MARKET Insights

Webster Private Bank®

April 2019

Accelerating Into The Down Shift

The first quarter was the best three month start to the year for US stocks since 1998. Almost all markets rebounded sharply from their late 2018 swoon. The S&P 500 delivered a total return of **+13.6%** in the first quarter.

Prosperity has been broadly shared across US small companies and foreign markets. The Russell 2000 small company index returned **+14.6%**, while international (MSCI EAFE) and emerging (MSCI EM) stock markets delivered **+10.7%** and **+9.9%**, respectively. Bonds have rallied in recent months, both due to expectations that the Federal Reserve has finished increasing interest rates in this cycle, and because global economic growth appears to be stalling (especially in China and Europe). The broad bond market (Barclays US Aggregate index) was up **+2.9%**, and more speculative high yield bonds (Barclays US High Yield Corporate index) rallied **+7.9%** in the first three months of the year.

Sunshine Follows The Rain: In Q1, Markets Recouped Their Losses From 2018

Asset Class Returns		Q1 2019	Q4 2018	Full Year 2018
Equities	US Large Cap	13.6%	-13.5%	-4.4%
	US Small Cap	14.6%	-20.2%	-11.0%
	Intl Developed	10.7%	-12.2%	-10.5%
	Emerging Markets	9.9%	-7.3%	-9.7%
Fixed Income	Investment Grade	2.9%	1.6%	0.0%
	High Yield	7.3%	-4.5%	-2.1%
Alternatives	Absolute Return	1.6%	-4.9%	-5.0%
	Commodities	15.0%	-22.9%	-13.8%
	REITs	16.3%	-6.7%	-4.6%

Source: FactSet Indexes, total returns in USD as of March 31. US Large Cap is S&P 500 index, US Small Cap is Russell 200 index, Intl Developed is MSCI EAFE index, Emerging Markets is MSCI EM index, Investment Grade is Barclays US Aggregate index, High Yield is Barclays Corporate US High Yield index, Absolute Return is Credit Suisse Equity Market Neutral index (through Feb 28), Commodities is S&P GSCI index, REITs is MSCI US REIT Diversified index.

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"Down Shifting" In 2019: Our Key Investment Themes

This winter, we identified three investment themes that inform how we will adjust to economic growth rates and corporate earnings that have shifted down to lower levels. We noted that much of the down shift in earnings and growth was already underway, and that the market rebound was likely because investor expectations had become so pessimistic at the end of last year. These themes are intended not to make particular predictions about market prices or interest rates, but rather to demonstrate what our clients can expect in their portfolios in 2019.

THEME 1 — The Path of Interest Rates Is Changing

As we wrote in January, we expected the Federal Reserve to stop hiking interest rates this year. That action was confirmed on February 26, when Chairman Jerome Powell stated the central bank would take a "patient approach" to implementing its monetary policy. Current interest rate futures indicate that the market expects no more increases in the overnight Fed Funds rate in 2019. In fact, these markets point to the possibility of a rate cut in the first quarter of 2020.

Short term Treasury securities of less than one year still offer higher yields than other securities out to ten years. This is an uncommon situation – normally investors would demand higher interest rates for having their money tied up in debt with longer maturities. We believe the prudent approach at this time is to keep fixed income allocations "short and safe" by holding shorter maturities and focusing on sectors or issuers with higher credit quality. Investors simply are not compensated with a meaningful additional yield on either longer maturity or less creditworthy bonds at today's prices.

THEME 2 — Volatility Is Here To Stay

We expected market volatility to reign again in 2019. Thus far, we have been correct… to the upside. The US stock market, as measured by the S&P 500 index, swooned down **-19.8%** from September 20 to December 24 last year. From Christmas Eve to March 31, the market rebounded by **+20.6%**, recapturing almost all of its losses. (NB: due to the mathematics of compounding an almost **-20%** loss requires an almost **+25%** gain to break even. For example, going down **-20%** from 100 to 80 requires a **+25%** gain of 20 from 80 to reach 100 again).

Investors who have felt whipsawed lately might be tempted to try to time their investment in the market. We strongly caution against this temptation. The latest episode of volatility in Q4 2018 and Q1 2019 has demonstrated that market timing erodes long-term returns. Investors that shifted out of the market last fall ended up with portfolios that were not fully invested when the market recovered recently. As the following chart shows, those with portfolios that remained invested rebounded quicker, by participating in the early weeks of the recent rally.

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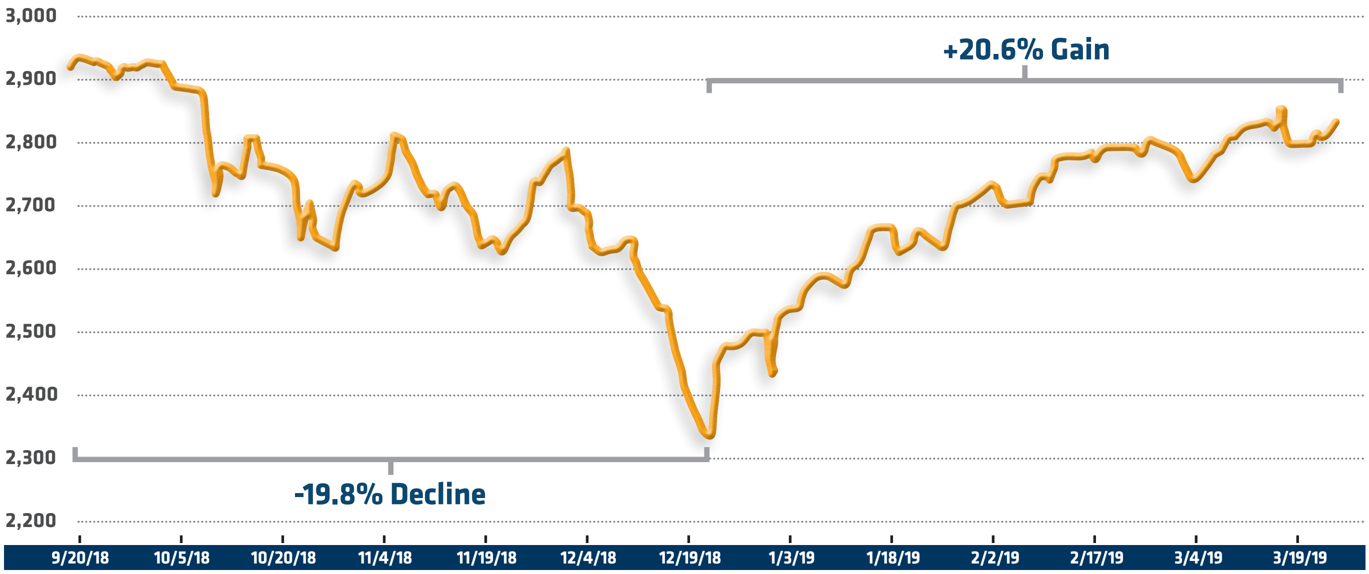
Roller Coaster: US Stock Market in Q4 2018 and Q1 2019



Source: FactSet Indexes, S&P 500 daily closing price, 9/20/2018-3/31/2019.

THEME 3 Earnings Growth Becomes More Difficult

Stock market analysts already expect earnings to have declined in the first quarter. The latest estimates for S&P 500 companies (per FactSet Earnings Insight, April 5) expect earnings to decline by **-4.2%**. The last time earnings for the index were negative was in Q2 2016 (which were reported in September of that year).

It is worth remembering that earnings and stock prices are not perfectly correlated in the short-term. For example, even though earnings declined by **-3.2%** in Q2 2016, the S&P 500 returned **+17.9%** in the twelve months that followed that down quarter. Looking ahead to the rest of 2019, the Wall Street analyst forecasts tracked by FactSet expect no earnings growth in Q2, low single-digit growth in Q3 and high single-digit growth in Q4. In the face of such modest expectations, any upside surprises could reward investors with higher dividends and price appreciation.

> ***"Financial markets in 2019 will be more volatile than last year, so our clients should expect to see more variation in the values on their account statements."***

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Conclusion – Prudence, Not Panic

While investment valuations are not nearly as attractive now as they were at the beginning of the year, we still expect stock holdings to deliver positive results for the rest of this year. The picture is not as bright for bonds, which have rallied strongly in 2019. The yield on the benchmark Treasury ten-year note fell sharply in March and touched a low of **2.38%** on March 27th. It had been trading as high as **3.23%** on November 8th.

Lower interest rates obviously are helpful to major sectors of the economy, namely housing and consumer spending. However, long-term bonds with yields below **3%** offer much less "shock absorption" to portfolios now. Investors who continue to hold long-term bonds as a "safety" asset may be deeply disappointed when the bonds fail to react as expected. As noted above, we have been shifting our clients' fixed income holdings to more of a "short and safe" profile as a result.

As the global economy evolves, investors need to migrate to where new sources of growth reside. Buy-and-hold investors that have grown accustomed to the "easy ride" of US stocks in this cycle might mistake past results for future performance. The main obstacles to higher returns in foreign stock markets are the US-China trade dispute and less accommodative monetary policy in Europe and Japan. Much of the bad news is already reflected in prices, but we await confirmation of positive economic growth in order to add any further capital to international markets in 2019.

We continue to manage client investment allocations across both stocks and bonds, as well as to alternative investment vehicles that can hold their value in either a stock market rout or a bond market sell off. We view hedged and absolute return mutual funds as a way to build patient "dry powder" that earns a return above cash rates or inflation, and can be used as a source of funds for investments in stock holdings when pricing becomes more attractive.

We welcome your comments, insights and concerns. Please contact your Webster Private Bank Portfolio Manager at any time for a discussion about your personal investment portfolio.

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