Economic Update

A Review of First Quarter 2019

The stock market rebounded sharply this quarter, roughly making up for all of its losses during the fourth quarter of 2018. For the S&P 500, this marked the best three-month start to the year since 1998. The index climbed 13.1 percent during the period.

Economic news did not change substantially over the last three months, yet market sentiment clearly did during that time. First, we got an end to the government shutdown, which was the longest on record. All told, the shutdown lasted 35 days before finally coming to a close on Jan. 25.

More importantly, perhaps, was that we also saw a shift in messaging from the Federal Reserve Board of Governors. After initially telegraphing two likely raises during 2019, Jerome Powell changed his tune at the start of the year due to continued global economic uncertainty. As a result, not only did the Fed choose not to raise rates in January or March, but now it appears unlikely that we will even get one raise this year. In fact, market futures now predict that the next Fed move will be a *cut*, not a raise. Top White House economic advisor Larry Kudlow agrees. He is now calling for an immediate cut of 50 basis points.

U.S. Economy

While Kudlow is being a bit unrealistic, the yield curve does in fact seem to support at least one 25 basis point cut at some point this year. The bond market currently has very little confidence about the long term economic growth prospects for our economy. Depending on which portion of the yield curve that one looks at, we could be considered inverted now. At the very least, the curve is very flat. As of the end of the quarter, 30-day treasuries were yielding 2.43 percent annualized while 30-*year* treasuries were yielding just 2.81 percent annual return. That is a very small spread by historical measures.

The final estimate for U.S. GDP growth registered 2.9 percent during 2018. This is the highest growth rate since 2015. However, much of that was likely driven by last year's corporate tax cut and there is currently nothing of that magnitude on the horizon for 2019. In January, the IMF predicted 2.5 percent U.S. GDP growth 2019, but most economists now think that the actual number will be far below that level.

Oil prices rebounded along with stocks during the first three months of the year. After peaking at roughly $75 per barrel during October 2018 and crashing as low as $45 per barrel by the end of the year, West Texas Intermediate Crude has now split the difference between the two and closed the first quarter at $60.14 per barrel. While it is hard to predict exactly where the price of oil will go in the short run, booming U.S. shale production should continue to be a major force in keeping oil prices somewhat in control for at least the next few years.

Jobs numbers have been mixed for the past few months. The most recent reading shows that 196,000 jobs were created during March. This follows 33,000 new jobs created in February and 312,000 created during January. The unemployment rate is now 3.8 percent.

Like jobs growth, retail sales numbers have also been choppy during the last three months. In February, sales dropped 0.2 percent as consumers cut back on purchases of building materials, furniture, clothing, food and appliances. This followed a 0.7 percent gain in January and a 2.0 percent decline during the month of December.

That choppiness is consistent with the most recent Chicago Purchasing Managers Index readings, which dropped to 58.7 during March. This follows a 56.7 reading in January and a 64.7 figure in February. Still, the metric remains well above the 50.0 level that predicts economic expansion.

International Economy

While U.S. data continues to be mixed, signals are much clearer in Europe. Euro Area PMI has been trending down since December 2017. The most recent reading of 47.6 signals upcoming economic contraction. These warning signs have already forced the European Central Bank to rethink its plans for removing stimulus this year. The negative sentiment has also pushed investors into government bonds. As of this writing, the 10-year yield for German bonds is below zero for the first time since 2016. Core inflation is also down to just 0.8 percent.

Some of this could be an overreaction to Brexit news coming out of the U.K., which continues to be very discouraging. In late March, Prime Minister Theresa May’s EU exit plan was voted down by the British Parliament for the third time, leaving the country pretty much where it started three years ago, right after citizens initially voted to leave. Odds of an un-negotiated “hard” exit continue to increase as nobody seems to be able to agree about the terms of a negotiated one.

Recent optimism regarding U.S.-China trade negotiations could help combat the European malaise, however. As of this writing, President Trump says that we are now “rounding the turn” for an agreement. In anticipation of a likely deal, manufacturing PMI for Japan, South Korea and China all rose during this past month. A new deal would be welcome news since the World Trade Organization projects global trade growth at only 2.6 percent this year, which would be the lowest increase over the last three years.

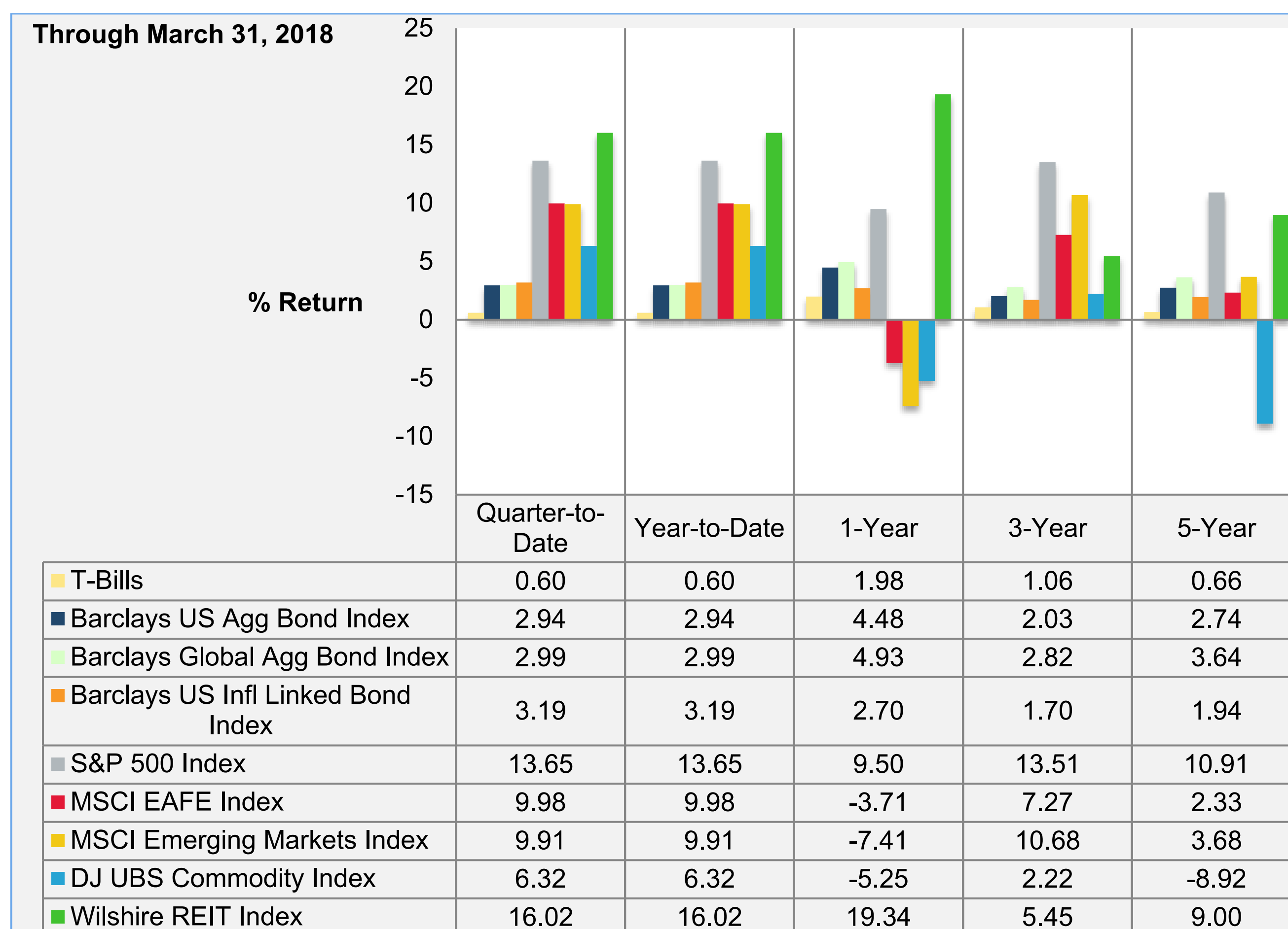
Markets

The first quarter of 2019 was very good for markets throughout the world, wiping out a lot of the losses experienced during the last three months of 2018. U.S. large-cap equities, as represented by the S&P 500 Index, gained 13.65 percent for the quarter. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter up 9.98 percent.

Emerging markets also mostly kept up with developed international markets for the first three months of the year. The MSCI Emerging Markets finished the quarter up 9.91 percent. Alternatives such as commodities and real estate experienced gains as well. The Dow Jones UBS Commodity Index gained 6.32 percent for the quarter, but is still down an average of 8.92 percent per year during the last five years. Commodities flourish when we see global growth and/or inflation and there have been scant signs of either one of those during the past five years.

The Wilshire REIT Index has been a big winner the past three months, gaining 16.02 percent during that time. Commercial real estate has benefited from declining long-term interest rates during the first quarter and should continue to perform well assuming rates continue to stay low.

Lower interest rates throughout the world allowed bonds to flourish as well. All of the benchmarks that we track had comparable returns during the quarter. The Barclays U.S. Aggregate Bond Index gained 2.94 percent, the Barclays U.S. Inflation-Linked Bond gained 3.19 percent and the Barclays Global Aggregate Bond Index was up 2.99 percent during the period.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.60	0.60	1.98	1.06	0.66
Barclays US Agg Bond Index	2.94	2.94	4.48	2.03	2.74
Barclays Global Agg Bond Index	2.99	2.99	4.93	2.82	3.64
Barclays US Infl Linked Bond Index	3.19	3.19	2.70	1.70	1.94
S&P 500 Index	13.65	13.65	9.50	13.51	10.91
MSCI EAFE Index	9.98	9.98	-3.71	7.27	2.33
MSCI Emerging Markets Index	9.91	9.91	-7.41	10.68	3.68
DJ UBS Commodity Index	6.32	6.32	-5.25	2.22	-8.92
Wilshire REIT Index	16.02	16.02	19.34	5.45	9.00

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

For what it's worth, a strong first quarter in U.S. markets has often been followed by subsequent gains for the next three quarters as well. The S&P 500 has risen more than 10 percent only four times since 1990, per analytics firm Kensho. In those years, the S&P 500 has then averaged an additional gain of 10.3 percent during the last nine months of the year.

A repeat of that history is certainly possible. While Europe is clearly in bad shape, Asia seems to be improving as of late. Also, U.S. stock valuation is still reasonable and while our economy does appear to be slowing, there continues to be enough positive data to support continued growth. Therefore, we

believe that we probably won't see a recession despite what the flat/inverted yield curve is currently indicating.

As a result of that yield curve, fixed income does not look particularly attractive right now aside from cash and short duration bonds. By comparison, stocks still look like a solid choice. With seemingly perpetually low interest rates and still reasonable valuations, we believe that the stock market could still have further room to grow from here. The biggest immediate risk, however, is the state of the current U.S./China trade negotiations, which look promising at this point but are subject to change at any time.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0 percent of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ The DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.