Market Commentary

March 31, 2019

Despite declining stock prices and mixed economic reports in Q4, the Fed hiked the federal funds rate in December and telegraphed two additional rate hikes in 2019. Investors revolted as stocks plunged and the US Treasury yield curve flattened dramatically. Suddenly, Chairman Jerome Powell and the rest of the Fed did a complete 180 on their outlook for monetary policy. Federal Reserve officials abandoned their previously hawkish rhetoric and began characterizing their stance toward further rate hikes as "patient."

Stock market investors apparently liked what they heard from the suddenly-dovish Fed. Since the stock market route reached its nadir on Christmas Eve, the S&P 500 has taken off. From 12/24/18 through April 12, the S&P 500 is up 24.4%. For the calendar first quarter of 2019, the S&P 500 returned 13.6%. In Q1, Growth stocks (16.2%) outperformed Value (11.9%). International Developed Markets (10.0%) and Emerging Markets (9.9%) lagged US domestic stocks in Q1. Given the strong performance of Growth stocks, it's no surprise that the Technology sector (19.9%) led the way. Every S&P 500 sector had double-digit returns in Q1 except for Financials (8.6%) and Health Care (6.6%).

The 10-year US Treasury finished 2018 at 2.69%, and then proceeded to trade in a range of 2.4% to 2.8% throughout the first quarter. The 10-year ended Q1 at a yield of 2.41%. The Barclays Aggregate Index returned 2.9% in Q1, driven largely by the performance of lower quality bonds. Similar to stocks, a dovish Fed provided a huge boost to the riskier segments of the fixed income universe. The BBB-rated component of the US Aggregate index returned 5.8% in Q1, while high yield (junk) bonds returned 7.3%. By comparison, the US Treasury component of the Aggregate was up only 2.1% in Q1.

The US Stock and Bond markets are currently sending very different signals regarding the outlook for investors. Stocks are soaring, implying that US corporate earnings, job growth and Fed policy are supportive of strong US growth and higher stock prices. Supporting this perspective, the Atlanta Fed's GDP Now model is projecting 2.3% growth in Q1, up substantially from estimates earlier in the quarter. US jobs grew at an average rate of 180,000 per month in Q1, and new claims for unemployment insurance reached a 49½-year low in March.

On the other hand, much ink was spilled during the first quarter discussing "inverted yield curves" and their track record as predictors of recessions. Economists like to focus on the US Treasury 3-month vs. 10-year yield relationship as a recession indicator. This curve briefly inverted in March, causing much consternation among analysts. Typically, the curve inverts when the Fed fears inflation and starts raising rates to slow the economy. However, the market currently sees few signs of inflation and investors are buying long-term Treasurys fearing the Fed will cause a recession. As former Fed Chairman Ben Bernanke said recently, "Expansions don't die of old age. I like to say that they are murdered instead." And the "murderer" is typically the Fed. Right now, the yield curve is quite flat, signaling that Fed policy is too tight, and if they aren't careful, could tip the economy into recession.

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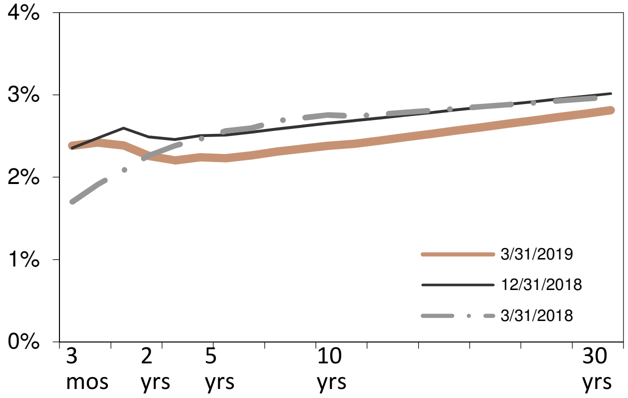
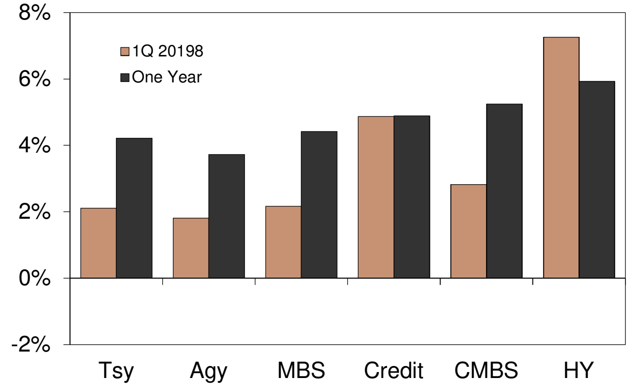
US Treasury Yield Curves



Sector Index Returns



So who is correct? Is it the euphoric stock market, which is once again approaching record highs, or is it the skittish bond market and it's fear of economic doom? At some point, it's likely that one of them will be proven right, and the other market will adjust accordingly. So we are likely to see a stock market selloff due to economic weakness OR higher interest rates as fears of recession subside?

The Fed and Chairman Powell have faced great scrutiny over the past few months. Powell has been accused of being tone deaf, seemingly determined to continue raising rates in the face of weakening economic data, faltering stock prices and a lack of inflationary pressures. After the stock market route, Powell appeared to back pedal, sounding much less strident regarding future rate hikes. Market expectations of 2019 Fed rate hikes have changed dramatically over the past several months. At one point, as many as four rate hikes were expected in 2019. Currently, the market has priced in zero hikes, with the small probability of a rate CUT in late 2019.

The Q4 stock market sell off has certainly improved equity valuations. While 2019 earnings estimates are currently being slashed, stocks look much less expensive that they did a quarter ago. In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. For the past several weeks, in expectation of higher rates, our client portfolios have maintained average maturities that are shorter than their respective benchmarks. While this defensive posture did not pay off in Q4, we believe that the US economy is on solid footing and rates are likely to drift higher in Q1 2019. Our portfolios continue to be underweight government and mortgage-backed securities, while maintaining an overweight position in the investment grade credit sector.