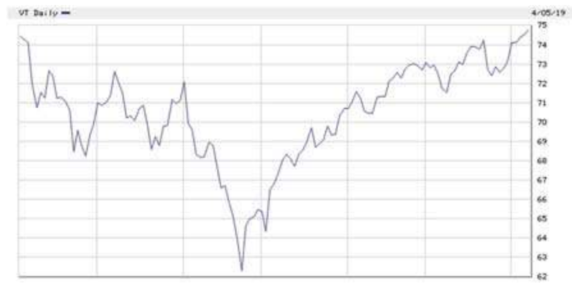
Market Review and Outlook—April 5, 2019

V for Victory, or Vindication—You may recall that the January 2019 Market Review had a lot of red ink, as the 4th quarter brought sharp losses to both US and foreign stocks, double-digit losses. This brought the full year losses to most stock categories, in some cases double-digit losses. The chart at the bottom was ugly. We have enjoyed what is known as a V Recovery, (the chart to the right is a global stock fund's price for the past six months) where a sharp decline is quickly followed by an almost exactly matching sharp recovery. In some cases this merely highlights the highly emotional nature of investor behavior. In other cases, it is related to one or more factors which causes significant investor worry, but which were fairly swiftly addressed.



By late December 2018 there were heightened fears of a worsening trade war with China, of a never-ending series of interest rate hikes by the Federal Reserve Bank (the Fed), and the end of strong US economic growth. Deadlines for US/China tariffs were postponed, the Fed essentially announced the end of rate increases, and US economic growth has certainly fallen to a lower level, but that level is still in the positive direction. The previous quarter's "wall of worry" was successfully ascended during the past quarter, and the results were welcome.

Economic Update—Core inflation (which carves out food and energy) has been very steady for twenty years, and is currently 2.1%, about half its 50-year average. Energy prices have been jumpy, yet stands at 8½% below levels a year ago. The US dollar has continued to climb, 19% in the past quarter and 27% higher over the past year. This has provided a strong boost to US stocks versus foreign stocks in the past year, as shown below. Unemployment has continued to remain very low, at 3.8% (well below the 50-year average of 6.2%), and while wage growth has been rising, at 3½% it remains below the 50 year average of 4.1%.

Bonds did not fare well in 2018, but have provided solid results during the quarter, aided by the nearly-eliminated concern over rising interest rates.

When markets move sharply, either up or down, long-term investors should stick to their rebalancing discipline. In hindsight, we had a nice buying opportunity at the start of the year. We appear to be at a strange period—one of a normal level of opportunities and risks with stocks, and normal opportunities and risks with bonds.

Category	**3 Months**	**12 Months**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.53%	+1.78%	+0.90%	+0.54%	+0.31%
Intermediate Term Bond	+3.13%	+3.98%	+2.37%	+2.51%	+4.56%
Intermediate Muni Bond	+2.67%	+4.52%	+2.09%	+2.99%	+4.08%
Large-Cap Stock	+12.94%	+6.90%	+11.84%	+8.91%	+14.54%
Mid-Cap Stock	+13.94%	+2.33%	+9.67%	+6.34%	+14.51%
Small-Cap Stock	+13.34%	-0.03%	+10.17%	+5.62%	+14.67%
Foreign Large-Cap Stock	+10.24%	-5.01%	+6.62%	+2.10%	+8.43%
Health	+12.90%	+10.64%	+13.01%	+10.02%	+17.07%
Real Estate	+16.14%	+17.08%	+6.00%	+8.29%	+17.24%
Technology	+19.73%	+9.94%	+21.78%	+15.26%	+18.72%
Moderate Allocation (60% stocks)	+8.89%	+3.90%	+7.44%	+5.12%	+9.98%

The data in this table comes from Morningstar and is as of March 31, 2019

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Recession Fears—There are two commonly identified signs indicating an imminent recession. The first is simply the length of the current recovery, now exceeding 10 years, soon to break the record. The second is the nearly "inverted" yield curve. This is a fancy way of saying that some short-term bonds are yielding more than longer-term bonds. As of March 31st, 1 year treasury bonds yielded the same 2.4% as 10-year treasury bonds. This indicator is not foolproof. It has predicted nine of the last seven recessions; thus it issues "false positives." Furthermore, this signal typically precedes a recession by more than a year, thus <u>no imminent recession threat is apparent</u>. The warning system I prefer is the Conference Board's LEI, Leading Economic Indicator. While it has stopped increasing, it is now flat. I will begin to worry when it declines for several months, and we are not there. It, too, has historically given a signal several months before recessions.

Low Cyclicals—Several industries in the US are identified as cyclicals, due to the volatility of their revenues—they represent areas that fall sharply during recessions, when consumers are under financial pressure. These include homebuilders, auto manufacturers, business fixed income and private inventories. Of these four areas, one is well above its average, one is barely above its average, and two are well below their average. True to the concept that "you can't fall out of the basement," this relatively modest level of cyclical activity indicates that, <u>even if a recession were to begin shortly, its depth is unlikely to be very painful</u>.

Economy—The income tax cuts passed in December 2017 were known to boost the US economic growth from 2 to 3% for one year, at which point it growth was expected to fall back to a 2% level. That is almost exactly how it unfolded. Our growth is largely limited by the growth in workers, which in the past decade has been only 25% of the level from the 1970s, when economic growth was regularly over 3%. We are back to a "plough horse recovery", with a slow, steady pace that is extremely hard to disrupt. There are worse paths to be following.

Global economic growth has slowed over the past two years. This appears to be primarily due to the heightened trade/tariff concerns. While the US has been largely driving these concerns, our economy is among the most shielded, for our economy has far less reliance on trade than most other major countries. One of the countries with heightened concerns on growth in manufacturing is Germany, an export powerhouse.

Bonds—With the Fed's rate increases near or at an end, it appears that for the time being bonds will trade based on their underlying merits, and not be driven by interest rate moves. This more normal environment causes us to boost our conventional (quality) bonds, and reduce our opportunity bonds which do best in a solidly growing economic environment.

One of the types of opportunity bonds we have used in recent years are bank loan (floating rate) bonds. When an apparent end of rising interest rates, these are no longer very attractive, and we are working to eliminate them in client portfolios. This helps free up dollars to shift into quality bonds. Within quality bonds, we have boosted long-term bonds from 5 to 10%, spreading our quality bonds broadly across maturities.

Stocks—While the December 2018 bargain levels are gone, <u>we still like the apparent values that today's stock prices provide</u>. With US exports comprising a smaller portion of our economy versus most major countries, the top economic concern of trade wars affects us nearly the least. This supports the US stock market, whose values are higher/stronger/pricier than foreign markets. Should (and we hope when) trade tensions lessen and are resolved, the US will receive amongst the least benefits.

Foreign stocks are less expensive than US stocks, on both an absolute and relative basis. This can persist and has done so for the past eight years. The recent and continued strength in the US dollar makes buying and holding foreign stocks even more attractive for US investors. We have been expecting the US dollar to weaken for a few years (and while it fell in 2017 the drop has since largely reversed), and we now have a solid catalyst to drive this—the end of rising US interest rates and the start of rising interest rates in Europe. A falling US dollar will strengthen foreign stock returns for US investors (finally).

We appear to be in a near-normal environment, after over a decade of ultra-low interest rates, followed by steadily rising rates. We are also hopeful that trade tensions are receding, which can raise all economic boats, and with them, stock investor confidence. **2019 is looking to be a much better year than 2018 for investors.**