Market Review

First Quarter 2019

Equities rebounded sharply in the first quarter from Q4 2018 lows with large-cap stocks (as measured by the S&P 500 Index) rising 13.1%, and small-cap stocks (as measured by the Russell 2000 Index) increasing 14.6%. The S&P 500 posted its best three-month increase since Q3 2009, and all major U.S. equity indices closed out March with quarterly returns ranging from roughly 12% to 20%. During the first quarter, growth stocks noticeably outpaced their value counterparts. Within the large-cap space, the Russell 1000 Growth Index increased 16.1% versus an 11.9% rise for the Russell 1000 Value Index. The discrepancy was even larger within the small-cap spectrum, as the Russell 2000 Growth Index increased 17.1% versus an 11.9% rise for the Russell 2000 Value Index. On a trailing 12-month basis, growth stocks maintained a wide lead over their value counterparts (12.8% vs. 5.7%, respectively within large-caps; and 3.9% vs. 0.2%, respectively within small-caps).

Throughout the quarter, investors focused on key economic and trade developments. The monetary policy minutes released from late March indicated that the Fed is keeping its options open as it assesses significant economic uncertainties; however, markets remain confident in the belief that the Fed will maintain a data-dependent approach concerning rate increases. After the most recent updates, end-of-March CME Group projections place nearly a 57% chance that rates will be cut by the end of 2019, with approximately a 43% chance that rates will remain unchanged.

Also in March, the yield curve became a key consideration for investors as some longer duration Treasury yields were lower compared to those with shorter duration. Historically there has been a relationship between inverted yield curves and recession over the subsequent few years. Specifically, the 10-year Treasury yield dipped below the 3-month yield the first time since August 2007, igniting concerns over economic stability, however other key yield relationships remained positive (notably the 2-year and 10-year). According to Bloomberg data, “false positives” in yield curve inversions are relatively common in the later stages of market cycles. While the recent inversion warrants monitoring, the quick recovery of the yield curve - and the modest nature of both its duration and negative spread- has led investors to believe that the inversion was more of a result of technical factors rather than fundamental economic issues, and no reason to sound the alarm bells.

Turning to international trade, negotiations between U.S. and Chinese officials continued throughout the first quarter. Although reports in early February hinted that the two sides were still far apart, subsequent updates provided a sense of confidence in regards to a deal being struck. Optimism was further bolstered after Secretary Mnuchin indicated that both parties have primarily agreed upon an enforcement mechanism. Skeptics, however, point to the fact that the administration has declined to commit to a hard deadline to finalize a deal while also refusing to

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state whether or not it would agree to lift the tariffs it imposed last year, even in the event an agreement is reached.

Activity in the manufacturing sector expanded for the 31st straight month in March as the Institute for Supply Management's Purchasing Managers Index increased by 1.1% from its February levels to 55.3% in March; however slowdown was seen in several key indicators, such as inventories, backlogs, new exports, and supplier deliveries. Job growth rebounded in March after February's employment slowdown raised investors' concerns over general economic weakness. Specifically, nonfarm payrolls rose by 196,000, beating estimates of 177,000. Wages grew by 3.2% year-over-year, a pace which should continue to elevate consumer confidence, and subsequent spending, but is still below the 4% threshold that investors often note, by historical standards, to be the potentially problematic growth rate which could threaten economic output. Unemployment held steady at 3.8%, a near-cycle low, and the labor force participation rate dropped slightly to 63% but remained close to recent highs. Furthermore, initial jobless claims, often considered a leading measure of the health of the U.S. economy, fell to 49-year lows, indicating labor markets are experiencing stable hiring conditions as unemployment continues to decline.

On the commodities front, West Texas Intermediate crude rose 32% in the first quarter. Crude's rise has mostly been attributed to voluntarily supply cuts by OPEC and other major producers, prices being propped up by U.S. sanctions on Venezuela and Iran, and general optimism in global trade due primarily to the U.S.-China trade talks as well as better-than-expected demand from China.

The market's year-to-date rally has lifted the price-to-earnings multiple on the S&P 500 to just over 17x 2019 earnings expectations, which is not differentiated from the long-term median multiple. With inflation as benign as it has been at below 2%, there is little reason to believe stocks can't trade at mid-to-high teens multiples, particularly if a recession remains absent over the near-to-intermediate terms. While material expansion in price-to-earnings multiples is unlikely at this perceived late-stage of the economic cycle, a healthier backdrop for corporate profitability could support further market advances. As always, we will continue to remain steadfast in our bottom-up approach and target stocks with relatively attractive valuations and the ability to exceed consensus expectations.

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