AMB Newsletter
2nd Quarter 2019

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1st Quarter 2019 Review

Global markets have made a 180 degree turn from the 4th quarter of last year. Heading into January, pundits were certain a recession was just ahead and the Federal Reserve's hawkish stance was leading the way. The Federal Reserve president Jerome Powell was also signaling continued hawkishness in the coming year with his comments regarding the balance sheet run-off being on autopilot and the Fed Funds rate being far from neutral. What a far cry from last month when economic deterioration seemed to be taking hold around the globe causing the Fed to pivot from a hawkish to a very dovish stance. This change projects looser financial conditions in the future which seems to have eased recession worries and pushed global markets higher.

US equity markets, measured by the S&P 500, finished the quarter up 13.64%. Information Technology led the market higher and contributed 3.99% of the upside return. The overall return from the market has been broad based with all 11 sectors trading higher on the quarter. The two largest laggards for the quarter were Health Care and Financials. Health care has continued to deal with scrutiny over drug pricing which has weighed on the sector while financials have struggled with the recent inversion of the yield curve diminishing their spread.

International developed equities trailed the US market for the quarter. Our international counterparts posted a combined return measured by the MSCI EAFE of 10.34% which was slightly lower than the S&P 500 for the quarter. Last quarter, we wrote that international markets may not be as cheap as they appear based on their recent economic slowdown. This has come to fruition as Eurozone economic growth continues to slow causing us to lower our current expectations of their equity markets going forward. In the 4th quarter, the Eurozone GDP came in at .2% which was well below the 1st and 2nd quarters. This put GDP growth at sub 2% for the year which is well below the 2.6% posted in 2017. Future economic growth in the EU has also been downgraded with economists now expecting 1.6% for 2019. We expect that growth to be closer to 1% for the year.

Emerging market equities had a good quarter but trailed their developed counterparts. Emerging Markets, measured by the MSCI Emerging Markets Index, was up 9.92% for the quarter but still down 7.41% over the previous one year. The same factors that plagued Emerging Markets at the end of the year were still in play in the 1st quarter. We do not expect emerging market strength to occur until we begin to see a real weakness in the US Dollar or growth around the globe starts to show signs of life. For now, we would rather be invested in the US equity markets.

1st Quarter 2019 Review (continued)

Interest rates continued their downward move during the 1st quarter as economic hard data continues to disappoint and Central Bank policies move to a more dovish stance. In the US, Federal Reserve president Jerome Powell commented in the third quarter that monetary policy regarding rate hikes and balance sheet reduction was on autopilot. After the equity markets return of -13.52% quarter, the Federal Reserve's tone has changed. Powell is now admitting that the Fed is listening to the market. He confirmed this at the latest FOMC meeting, as the Federal Reserve is now projecting zero rate hikes for 2019, down from three, with only one rate hike for 2020. The Fed is also now ending the balance sheet run off in September of this year which will leave the remaining balance well above our expectations. This is a massive shift from what we were hearing just a few months ago. We feel comfortable on the short end of the curve as investors are not currently rewarded for taking on additional interest rate risk.

Economy (Global)

Even with the recent spike in global economic fears, US economic growth has continued to impress through the 4th quarter of 2018. It also seems 1st quarter GDP will be much stronger than anticipated. At the beginning of March, US GDP was tracking at .2% but has since moved up to 2.30%. This puts growth expectations closer to our forecasts for 2019, and our thoughts from last quarter still hold, "Slowdowns in the second half of the year in China, Japan and the Eurozone definitely spiked concerns of an impending global recession. This fear was wide ranging and could be seen in markets across the globe. For 2019, even with the recent global weakness, we expect the global expansion to continue, led by US growth. We do, however, see the divergence between US growth and the rest of the world closing. In our opinion, global domestic markets growth and emerging markets growth will move higher coupled with US growth moderating back down to around the 2.5% level."

Even though we expect US economic growth to continue throughout 2019, it does not mean our thoughts on being in the late-stage of the expansion has changed. As previously discussed, we expect to see slowing growth throughout the year. We do not currently see any signs of the economy overheating, financial conditions remain stable and inflation has continued to stay subdued which was confirmed once again by the CPI releases for March. Historically, recessions are inevitable, but we believe the earliest we will see a recession is the summer of 2020.

Inflationary pressures will remain our focal point with our main indicator from those releases being wage growth. With 70% of the US economy compromised of consumer spending, this metric is our favorite for obvious reasons. If we begin to see upward pressure from wages, our outlook will change. As it currently stands, the majority of World Central banks are easing as inflation has waned once again giving them the leeway to loosen financial conditions further. However, if wages pick up, we believe the Central Banks will act to stymie inflation. This may cause the world Central Banks to pivot, but this time to a more hawkish stance. This scenario could bring global economic growth to a standstill.

In our view, everyone's main focus for the Global Economy should be on China as it contributed approximately 1/3 to global growth for the past eight years. Starting in 2018, China's slowing has been a drag on the global growth story which was brought on by increased trade conflicts with the US and tighter domestic policy. Both of these issues appear to be improving. Trade negotiations seem to be progressing between the two global economic powers and financial conditions are easing. Even with a trade deal, however, conflict between the US and China will be long lasting as both are fighting for global economic dominance. With that being said, we do expect growth in the second largest economy to reaccelerate in 2019, which will contribute heavily

Economy (Global) (Continued)

Central Bank monetary policy will continue to play a role in our economic projections as their role in the global economies continues to expand. Their actions have a direct impact on the money supply which can either promote or hamper growth. Our thoughts going into the year were for the US Federal Reserve to hike rates twice, which is half the number of times the market expected at the end of the 3rd quarter 2018. We were right on our call of the Fed being easier than the market expected, but the Fed went even further and now does not expect any rate hikes in 2019. We also stated the Fed would be taking a “wait and see” approach going forward to try and gauge the actual health of financial conditions unlike the “autopilot” comment the Fed Chair made last year. This has played out exactly as we thought as the Federal Reserve has moved to this more patient approach. We also stated that a more dovish Fed could help ease recession fears in the US. This also came to fruition and the equity market has responded with one of the strongest quarters in memory and the strongest start to a year since 1998.

Politics will always play a role in economic conditions. Geopolitical turmoil reigned in 2018 due to trade tiffs between the US and “everybody”. Politics are a major uncertainty and that has never been as true as it is today. We do not expect the current political environment to change in 2019; but if we do begin to see a light at the end of the tunnel, it would be a welcomed sign and markets would react in a positive way in our opinion.

US Equity Market

After the worst multiple collapse in a decade at the end of 2018, 2019 has been the exact opposite with equity markets roaring higher. As we look forward to the second quarter, equity markets are facing head and tail wind pressures. For us to have a good understanding of what may happen, we must understand both the positives and the negatives, and then position accordingly.

The tail winds consist of an ongoing global expansion and easier monetary policy around the globe. As we mentioned before, we do expect growth to moderate but we believe the expansion will continue which will be a positive for stocks. We believe the easier financial conditions will also be a tail wind as it will ease fears of an imminent recession brought on by tight financial conditions.

The head winds include extended valuations and slowing earnings. Going into 2019, stock price valuations looked attractive compared to where they are now. The entire move so far in 2019 has been driven by multiple expansion – not earnings growth expectations – which can cause problems if earnings do not improve. We will also pay close attention to profit margins. With recent readings on wage growth increasing (except for March) cost pressures may be rising for companies which could put pressure on margins. This metric will be our main focus point this earnings season.

We continue to believe the bull market is intact; however, there is room for caution. Some economic indicators have begun to flash a warning sign that a recession is near. The yield curve has collapsed with the fed funds and ten-year note inverting. This is usually a sure sign of an incoming recession but the credit markets are currently telling us a different story. If the inversion was due to fear of an imminent recession, we would expect spreads in the credit market to begin to widen. This has not happened leading us to believe the market still believes the economy will grow albeit at a slower pace. However, we will be keeping our eye on this moving forward.

US Equity Market (continued)

AMB believes the market will trade higher in 2019 but upside might be capped as returns have already reached a yearly level. We believe quality companies will begin to outperform. This trend started at the end of 2018, and we expect it to continue. Even with the recent downward revisions of the corporate profits, we believe they will still show growth in 2019; and if that is the case, the market will be proven to have overshot to the downside and this rally was justified.

US Fixed Income

Global Central Banks have played a large role in interest rate levels since the global financial crisis. Coordinated unparalleled monetary policy has suppressed rates at historic lows not only in the US but also around the globe. In 2018, we started to see a return to normalcy with Central Banks from the US and EU starting the tightening process. However, toward the end of the 4th quarter when equity markets cratered and global growth seemed to hit a wall, we saw a pivot back to a dovish stance. This has put pressure on rates across the curve, and we are now at levels we have not seen since 2017.

So far in 2019, the US interest rate curve has continued its flattening pattern and recently inverted all the way out to 10 years. What is surprising about this move is the way credit has responded. One would expect credit spreads to be blowing out wider if the yield curve was predicting that a recession was imminent, but this has not been the case. Spreads have stayed tight throughout this move. This is telling us that credit markets are not currently pricing in a recession. We are receiving mixed signals from the fixed income market, and we will be watching it closely throughout 2019.

Overall, we believe it is a good time to move out of lower credit and into high quality credits. As we have seen, credit markets flashed warning signs at the end of the 4th quarter and now the yield curve and economic data are flashing yellow. With the massive amount of corporate debt on the books, a major economic downturn could turn ugly fast, so in our view, being in higher quality names is prudent. We still like the belly of the curve, but investing on the front end is more sensible now than it was a year ago. We would currently stay away from the long end as one is not being rewarded for the increased interest rate risk that would be taken on.

As always, investors should remember why we invest in fixed income. It is not the growth engine of portfolios, yet it brings stability and predictability. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

Conclusion

In our last letter we stated, "we believe equity markets will provide growth in 2019, while fixed income provides stability as rates remain relatively stable." This has been the correct call, with US equity markets turning in their best start since 1998 while fixed income markets have remained stable. Our outlook for the equity markets going forward has been lowered with the returns approaching 20% in the first 3 ½ months. As we stated throughout our letter, we will be keeping a close eye on economic, geopolitical and fundamental data and if perceived risks begin to rise, we will take measures to position portfolios accordingly. We look forward to working with you in 2019 and as always, we appreciate the opportunity to help you achieve your financial goals.

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