Investment Update
First Quarter 2019

Stock and bond returns in 2019 have been quite strong after a tumultuous fourth quarter of 2018. The stock market's initial downturn in October was based on reasonable fundamental concerns but, as outlined here three months ago, the negative price action throughout the rest of the year seemed caused by several different self-reinforcing technical factors. By Christmas Eve, when the S&P 500 was down 20% from its September highs, the selloff simply seemed overdone based on any evident deterioration in fundamentals alone.

Last quarter investors had worried that the Fed was set to increase short-term rates several more times in 2019 despite signs of moderating domestic economic growth and various other threats posed to global growth. Since then, the Fed has reversed course and made it clear that it is unlikely to raise interest rates in 2019; that it will stop shrinking its balance sheet sooner than anticipated; and that rather than targeting 2% inflation it might potentially allow actual inflation to drift higher as long as it stays, on average, near that level.

Equity Markets (Total Return)	1Q19	1-Year
Dow Jones Industrials	11.8%	10.1%
S&P 500	13.7%	9.5%
S&P Mid-Cap	14.5%	2.6%
S&P Small-Cap	11.6%	1.6%
MSCI All-Country World	12.3%	3.2%
MSCI Foreign Developed Markets	10.0%	-3.7%
MSCI Foreign Emerging Markets	10.0%	-7.1%
US Bond Markets	**1Q19**	**1-Year**
Barclays US Govt/Credit Intermediate	2.3%	4.2%
Barclays US Govt/Credit Long	6.5%	5.2%
BAML Municipal Intermediate	2.2%	4.6%

With prior concerns about the Fed largely allayed, and liquidity returning to the market in the New Year, stock prices have rebounded persistently throughout this first quarter and the S&P 500 is now back just short of 2018 highs. The other major indices we follow trailed but were not far behind, although the performance dispersion is markedly larger looking back a full year. Bond prices have rallied (with yields falling), reflecting the dampened inflation and growth expectations that investors worried the Fed was overlooking in 2018.

The Treasury yield curve briefly inverted in March, with shorter-term securities yielding more than those with longer maturities. Historically inversions have proceeded every recession, so avoiding prognostication about what this one means has been near impossible, and you will not avoid it here as we would like to make several observations.

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First, while the bond market typically does a better job than the stock market at forecasting recessions, there have been several instances of inversions not being followed by a recession. Second, while the Treasury yield curve did invert last month, the curves for other significant sectors of the bond market (municipal, corporate, and mortgage-backed bonds) maintained their normal upward-sloping shape, suggesting that perhaps there were idiosyncratic supply and demand dynamics at play at various points along the Treasury curve. Finally, even if the predictive power of a yield curve inversion again proves correct, the recession still typically does not arrive until as much as 12 to 24 months later, and further stock market gains during this period also are common.

Surveying the policy and economic landscape for trouble, we find most areas are generally moving in a supportive direction for the economy. In the US, monetary policy is now more accommodative than previously expected and the Fed does have time and some room to make it even more so should that appear necessary. Changes to regulatory and fiscal policies continue to make it easier for companies to do business and are allowing them to keep more of each dollar they make. Credit spreads have tightened and commodity prices are not contracting, two important indicators that normally move in the opposite direction when a recession is imminent. While trade policy has been troubling the last few years, most ongoing disputes appear headed for positive outcomes, including the most significant one with China. Global economic growth definitely continues to be weak, which will hurt the earnings and perhaps the stock prices of multi-national corporations, but exports are only about 12% of our economy so it would be difficult for this weakness alone to cause the US economy to contract.

We cannot absolutely rule out a recession in the near future, but on balance we do not think one is likely, absent some sort of exogenous event whose likelihood and effect are difficult to handicap in the first place. Even if we are wrong on this point, a long or deep recession would seem unlikely given that we do not currently see the sorts of speculative excesses that were on display leading up to the internet and housing bubbles.

Nonetheless, the stock market drops on concerns of an imminent recession with some frequency, often just as much as it would in an actual recession. Most of the time, the market is proven wrong (there is an old saying to the effect that "the stock market has correctly predicted six of the last four recessions") and prices rebound. Even when the market correctly anticipates a recession, it eventually ends and prices rebound then too. Our role as advisors is to make sure that sufficient cash for known client spending needs is out of the stock market and available regardless of where we are in this cycle, and to position overall portfolio allocations so that clients are comfortable with the amount of risk taken and we are not forced to act at inopportune times when these inevitable gyrations occur.

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