Investment Review and Outlook

First Quarter 2019

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Markets Rebound Strongly in First Quarter, but the Economy is Slowing

An accommodative Fed acted to boost the financial markets after the December plunge, and the S&P 500 regained almost all its value by March. No recession is likely in 2019, but overall, US and global growth are slowing.

Highlights

- Equity markets rebounded strongly from worst December since WWII, back again near record highs
- Lower Fed rates and minimized inflation expectations drove favorable equity returns
- While markets are healthy, US growth is slowing: annualized 2019 GDP projected at 2.2% vs. 2.9% in 2018
- Late March inversion of yield curve indicates nagging concerns over growth
- US Employment strength: 196,000 new jobs in March vs. 20,000 in February, with solid wage gains
- Global growth projected by the International Monetary Fund at 3.3% this year, the lowest since 2009, due to the US drop, a sluggish China, trade uncertainty and an anemic Europe

Investment Implications

- No US recession forecast in 2019, but business cycle is mature and external risks of globalization are real
- Fed has managed inflation expectations smartly, so it can employ more strategies to support the economy
- Potential trade deal with China will likely provide market stability to offset Brexit risks and declines throughout Europe
- Tech Sector expected to slow down; IPOs are happening later in the cycle and valuations are higher and riskier
- Dividends are more important in a slow-growth environment

One Key Takeaway

- While we expect market volatility will increase during 2019, we will resist letting momentum dictate our actions. As we always counsel our clients, goals-based planning and investment management for the long-term are essential for financial success, and we will not be sidetracked by short-term market moves.

Economic and Market Drivers

Tailwinds	Headwinds
Dovish Fed Holding Rates	10 Year US Expansion Slowing
Low Inflation Expectations	China Growth Peaking
Accommodating Global Monetary/Fiscal Policy	Europe on Edge of Recession
US Wages Up/Unemployment Down	Waning Effects of Tax Cut
Consumer Confidence Rebounding	Political Uncertainty
Tax Changes Driving Demand for Municipal Bonds	Flattening Yield Curve for Treasuries

Economy

Despite a cautious business sector, we expect consumer spending to increase and support US GDP growth of 2.2% for 2019.

Economic Growth Slowing: We have revised our forecast for US annualized GDP growth down from 2.6% to 2.2%. Growth is slowing everywhere, as trade disputes, Brexit uncertainty, the December 2018 market sell-off, and the Q1 US government shutdown all weighed on activity. China has been modernizing for 30 years, so its growth will probably be in the lower 6% range, after exceeding 9% average GDP since 1989. Europe is struggling mightily because of lower consumer spending and an unfavorable balance of trade; a recession is possible, especially if Brexit creates further problems for the UK and its trading partners. Emerging markets have cooled, so global GDP is very dependent on US and China reaching a deal on trade.

GDP of Major Countries/Regions
2019 Annualized Projections

	2016	2017	2018	2019 est.	2020 est.
US	1.6	2.2	2.9	2.2	1.9
EU	2.0	2.5	2.0	1.5	1.6
UK	1.8	1.8	1.4	1.3	1.5
China	6.7	6.8	6.6	6.2	6.0
Japan	0.6	1.9	0.8	0.7	0.5
India	8.2	7.1	7.2	7.0	7.3
S. Korea	2.9	3.1	2.7	2.5	2.5
Brazil	-3.3	1.1	1.1	2.0	2.5

Source: 1919, Bloomberg

Decline in Retail Sales: The most troubling impact on domestic growth was a sharp deceleration in the retail sector, traditionally a key driver of the US economy. Retail sales unexpectedly fell 0.2% in February, continuing the downward trend which began in December, exacerbated by the 35-day government shutdown and extreme weather.

Employment Recovery: The very positive March employment report (196,000 new jobs added vs. only 20,000 in February, unemployment holding steady at 3.8% and a 3.2% increase in hourly wages vs. 2018) shows that companies are once again expanding workforces and increasing wages and benefits to stay competitive. The quarter-over-quarter rise in the labor participation rate is significant, too, because it ensures a supply of workers in an otherwise tight labor market. Positive labor trends will further support consumer confidence and spending, at a time when the savings rate is rising.

Effect of Tax Reform: The limitation on the deductibility of state and local taxes as a result of the 2017 tax reform is predictably hurting high-tax states. Overall, individual tax refunds are down slightly versus last year, but the full effects will not be understood until after April 15th. Meanwhile, the impact of lower corporate taxes continued to drive balance sheet strengthening and stock buybacks, but it has not yielded significant capital reinvestment.

Business Sector Disappointing: Global trade disputes and the economic slowdown in China had a negative impact on both corporate earnings and business confidence. Manufacturing activity has slowed markedly, due to declines in outputs and new orders. While the economy as a whole benefitted from a stocking of inventories last year, prompted by uncertainty over trade policy, the lack of progress on infrastructure will likely hinder any meaningful progress this year.

Housing Expected to Improve: Lower interest rates should stop the rise in mortgage rates that occurred with the interest rate moves of the Fed last year. While affordability and tight inventories are still an issue in certain parts of the country, a drop in conventional mortgage rates closer to 4% should rejuvenate the sector, particularly in an environment of rising wages.

Risks from Leveraged Loans: There are more than $1 trillion in leveraged loans made by banks and other institutions to companies that needed cash and borrowed heavily at lower rates. Many of these borrowers have unfavorable balance sheets and are vulnerable to an economic slowdown. 2017 deregulation eased underwriting requirements, so large banks could lend more easily to risky borrowers and re-sell these loans as Collateralized Loan Obligations (CLOs). The banks are not at risk because they do not hold the CLOs on their own balance sheets, yet the overall risk to the economy from leveraged loans is unknown. We will be watching this situation closely.

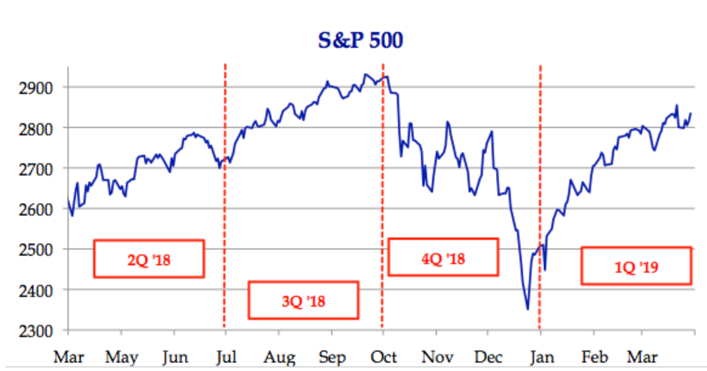
What We're Thinking

- One year ago, growth was on the rise in 75% of the world, but today, the opposite is true: Europe is the greatest risk factor, and policy choices are limited for already accommodative central banks
- Despite lower growth, the US economic picture is solid in many key fundamentals. A trade deal with China, consumer confidence and managing through occasional market volatility are keys to staying on track for 2.2% growth

Equities

After the significant market downturn at the end of 2018, the Fed sent positive signals to start the year, investors quickly regained their confidence, and the US stock market rebounded to near-record highs for the First Quarter.

The Fed is Flexible and the Market Responds: At the January 4th annual meeting of the American Economic Association, Fed Chairman Jerome Powell announced that "we will be prepared to adjust policy quickly and flexibly and use all of our tools … to keep the expansion on track, to keep the labor market strong and to keep inflation near 2 percent." That was what the market was waiting to hear: equity markets responded that day and kept going strong, with the S&P gaining back almost all of the Fourth Quarter 2018 loss. Low inflation expectations and lower rates produce a favorable environment for equity valuations to expand, even with slowing growth, and the Fed has strongly bolstered growth prospects by managing inflation risks and being nimble in its policies.



Source: Strategas

Earnings Growth is in Late Cycle: Growth expectations for Earnings Per Share are slowing in 2019 as we are in the mature stage of the expansion and GDP is moderating at 2.2%. First Quarter 2019 earnings for the S&P 500 will probably decline slightly year-over-year, since the effects of the corporate tax cut enacted in late 2017 fueled unusually high earnings through the first half of 2018. A drop in corporate earnings this quarter would be the first decline since Second Quarter 2016. We are projecting EPS growth of 7% in 2019 and 6% in 2020. Throughout the year, earnings growth will likely be more highly sought by investors, as profit margins decline and the risks of periodic volatility rise.

US Equities Rise: The S&P 500 return of 12.9% led both Developed Markets (EAFE) rise of 9.5% and Emerging Markets (EM) growth of 8.6%. EAFE was propped up by the large transnational energy providers but hurt by the flagging domestic economies of Western Europe and Japan. EM was pushed higher by China, up +15.8%, as fears of a trade war with the US receded. Growth of 14.2% in US Small Cap equities edged out the Large Cap (S&P 500) growth in the quarter.

Technology, Health Care Sectors at Risk: Technology led the S&P 500 sectors with returns of 18.70%, as investors appear less concerned about valuation than faster growing earnings. The Unicorn phenomenon -- billion dollar valuations for start-ups that are still unprofitable after years in business -- is a warning sign of greater volatility ahead. While growth domains within the Tech sector such as semiconductors (linked to 5G networks) and cloud computing are solid, the FAANG stocks (Facebook, Amazon, Apple, Netflix, Google) are finally slowing down. Health Care was the weakest sector in First Quarter 2019, up only 5.4%, with the political rhetoric about reductions in drug prices and restructuring of the insurance landscape clearly having an impact on investor confidence.

Public vs. Private Markets: Perhaps the greatest amount of overall risk lies in Private Equity (PE), where a downturn could have a disproportionate impact on the stock market. As an asset class, PE has catered largely to institutional investors who seek to capture the "private illiquidity premium." As institutions flooded into PE, they created a closed-loop system and took on huge amounts of debt. PE also became an investor in Tech Unicorns and other risk-enhanced businesses. If there is an asset bubble in the future, it is more likely in the private vs. public markets.

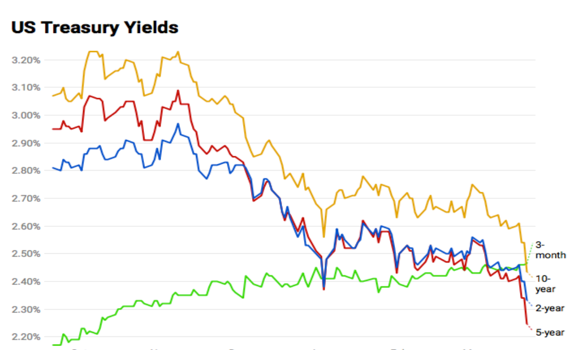
What We're Thinking

- Revenue and EPS growth become valuable attributes as the 10-year US expansion slows
- Dividends, supported by revenue and EPS growth, become more important to investors at this point in the cycle
- A low interest rate environment and an accommodative Fed will provide some support to corporate valuations
- With the US stock market at historic highs, we consider this a good opportunity to trim stocks and replenish spending reserves for our clients, where appropriate

Fixed Income

For the first time since 2007, the yield on the 10-year Treasury note dipped below the 3-month bill. Is this inverted yield curve a harbinger of a looming recession?

The Inverted Yield Curve: Yields on shorter-dated securities are typically less than the yields on longer-dated ones, because investors who put money into Treasuries for an extended period of time should earn a greater return for taking on more risk. What happened on March 22nd was unusual: the 10-year yield fell below the 3-month yield. An inverted yield curve has often served as a predictor of a recession; in fact, an inversion has happened between 2 months and 2 years before each recession in the US over the past 50 years. We believe that the unprecedented period of low interest rates and minimal inflation risk during the current expansion has flattened the yield curve much more so than in past decades. The March inversion is more likely to be a signal for the Fed to cut rates than to indicate a recession is near.



Source: Fact Set

Treasuries: Increased domestic demand for Treasury securities, and the Fed's reduction in new supply, provided a positive technical backdrop for the quarter. We could see corporate bond spreads widen relative to Treasuries if the US economy and corporate earnings weaken further, and if the trade deal with China does not happen.

Investment-Grade Corporates: Returns for investment-grade corporate bonds were positive and supplies increased significantly from the shortfalls in the Fourth Quarter 2018. Spreads narrowed for the quarter with lower-quality BBB credits tightening more than higher-quality single-A bonds. With expectations of rate stability, we believe that these bonds are in fair-value range.

High-Yield Corporates: HY bonds saw material gains, due to low inflation expectations and more primary market activity. Lower-rated credits (BBBs) and longer duration generated the highest returns. Some sectors could be affected by the slowing economy, including Industrial, Technology and Consumer Discretionary.

Best Muni Performance in 6 Years: A healthy technical backdrop for municipal bonds fueled a 2.91% return, the strongest quarterly advance since 2014. Demand for traditional tax-free bonds is surging, due to the recently enacted cap on the deductibility of state and local taxes, driving investors into the tax-free bond market to soften the impact.

What We're Thinking

- Given the Fed's accommodative stance, we no longer expect a rate hike this year; the 10-year Treasury yield will have a difficult time approaching 3%.
- Investment-grade corporate bonds provide credit quality and are relatively attractive; Munis provide tax-free income on interest and often provide a better after-tax yield to a comparable Treasury bond.

Conclusions

We are cautiously optimistic that we are in a period of moderation, rather than deceleration

- After a volatile Fourth Quarter 2018, US markets have proven to be resilient; we foresee a period of slower but still solid growth in 2019, with US GDP at 2.2%
- The 10-year economic expansion in the US and the persistence of low rates and low inflation should hold reasonably stable through 2019, but fundamentals and global realities could give way to a recession by 2021
- We foresee market volatility increasing in the coming year, as the US expansion slows and the 2020 election creates uncertainty, but we believe US equities are reasonably valued and, in many cases, offer good sources of income through dividends

As always, our focus is on protecting and growing your wealth, regardless of economic conditions or the business cycle. Each individual, family and institution has unique needs, aspirations and values, and our commitment is to create tailored investment solutions that provide you with the freedom to realize all of your goals.