quarter begins, investors have set their sights on upcoming earnings announcements which are estimated to decline from levels seen one year ago.

US Stocks Near All-Time Highs While Yield Curve Inverts

The S&P 500 gained 1.94% in March. It is up 13.65% in 2019, its best quarterly showing since 2009. The rally has been broad-based with all economic sectors posting positive returns for the quarter. This has not happened since 2014. Technology was the best performer, followed by industrials and energy, as risk appetites increased once the Fed paused on raising interest rates and trade talks with China progressed. The rally has been so strong that the S&P 500 is within 3.5% of its all-time high level.

The Dow Jones Industrial Average increased 0.17% in March and is up 11.81% year-to-date. The Dow's performance was negatively impacted by Boeing as their 737 Max airplanes were grounded worldwide following the second deadly crash in six months.



The NASDAQ continues to be the best performer among large-cap indexes rising another 2.70% last month. Thus far in 2019, it has zoomed 16.81%. Gains in software services, internet portals, biotech, and semiconductors have powered the tech heavy index.

As the quarter ended, much attention was given to the shape of the yield curve as short-term interest rates surpassed the rates on longer maturities. This is known as an inverted yield curve, and it has historically been a harbinger of an upcoming recession. Investors panicked and heavily sold community bank stocks which are large constituents of mid and small-sized indexes. The S&P 400 Mid-Cap Index declined 0.57% in the month, while the S&P 600 Small-Cap Index fell 3.33%. Year-to-date, mid-cap and small-cap stocks are still up 14.49% and 11.59%, respectively. Like large-cap stocks, the largest gains were seen in industrial, technology, and energy companies.

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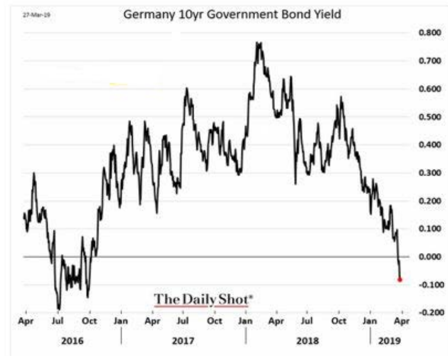
<u>ECB Provides More Stimulus, Brexit Uncertainty Continues, & China Shows Signs of Bottoming</u>

International markets continue to lag the US as worries about economic growth intensify. The MSCI EAFE Index gained 0.72%, while the MSCI Emerging Markets Index was up 0.83%. Thus far in 2019, these indexes have risen 10.15% and 9.90%, respectively.

The weakest economic data continues to come from Europe. In Germany, factory output fell at its fastest pace in 6 years. After several months of anemic economic readings, investors are concerned that the largest economy in Europe is teetering on the brink of recession. As I have stated in my last two writings, Italy has officially entered a recession, and several parts of the French economy are at multi-month lows.



The situation in Britain remains uncertain even after the European Union extended the March 29th Brexit deadline by two weeks. The British Parliament reminds me of my three-year-old son by saying no to every option presented to them. They voted down the deal Prime Minister Theresa May negotiated with the EU three times even after she vowed to resign her post if they approved it. They also rejected a motion to leave the EU without a deal twice, and they refuse to allow the citizens to vote again on the Brexit referendum. With the new deadline approaching, it is likely the Prime Minister will have to ask the EU for another delay.

With economic growth weakening throughout Europe, the ECB unveiled a surprise plan to stimulate the economy. Less than three months after ending their multi-year quantitative easing program, the central bank announced they would not raise interest rates at all in 2019, and they are issuing a fresh batch of cheap long-term loans for banks linked to business and household lending. This lending program has been used before by the ECB without much success, but it is one of the few options the central bank has at its disposal considering their interest rates are already at -0.40%.

In emerging markets, investors' attention continues to be on China. Early in the month, Premier Li Keqiang lowered China's GDP target to between 6% and 6.5% this year, which would be the slowest annual growth rate in 30 years. He also introduced a series of stimulative measures including tax cuts, monetary easing, and greater deficit spending. A few weeks later, Manufacturing PMI was above 50 (the level that separates expansion from contraction) for the first time in three months. This provided investors with hope that China's economy is stabilizing. Finally, the month concluded with positive developments in the trade negotiations with the Trump Administration. The media reported that Chinese negotiators offered concessions on forced technology transfers in exchange for the elimination of tariffs on Chinese goods. A deal has still not been reached; however, *The Financial Times* reported the two sides have resolved "most of the issues" needed to make a deal.

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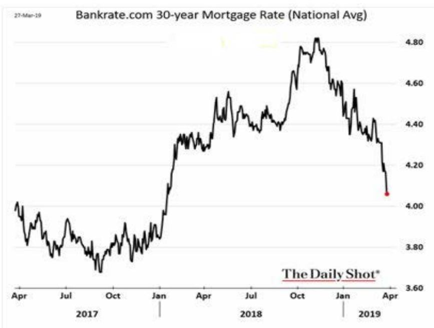
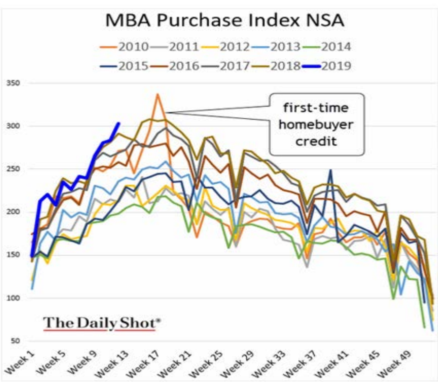
US Economy is Healthy but Softens, while the Fed Gives Dovish Commentary

The US economy remains strong, although economic data has slowed from levels seen in early autumn as international cross-currents impact US companies doing business abroad, and consumer expectations were dampened by the government shutdown. US manufacturing activity slipped to its lowest level in two years, while the service sector slowed more than analysts thought. Consumers continue to power the economy as unemployment data remains near 50-year lows, and the labor market has added jobs for a record 101 consecutive months.





In response to the weakness both domestically and abroad, the Fed left interest rates unchanged, which was in-line with market expectations. However, they surprised the market with two significant developments. First, the updated dot plots show the Fed does not see any reason to raise interest rates this year. This is a departure from the December meeting which indicated two rate hikes in 2019. Second, they released concrete details on the balance sheet reduction program. The Fed plans to slow the rate of reduction in both Treasuries and mortgages until the size of their balance sheet hits $3.7 trillion in September. At that point, they will hold the size of the balance sheet steady. This is a reduction from the balance sheet's peak of $4.5 trillion, but it is much larger than the pre-financial crisis level of $800 billion.

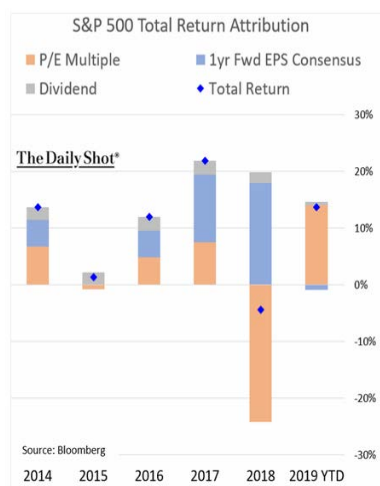
The market responded to the Fed's dovish commentary by lowering interest rates across the entire yield curve. Long-term rates dropped precipitously, which caused the yield curve to slightly invert as 10-year yields fell below the 3-month rate. Investors viewed the inversion as an indication that the Fed will have to cut rates later this year, so they sold bank stocks heavily.

However, lower rates sparked a wave of interest in housing, which has been weak for the last six months. The interest rate on a 30-year mortgage has fallen to levels last seen in early 2018. As a result, mortgage applications increased, and existing home sales posted their largest monthly gain since 2015.

Markets Have Priced-In a Lot of Good News, so Pay Attention to Earnings Announcements

The S&P 500 currently trades at 16.71x forecasted earnings for the next twelve months. This is an increase from the 14.90x forecasted earnings seen at year-end, and it is above the 10-year and 30-year average of 14.94x and 15.75x, respectively.

As the second quarter begins, investors will be closely following the upcoming earnings season. Analysts have dramatically cut their first quarter earnings growth rate to -3.9%. It is widely believed the market may experience an earnings recession in the first half of 2019 as year-over-year earnings growth is negative versus its 2018 comparison. However, analysts are forecasting an acceleration in growth in the second half of the year in anticipation of a trade deal between the US and China. At the current time, the consensus earnings growth rate for full-year 2019 is 3.7%.



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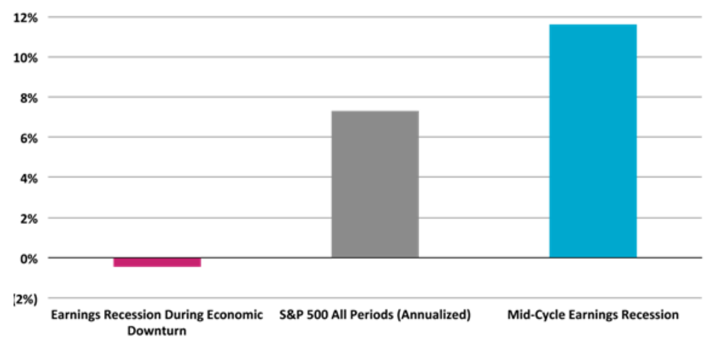
The most thought provoking piece I read this month came from Joe Zidle, Chief Investment Strategist at Blackstone. He said an earnings recession is not necessarily a bad thing. There have been 14 earnings recessions since World War II. In six of those instances, the economy did not experience a recession in the following year, and stocks rallied on average 12%. However, in the eight instances in which the economy did slow, stock performance 12 months later was negative. This tells me the market will be paying very close attention to corporate earnings, the Fed, and any developments in the trade negotiations between the US and China.

Next Twelve Months Stock Performance (1945-2018)



Source: Blackstone calculations, Bloomberg and Shiller. Stock performance based on S&P 500 price return. For earnings recessions, next twelve month performance based on 12 months from the first quarter of the earnings recession.

What We Are Doing—Our Strategy

The US economy is on firmer footing compared to other countries around the world. The state of the consumer remains strong as the labor market continues to add jobs. Inflation readings are stable and near the Fed's 2% target. Most data points in our proprietary economic checklist indicate the US economy is in the late stages of the economic cycle. Despite the insistence from central bankers that they will be patient in any further rate hikes, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here on the shoulders of continued earnings growth and improving economic conditions, which leads us to believe that total returns in stocks will be much lower than what has been seen over the past 10 years with higher bouts of volatility.

Throughout the quarter, we used the rally in stocks to trim earnings risk from our portfolios. We lightened our exposure to biotech, information technology, and energy. With the proceeds we boosted our exposure to utilities and managed healthcare providers. We also changed our mix in financials to be less dependent on higher interest rates. For clients with fully diversified portfolios, we widened our underweight position in developed international markets given their low earnings growth potential and continued risk of economic malaise. With the proceeds, we increased our overweight position in emerging markets.

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