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First Quarter 2019 Newsletter

Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

Stocks posted strong gains in the first quarter of 2019, recovering most of last year's losses. The large cap S&P 500 index (**Figure 1**) posted a total return of +13.7% after losing -13.5% in the previous quarter. The Russell 2000 Small Cap index gained +14.6% as small company stocks benefited from improved confidence in the economy. International markets also rose, after suffering heavy losses in 2018, but continued to lag U.S. indices. Emerging markets (**Figure** 3) gained +9.6%, shaking off concerns about slowing growth in China. Developed countries outside the U.S., including Europe and Japan, rose +10.0%.

In the fourth quarter of 2018, large U.S. corporations posted double-digit earnings increases for the fourth consecutive period. S&P 500 earnings rose +13.1%, a sharp decline from the third quarter's 26% growth, but slightly better than the 12.1% expected at the beginning of earnings season. Revenue grew +5.8%, also a significant drop from third quarter's +9.3% gain. According to research service Factset, 69% of S&P 500 companies topped earnings expectations, which is below the 5-year average. This slowing in earnings growth was largely anticipated by stocks in the fourth quarter's index declines. Earnings expectations for 2019 have dropped significantly. Analysts now forecast +4.1% aggregate growth for the year vs. the +9% expected at the end of 2018. As companies report, market participants will be looking for signs of acceleration in the second half of the year.

Economic news in the quarter was generally weaker, reflecting the slowing telegraphed by stocks. Gross domestic product grew 2.1%, much slower than the third quarter's +3.4%. While GDP is expected to slow further, as of this writing economists are still projecting about 2% growth in 2019. Purchasing manager surveys, a closely watched sign of current and future activity, were weak at the beginning of the quarter, but began to firm in March. For the first time in seven months, housing starts showed some signs of improvement. Housing has been a weak area, as higher costs and rising interest rates have crimped profits for builders and hurt affordability for buyers. Consumer spending also slowed in the quarter, particularly for big ticket items like automobiles. Like housing, some of this may be attributable to higher interest rates. Employment has stayed very strong, with the unemployment rate below 4% and relatively few layoffs.

After half a year of mostly negative headlines, the first quarter brought U.S. investors some relief. After a year of tightening, the Federal Reserve signaled, and then confirmed, that they did not expect to raise interest rates in 2019. This change in policy was well-received by investors who bid up both stock and fixed income investments. There was

Index returns taken from Morningstar.com also more positive spin on trade negotiations with China, as administration officials have suggested repeatedly that they are making progress. In addition, the government shutdown that began in December ended with a new spending resolution. These factors boosted investor sentiment and stocks posted their best first quarter since 2009.

With interest rates stable, investors also added to fixed income positions, pushing bond yields down. The Bloomberg Barclays U.S. Aggregate Bond Index rose +2.9%, and some segments, including high yield bonds, posted even stronger results. However, this bond buying has had a potentially worrisome effect, as the yield on ten-year U.S. Treasuries (**Figure** 2) briefly dipped below the yield on 3-month Treasury bills. Generally, bond investors require a higher yield to hold longer term paper. This situation, known as an inverted yield curve, shows that investors are somewhat pessimistic about long-term economic growth, and may be expecting further slowing and interest rate cuts. We will continue to watch interest rates and other economic data for evidence of economic weakness.

European and Asian stock markets rallied in the fourth quarter, but still lagged U.S. markets. The slowing in Europe was marked by very weak German manufacturing data late in the quarter. As a result, the European Central Bank has moved to a more accommodative position, to help stimulate their economy. Chinese purchasing manager and export data was also weak for most of the quarter. However, at the start of the second quarter, new Chinese data indicated growth in their manufacturing sector, boosting investor optimism. While U.S. consumers are largely insulated from slowing overseas, U.S. multinationals such as United Technologies and Boeing rely on China for much of their growth. A rebound in China would help industrials (**Figure 4**) continue their rebound.

Fig. 3 – iShares Emerging Markets

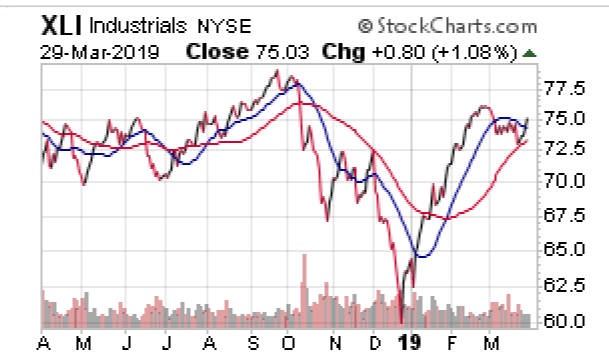

Fig. 4 – Industrial Select Sector Fund

The first quarter's strong rally underscores one of our primary investing principles. Investors are generally well-served staying invested through good times and bad.

We hope that you are well, and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard

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