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2019
1st QUARTER

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The Equity Market

Cautiously Optimistic

By Sarah Swan
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The first quarter of 2019 was certainly easier to stomach than the one prior in which we experienced a dramatic sell-off to finish 2018. Refreshingly, the S&P 500 Index finished the first quarter up over 13%, recouping nearly all of its losses from the fourth quarter (although it hasn't quite cut through its 2018 high of 2929.67). This was actually the market's best start to a year since 1998—and every sector brought in positive returns. Market performance is just one piece of the puzzle, though, so we look to the economic backdrop and the behavior of monetary and political policy makers to get a true pulse on things.

Current Market Environment

US equity market multiples started the year fairly cheap but have crept up to be on the higher end of normal, based on historical averages. The market now trades at 16.8x forward earnings. While the valuation of the market is not at its peak, it's no longer considered cheap outright—it is pretty in line with levels we saw in mid-2018 (before the nightmare that was the fourth quarter of 2018). The strong corporate earnings growth investors may have become accustomed to the past couple of years (boosted, too, by 2017 tax cuts under President Trump that should be seen as a one-time event already well-priced in) isn't likely to be repeated in 2019. 2018's sizable earnings beats set a very high bar, and one that will be difficult, if not impossible, to surpass again this year.

continued on page 2

John Trentacoste,
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The Bond Market

1st Quarter Overview

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The fixed income markets certainly started off 2019 on the right foot. To use an old saying generally reserved for the month of March (though this is a quarterly commentary), the first quarter came in like a lion. The first two weeks of 2019 saw 10-year Treasury yields jump by over 20 basis points. And the first quarter went out… like a lion. Following the volatility that we saw in the last quarter of 2018 in risk assets (equities and non-Treasury securities) and the resulting flight to quality, the Federal Reserve's attempt at calming the markets had an over-sized effect of sending them in the opposite direction.

Over the years a number of buzzwords or phrases have been concocted to explain the Fed's intentions; more commonplace are the terms "rate hikes" or "rate cuts." But more technical terms might include "quantitative easing," "dot plot," and "symmetrical." There is also the more unusual, such as "irrational exuberance" used by then Fed Chairman Alan Greenspan in a speech in 1996 about the dot-com bubble.

More recently, by the time the Fed raised the overnight rate in December to 2.25%-2.50% (the fourth quarter-point increase in 2018), equity markets had fallen dramatically, and credit spreads were closing in on the widest they had been since the middle of 2016.[1] The markets needed a new buzzword—one that should describe the Fed's new intentions: patience.

continued on page 3

Many recent earnings announcements are showing signs of material deterioration in corporate profitability. Essentially, current market multiples are likely not validated unless earnings growth turns out to be much better than what is currently expected. Therefore, we are prepared for negative growth or single-digits earnings growth for the remainder of 2019, but there is some hope we could be at the trough.

The Economy Near and Far

Domestically, our economy is holding up just fine, but it is slowing a bit. First quarter GDP estimates are expected to come in a little weak, which is not un-meaningful, but it also tends to be the case that first quarters stray from trends we see throughout the rest of the year. For instance, the first quarter could be skewed slightly by seasonal factors and the government shutdown we experienced during the first few weeks of the year. That being said, no one expects to grow like gangbusters in the remainder of 2019 either—we've already discussed the lack of contribution expected from corporate earnings. A bright light does continue to be labor markets, which are still quite positive overall, even despite small blips—the unemployment rate is sticking around its long-time low and wages are increasing. Inflation has receded, as have expectations for it, despite increasing wages and higher prices for some goods. It is also important to remember that in late March, we saw the inversion of the 10-year and 3-month Treasury yield curves, which is historically a dependable indicator of impending recession (and is certainly indicative of investor sentiment of the state of economic affairs). In a normal environment, longer-term investors are compensated with better interest rates than those who loan money for a much shorter time period. Its usual upward shape can change when investors think economic growth and inflationary pressure is likely to fall, which is what we saw just before the quarter ended. However, the inversion was a temporary and short-lived one, reducing its strength as a negative indicator.

Globally, several of the world's largest economies are slowing, too, and some of them seem dangerously dependent on their central banks who are quick to step in and provide dovish support (not wholly unlike the US right now, mind you). China's economy, arguably the largest driver of global GDP growth, is showing signs of bottoming in 2019, which would be positive for recovery. The euro zone will hopefully see stabilized growth soon, although it's struggled with general weakness in manufacturing data in some of its larger economies, as well as just general sentiment. We know that the euro zone is no stranger to geopolitical concerns—namely the impending Brexit process (which was voted on nearly three years ago at this point!) that has now been delayed another six months to October. Kicking the can down the road certainly helps with short-term volatility, but we're too old to believe that the issues don't come back with a vengeance later on—a hard Brexit, or an exit from the Union without a solid deal in place, would be the default if agreement isn't reached. This kind of haphazard exit is the exact sort of thing that economies and markets do *not* like.

Speaking of kicking the can down the road, trade relations have become a crucial part of the perception of global economic health. Ever since early last year when the planned levying of US tariffs on Chinese imports took the scene, ongoing negotiations about trade policy have been critical in investors' assessment of prospects for global growth and, at the very least, have dictated market movements on countless occasions. Over the last few months we've seen the trade dispute between the US and China begin abating, but we've yet to see any real deal hammered out. This headwind, and global trade more broadly, isn't going away anytime soon, especially when President Trump's protectionist ideology isn't unique to our relationship with China. As we have said before, the topic of trade wars is not one to be taken lightly, and we won't underestimate its power to impact global growth and the onset of a global recession.

You Have Our Attention, Fed

Just as everyone's eyes were on the Fed last quarter, the central bank still holds investors' attention. What's changed is not only the Fed's sentiment about its course of action going forward, but people's perception of what that means for the economy. Last time we talked, investors feared that the Fed's continued tightening could accidentally launch the economy into a recession. Developments over the past few months have quelled investors' fears that monetary policy error could get us in recession-like trouble. This is because the Fed has softened its approach and has committed to a path of patience regarding raising short-term interest rates—and for now, the fed funds rate will remain unchanged at 2.25%-2.5%. Whereas two quarters ago, Federal Open Market Committee consensus was for four more rate hikes in 2019-2020, consensus now conveys expectations for just one hike in 2020. The markets seem to be forecasting an even more dovish path for the Fed, suggesting at least one cut before the end of 2019 with possible additional cuts in 2020. We fear this market optimism over the Fed might be overdone, especially since it's been driving the market in a big way.

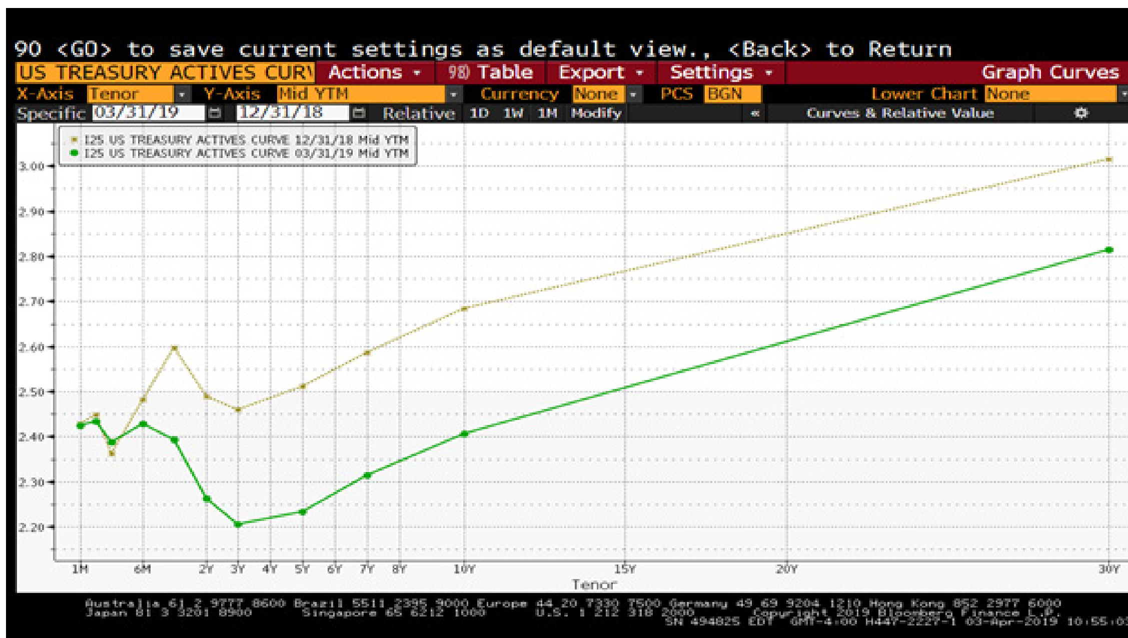
continued on page 4

During the press conference following the Federal Open Market Committee (FOMC) meeting on January 30, the market was keen on hearing patience, and Chairman Powell revealed some big changes in Fed thinking since the previous meeting in December. The Fed's monetary policy statement referred to softer inflation expectations, a downgrade to economic growth, and specifically stated that "the Committee will be patient…". What Powell did not talk about was the dot plot (individual Fed Governors' expectations for the fed funds rate going forward). That left open the potential for the Fed to more easily drop the levels at subsequent meetings.

Suddenly the markets were reveling in the idea the Fed could "pause" any further rate hikes to at least much later this year (that is another buzzword heard many times over the past few months). At the March 20 FOMC meeting, the Fed made no change to the overnight rate, spoke more of the global economic slowdown and its effects on our economy, lowered the dot plot materially, and confirmed it will have a larger balance sheet than originally thought. The Fed will again be one of the biggest buyers of Treasury securities. There is a buzzword for that: "reverse taper." The second half of March saw 10-year Treasury yields fall a full 20 basis points, down almost twice as much from the high-water mark in the middle of January. Strong performance in the fixed income markets prevailed with some sectors trading as though the next move by the Fed will actually be a rate cut by mid-year. In our view, a near-term rate cut is unlikely, though we do believe the overnight rate will hold steady the remainder of this year.

For the quarter, the Bloomberg Barclays U.S. Aggregate Index, the broadest bond market index, returned 2.94%. The Bloomberg Barclays Intermediate Government/Credit Index, our benchmark, returned 2.32%. Intermediate Treasuries returned 1.59%, while intermediate corporate bonds returned 3.82%. Investors welcomed back corporate debt in a big way during the first quarter as seen in the spread compression of the Bloomberg Barclays Aggregate option-adjusted spread. After topping at 157 basis points in January, spreads rallied back to finish the quarter at 119 basis points.[2] In the corporate bond market, as is typical with risk-on trade, not only do lower rated bonds outperform higher quality names, but long maturities outperform short maturities. Within the broad market index, triple-B rated securities, the lowest category of investment grade bonds, returned almost 6%. The highest quality returned just over 2%. The longest maturity bonds returned approximately 6.5%, while the 1–3-year maturity range returned 1.22%. Intermediate investment grade financial bonds performed very well during the quarter, returning 3.85%. We have been selectively adding financial names (banks and non-banks) to our clients' portfolios, as we see strengthening balance sheets and the potential for mergers and acquisitions.

In the tax-exempt markets, the Bloomberg Barclays Quality Intermediate Index returned 2.35% for the first quarter of 2019. So far this year in the municipal bond market, we have not seen new issue supply keep pace with demand. We noted in the fourth quarter commentary how retail demand had been picking up last year due to tax law changes.



Source: Bloomberg

continued on page 4

The Equity Market *continued from page 2*

Remember, 10 of the last 13 Fed hiking cycles have culminated in recessions and, interestingly, the other 3 involved the Fed actually cutting interest rates. Furthermore, historically, it is not uncommon for the Fed to forecast positive growth in the (unknown) face of a recession. These serve as important reminders that the Fed's actions are very important and that by no means is it an all-knowing policy making body.

Our Plan of Action

While we still do not believe a recession is imminent, it isn't out of the realm of possibility, and it is a natural part of the economic cycle to some degree, especially this late in a historically long bull market. We do think an earnings recession or prolonged sluggish growth are much more palpable possibilities at this point. Therefore, we consider ourselves to be cautiously optimistic and always on watch for signs of a significant downturn.

We are trying to focus our portfolios on quality companies with lower relative valuations, consistent earnings, and generally strong balance sheets (these are the companies that tend to hold up better in difficult times—even during recessions). We are also trying to minimize exposure to names with big growth stories and stretched valuations that tend to be much riskier, especially at these volatile times. While it may not be as exciting to stick to what's safe when the market is still producing some big winners, it's a much better position to be in in the event of a downturn or sudden spike in volatility. As has been the case for several months now, we think it is most prudent to capitalize on any volatility we see by getting into quality names we've been eyeing at more attractive price points.

End

The Bond Market *continued from page 3*

Demand for tax-exempt bonds has remained robust this year, possibly due to tax payers now seeing the effects of reduced SALT deductions as tax returns are being prepared. [3] In high tax states (NY, CA, and others), it is especially telling as yields on in-state bonds have fallen below the general market, triple-A rated yields. Inflows to tax-exempt mutual funds, just one sign of increased demand, have averaged almost $1 billion per week this year, well ahead of previous years. Municipal bonds relative to Treasury securities less than 10-years to maturity are the richest they have been in at least a decade. For these reasons, and for greater diversification, we have been adding more general market, tax free securities and using the 10 to 15-year maturity range to add incremental income and find more attractive offerings.

During the first quarter we have continued work on our strategic objective of increasing the overall quality of our clients' fixed income portfolios. We continue to believe the chances of a recession in the near term are low but not out of the question. In this late cycle environment, we are keeping a close eye on lower rated bonds. We know that in the first quarter, downgrades for U.S. companies versus upgrades were the highest since early 2016. The snapback in price on many such securities provides a better exit opportunity. We look at our positions on a case by case basis in order to maintain high current income without subjecting the portfolios to undue risk and volatility. We are comfortable with our neutral duration target for benchmarked accounts with a slight overweight to credit in the taxable portfolios. For our clients invested in municipal bonds, we are adding intermediate maturity bonds priced to a shorter call feature. The year has started with strong price performance, but adding incremental income will help performance for the entire year and beyond.

End

[1, 2] Bloomberg Barclays US Aggregate Corporate Average Option Adjusted Spread

[3] The federal cap on state and local tax deductions that was part of the 2017 tax overhaul which went into effect in 2018.

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