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Economic & Financial Market Outlook

Spring 2019

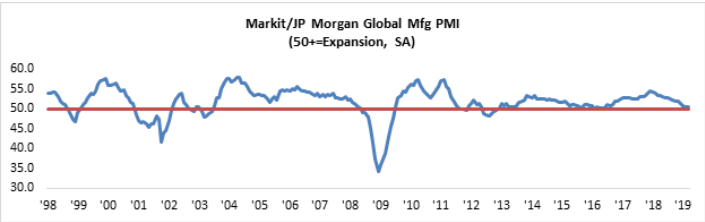
This summary is provided by BMT Wealth Management.

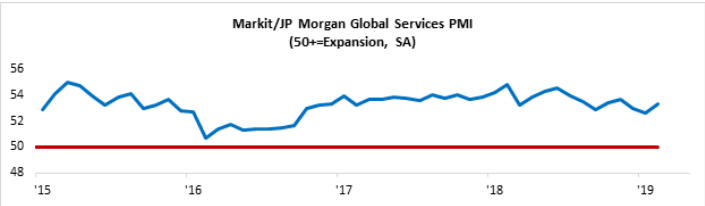
Global Economic Data Continues to Weaken

The global synchronized growth narrative that was the consensus view in late 2017/early 2018 has not materialized. Throughout the course of 2018 and thus far in 2019, albeit there only three months of data currently available, various economic readings used to measure growth have clearly weakened given a combination of more hawkish Fed monetary policy, concerns over global trade, the waning effects of fiscal policy (i.e., tax cuts), various geopolitical uncertainties (Brexit), and elevated debt levels.

The charts below show Global Purchasing Manager Index (PMI) survey readings for both the manufacturing and services sector. PMI respondents answer questions across five key areas: new orders, inventory levels, production, supplier deliveries, and employment. The responses are aggregated and assigned a score from 0 to 100. A numerical value above 50 is indicative of an economic expansion, while scores below 50 signify a contraction.

Global PMI Data: Manufacturing (1/98-3/19) & Services (1/15-3/19)





Source: Strategas Research Partners

As you can see from the charts, global economic growth has clearly slowed. The decline has been much more pronounced in the manufacturing segment of the economy. The services sector, which accounts for a larger percentage of global economic output relative to manufacturing, has experienced a more modest slowdown.

We've mentioned in previous market summaries that we thought economic growth would slow as the business cycle matured. A declining growth rate does not always result in a contraction. There were two other occasions when growth has slowed this business cycle, but a recession did not commence. Although we don't foresee a recession occurring in the near term, we are monitoring various economic data points, especially developments in the labor market, and looking for any indication that a more severe slowdown may be developing.

Yield Curve Inversion Hysteria

Countless articles have been published about the recent inversion of the yield curve and the imminent doom of higher risk assets, especially stocks. An inversion of the yield curve, 3-month T-bill interest rate > 10-year Treasury interest rate, has preceded a recession, usually within 18 months, of each of the last seven business cycles; this explains all the attention from the financial media.

We analyzed returns for stocks and bonds after the 11 occasions when the yield curve first inverted since the early 1960s, as indicated by the table below. We concluded that investment results have varied quite dramatically depending on the period analyzed. Yield curve inversions were a sign for sub-par returns for equities in the late 1960s/early 1970s, 1990s and the most recent period (1/2006). Equity returns were very strong after yield curve inversions in the late 1970s and 1980s. On the fixed income side, subsequent

returns were more a function of the interest rate level going into each of the periods, and not too surprisingly, inflation and the future path of interest rates. The worst 10-year return for long-term bonds for this data series occurred from 1/1966-1/1976. The 10-year Treasury yield started at 4.60% and rose about 300 basis points (+3.00%).

Average Returns After the Yield Curve First Inverts: 1966-2006

	1-Yr Avg	3-Yr Avg	5-Yr Avg	7-Yr Avg	10-yr Avg
IA SBBI US Large Stock TR USD Ext	9.26	7.74	8.58	9.87	9.90
S&P 500 TR USD (1936)	8.96	6.63	8.05	9.77	9.66
IA SBBI US LT Govt TR USD	4.22	8.20	8.59	8.00	8.52
IA SBBI US LT Govt T-Bill TR USD	**7.57**	**6.82**	**6.17**	**6.08**	**6.04**

Sources: Morningstar Inc., Strategas Research Partners and FactSet, Inc.

When looking at all time periods, curve inversion has not resulted in longer-term returns (seven years or greater) that were materially different from historical averages. Returns were more a function of economic environments (1970s stagflation, strong growth of the 1980s and 1990s, credit boom/bust periods of the 2000s), path of interest rates, and equity valuation levels at the start of each period. Nevertheless, we are paying careful attention to the shape of the yield curve in conjunction with various other economic data points.

Fed U-Turn Does Likewise for Stocks

As the S&P 500 started 2019, it had just posted its worst quarterly showing since the third quarter of 2011, registering a decline of -13.5% for the final stanza of the prior year. We believe the primary culprit of last year's sell-off was a Federal Reserve (Fed) that seemed determined to continue along the path of raising rates and unwinding its balance sheet, the latter of which had been accumulated because of quantitative easing. Financial markets did not react favorably to a more aggressive Fed, especially given that the worldwide economy seemed to be hitting headwinds.

In short, the markets were clearly concerned the Fed's actions were policy mistakes that could push the U.S. economy into a recession.

The stock market bottomed a few days after the Federal Open Market Committee (FOMC) met in December. Investors largely anticipated a rate hike at that meeting but also thought the Fed would back off on its tightening path. Unfortunately, Chairman Powell had other ideas, when in the post-meeting press conference, he telegraphed more rate hikes in 2019 and ongoing balance sheet reduction, the latter being on "automatic pilot." The markets thought this would be too much, and while stocks were already off dramatically for the quarter, the Dow Jones Industrial Average (DJI) declined another 500 points while Chairman Powell was speaking.

Thankfully, the Fed reversed course and telegraphed a far more dovish posture shortly after the first of the year (2019). To say markets reacted positively is an understatement. The S&P 500 Index registered a gain of +13.6% for the first quarter of 2019, its best calendar quarter return since the third quarter of 2009. By the end of March 2019, the Index was only 3.4% away from its all-time closing high that occurred on September 20, 2018.

The magnitude of the decline during the fourth quarter of 2018, along with the massive rally during the three months just ended, are depicted in the chart below. While other factors (U.S./China trade dispute, Brexit, etc.) may have factored into last year's sell-off at the margin, the fact that the recovery in share prices correlated so closely to the change in Fed narrative validates our belief that the Central Bank was the primary culprit.

S&P 500 Index
(October 1, 2018 – March 31, 2019)

Source: FactSet, Inc.

It should also be noted that the recovery in equity prices has been extremely broad-based, with small cap (Russell 2000 Index) stocks advancing +14.6%. Looking outside of the U.S., developed international markets (MSCI EAFE Index) had their best showing in over five years, advancing +10.0%. The MSCI Emerging Markets Index posted a return of +9.9%.

As we enter the second quarter of 2019, it seems highly likely that the Fed will remain on the sidelines for the foreseeable future. As such, investors will turn their focus to company "guidance" for earnings over the balance of the year.

The tariff spat with China has clearly created challenges for many domestic companies and those in China as well. While negotiations have been ongoing for months, a China trade deal, if completed, could provide added fuel to the recent rally in the equity markets.

Fixed Income Commentary
First Quarter 2019

U.S. Treasury yields dropped across the yield curve in the first quarter of 2019 led by slowing economic growth concerns. The 2-year and 10-year U.S. Treasury yields dropped by 23 basis points (-0.23%) and 28 basis points (-0.28%), respectively. Investor demand for longer-term securities contributed to the 10-year U.S. Treasury note yielding below the 3-month U.S. Treasury bill on March 22, 2019, referred to as yield curve inversion, for the first time since 2007.

10-year U.S. Treasury yield versus the 3-month U.S. Treasury yield
March 1, 2019 – April 1, 2019

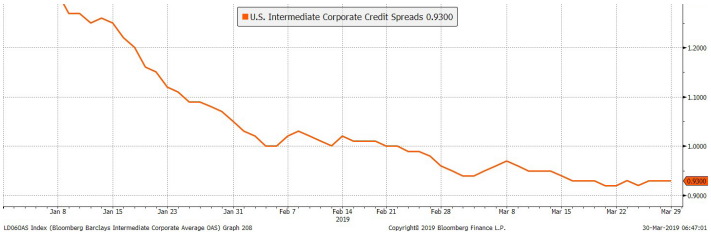
Source: Bloomberg Finance, L.P.

Investors' appetite for longer-term Treasuries increased after the Fed presented a more balanced, less aggressive stance on monetary policy at the March 20th FOMC meeting. The Fed left its target range unchanged between 2.25% and 2.50% while expressing concerns regarding recent weakness in U.S. economic data as well as more profound economic weakness in international markets, especially Germany and China.

Investors' appetite for longer duration fixed income securities provided a boost to performance during the quarter. The Bloomberg Barclays U.S. Intermediate Government Credit Index returned +2.32%, driven by outperformance of longer duration bonds as well as U.S. credit exposure.

Interestingly, investor risk aversion experienced in the 4th quarter of last year greatly diminished as depressed bond valuations and a lower interest rate environment were enough to lure investors towards higher yielding corporate securities. In the first quarter of 2019, intermediate U.S. Government securities and intermediate U.S. investment-grade corporate bonds were up +1.58% and +3.55%, respectively. Intermediate investment-grade credit spreads, the difference between U.S. corporate yields and U.S. government yields, decreased by roughly 40 basis points from 1.32% to 0.93%.

Bloomberg Barclays Intermediate Corporate Average Option Adjusted Spread
December 31, 2019 – March 31, 2019



Source: Bloomberg Finance, L.P.

Within the tax-free market, municipal bonds performed very well during the quarter. The Bloomberg Barclays Municipal Aa+ 1-10Yr Index returned nearly 2.0%, driven by longer duration bonds. Fears that the 2018 Tax Cuts & Jobs Act would have negative implications for the municipal bond market have mostly subsided. Instead, high-income investors, especially those residing in high taxed states, remain very active in the municipal bond market driven by the appeal of tax-free income.

It is also worth noting that non-traditional fixed income sectors performed very well during the quarter. High yield, bank loans, and U.S. dollar-denominated emerging market

debt (EMD) all outperformed their safer counterparts, U.S. governments, and U.S. investment-grade corporate bonds.

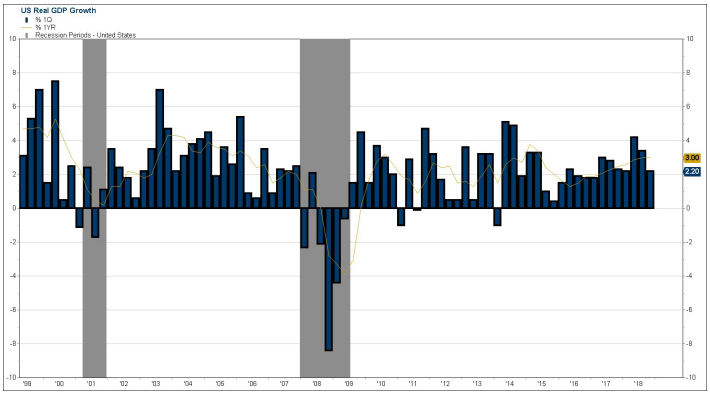
Looking Ahead

We will continue to monitor economic growth trends in both global and domestic markets very closely, as we move through this aging expansion. Our focus is most keenly upon the trend or rate of change, more so than any single data point or survey.

The graph below displays Real GDP growth on a quarterly basis (blue bars) over the 20 years ended in the fourth quarter of 2018. U.S. Real GDP growth came in at +2.2% and the gold line indicates the year-over-year change (+3.0%).

It has been widely forecast that first quarter of 2019 real GDP will be reported at a weaker level. As recently as last month, the Atlanta Fed was forecasting an increase of only +0.4% for the quarter. That estimate was recently revised upward and now stands at +2.1%, on the heels of better inventory investment and February's existing home sales data.

U.S. Real GDP Growth (20 Years Ended Q4 2018)

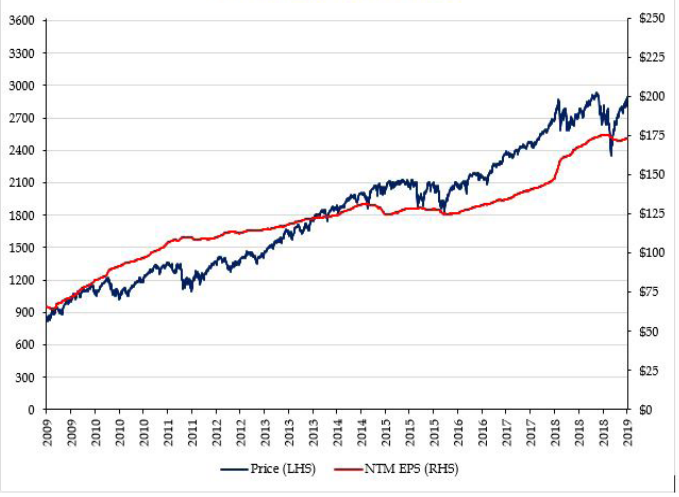


Source: FactSet, Inc.

The direction and magnitude of changes in economic growth rates are the major determinants for corporate earnings and interest rates and, in turn, financial asset valuations.

The graph below illustrates the growth in earnings per share over the ensuing twelve-month period (NTM EPS/red line) and the change in the price of the S&P 500 (blue line), over the last 10 years.

Growth in S&P 500 vs Forecast of Change in Next 12-Month Earnings Per Share Ten Years Ended March 2019



Sources: FactSet, Inc. and Strategas Research Partners

The graph visually illustrates the high correlation between price and earnings.

As we move forward, we expect to see more muted corporate profit growth in the large cap domestic equity space, with the potential for faster growth in smaller capitalization companies, albeit with a higher degree of volatility, given the nature of this sub equity asset class.

In assessing markets globally, we see faster economic growth in many of the emerging markets. Again, there is the likelihood of greater volatility in these faster growing markets.

Regarding fixed income investment going forward, the significant downward repricing of bond yields experienced during the quarter is somewhat overdone and we expect to see some reversal during the year. With this in mind, managing duration risk will be very important as well as monitoring the underlying fundamentals within the credit markets to determine if recent price appreciation is justified.

Given the many cross currents and issues noted, we wish to reiterate that this cycle is long in duration (10 years in June 2019). As a result, projections for growth, both at the macro (global/region/country) and at the micro (company/consumer) level will be more uneven and less predictable. We reiterate our call to assess risk in portfolios at the asset allocation level, as volatility rises due to an increase in assessing less certain outcomes and forecasts.

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