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Market Update: March 2019

After returning 14% in just three months, U.S. stocks registered their best first quarter in over twenty years and their best overall quarterly performance in nearly a decade. Rebounding from a fourth quarter thrashing, stocks were lifted by the Federal Reserve's promise to maintain interest rates at current levels.

The Fed basically pulled off a 180 degree turn, moving from hawkish to dovish. Investors quickly responded, and that sent stocks on a post-Christmas tear. Apparently, the market's response to the business backdrop was spot-on last year, and the Fed has finally caught up to the economic implications.

> **In the end, the Fed's medicine was enough to treat the cold, and then some.**
>
> **Alex Eule, Barron's Review & Preview – 3/29/19**

Driven by tame inflation and a dovish Fed, interest rates declined sharply during the quarter. The yield on the 10-year Treasury note ended March at 2.416% … well below the 2.684% yield at the end of 2018. In fact, the yield on the 10-year Treasury note has fallen by 68 basis points over the past six months. (A basis point represents 1/100th of a percentage point.) Since bond prices rise as yields fall, domestic bonds gained approximately 3% for the quarter.

There are broad concerns that the stock and bond markets are somewhat disconnected. Stock values and bond yields usually rise in tandem. Currently, they are diverging.

> **I would define this environment, year to date, as fascinatingly counterintuitive. Stocks are rallying, but bond yields are reflecting much lower growth.**
>
> **Michael Arone, State Street Global Advisors – Barron's 3/29/19**

Last year's fourth quarter plunge was the result of concerns over a global economic slowdown and a hawkish Fed. We now have a dovish Fed, but concerns over global growth persist.

U.S. GDP rose by 2.2% in the fourth quarter of 2018, down from an earlier 2.6% estimate. Overall economic growth came in at 3% last year. GDP growth for 2019 is

expected to range between 1.5 – 2 percent. Corporate earnings growth, which reached double-digits throughout 2018, is expected to be much more modest during 2019.

The labor market remains very strong, with wages rising in February at the fastest pace in a decade. Also, the economy continues to pull in and retain more workers. In the past six months, the number of people outside the labor force has fallen by 1 million … the largest such decline on record.

> **The performance of labor-force participation over the last three or four years has been an upside surprise that most people didn't see coming.**

Jerome Powell, Fed Chairman – WSJ 3/23/19

In contrast to the U.S., Europe and China are showing signs of deterioration. The eurozone has a multitude of political and economic troubles. This was further underscored when the yield on the 10-year German government bond fell below zero. China's struggles, in a nutshell, consist of finding ways to stimulate a slowing economy without aggravating already high debt levels.

> **With far more control over the financial system than most Western countries exert, Beijing has shown that it can keep periodic eruptions under control … But keeping that control comes at a price.**

Mike Bird – WSJ 3/22/19

China's problems are a product of excessive leverage. Massive amounts of debt have accumulated from years of aggressive "flood irrigation" economic stimulus. China's total outstanding debt currently stands at 250% of GDP … up from less than 150% of GDP just a decade ago. Current stimulus efforts are a more restrained "cocktail approach" mix of deficit spending, tax cuts and easier credit.

> **Behind the more modest growth push is a realization in Beijing that China's traditional debt-driven growth model has reached its limit.**

Lingling Wei, WSJ – 3/16/19

Everyone is freaking out because the yield curve inverted in late March. Inversion occurs when the yield on the three-month Treasury bill exceeds that of the 10-year Treasury note. (The yield on the 10-year note ended the quarter .008 higher than the three-month bill.) Why is this a worrisome sign? Every recession since the mid-

1960s has been preceded by an inverted yield curve. However, not every inversion leads to recession … so this could be a false positive.

> **This rather benign economic outlook conflicts with the traditional signal of an inverted curve … this curve inversion is unlikely to be the traditional signal of a U.S. recession.**

Mohamed A. El-Erian, Investment News – 3/25/19

The Fed indicated there would be no rate hikes this year and possibly one in 2020. If that proves to be the end of this "tightening cycle", that would put the so-called *neutral interest rate* (the rate that neither stimulates nor hinders economic growth) at less than 3 percent … incredibly low by historical standards. According to J.P. Morgan Asset Management, most hiking cycles end with rates at or around 7% percent, and no rate hike cycle has ended with a rate below 5 percent.

Demographic trends, massive global debt levels, and technology innovation are inherently deflationary influences. The U.S. labor force participation rate is expected to decline by about 2.5 percentage points over the next decade. As such, GDP growth of 3% may not be realistically sustainable. GDP growth of 1-2% will probably be the new normal. Investors should anticipate slower growth, lower rates, stable inflation, and investment returns below historical averages.

> **If you have prepared your portfolio, reevaluated your investment plan, confirmed your risk tolerance, and rebalanced your portfolio, there may be little you need to do … Investors should remain disciplined and diversified and continue to prepare for the inevitable end of this cycle – without needing to pinpoint the timing precisely.**

Sonders/Kleintop, Charles Schwab – Advisor Perspectives 3/29/18

The global economy may be sending conflicting signals, but the U.S. economy has a very strong labor market, wages are on the rise, and businesses are investing their capital. It appears that the glass is still half-full, but market sentiment can change quickly. Thankfully, spring is finally here and tax season is almost over!

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