1ST QUARTER 2019 UPDATE

April 12, 2019

Data arriving since September suggests that growth is slowing somewhat more than expected. Financial conditions tightened considerably over the fourth quarter. While conditions have eased since then, they remain less supportive of growth than during most of 2018. Growth has slowed in some foreign economies, notably in Europe and China. While the U.S. economy showed little evidence of slowdown through the end of 2018, the limited data we have so far this year have been somewhat more mixed.

Excerpt from Federal Reserve Chair
Jerome Powell's March 20, 2019
News Conference Opening Remarks

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Just joking?

The performance of the U.S. stock market in the 1st quarter of 2019 was almost the exact inverse of the stock market's performance in the 4th quarter of 2018. As measured by the S&P 500, stocks rallied 13.6% in the 1st quarter after selling off (-13.5%) in the 4th quarter. The result was an 87% recovery of the 4th quarter loss (note: since the recovery began from a lower base, the stock market needs to rally 15.61% to fully recover a -13.5% loss).

Outside of the quarterly timeframe, as measured from its September 20, 2018 all-time closing high of 2930.75 to its December 24, 2018 closing low of 2351.10, the S&P 500 declined a total of (-19.8%). The subsequent recovery, into the end of the 1st quarter, was up 20.56% (note: it would take a rally of 24.65% from the low to get back to the all-time high).

I have to say, this recovery rally is impressive! Particularly, given the doom and gloom into the December low, it is impressive to see the stock market back in a position to challenge its all-time high. At this point in my career, I am not usually surprised by the stock market's gyrations, but a straight up rally of 25% into a new closing high would be a surprise to me and fun to see. In the meantime, let's give a nod to volatility for reminding us (once again!) that investing in the stock market is a long and winding road.

A parting of the ways?

The chart above includes both the S&P 500 (in orange) and the level of interest rates on the U.S. 10-year Treasury note (in blue). The timeframe is from January 1, 2018 through March 31, 2019. I have included the chart to illustrate three things:

1) The "V" shaped decline and recovery in the S&P 500 that started at the end of last September;
2) The stock market has basically been moving sideways (with enthusiasm!) since January 2018;
3) The Interest rate on the U.S. 10-year Treasury note generally tracked the S&P 500 in 2018, moving higher when the stock market moved higher and moving lower when the stock market moved lower, but then diverged, as interest rates continued to move lower and stocks rallied in the 1st quarter of 2019.

The divergence of interest rates from the stock market is a material change of character. One way or the other, I believe the divergence is unsustainable and economic developments will get them moving in the same direction again. Growth will drive interest rates higher or economic weakness will drive stocks lower.

Slow and steady wins the race?

The Federal Reserve (the Fed) raised the Fed funds overnight interest rate to a range of 2.25% - 2.5% in its meeting this past December and then, effectively, put future rate hikes on hold until the economic picture, both in the U.S. and globally, becomes clearer. Per the quote that opened this letter, Fed Chair Jerome Powell specifically mentions slowing growth in Europe and China as "notable." Monetary authorities across the globe have become more dovish in an effort to stem the economic slowdown. China, in particular, has also taken fiscal policy steps, including tax cuts, to help stimulate its economy. Overall, we appear to be in an economic space similar to the 2015-2016 global slowdown. During that period, U.S. businesses entered both revenue and earnings recessions, but U.S. quarterly GDP growth did not turn negative and accelerated upward after dipping to a low of +0.4% in the 4th quarter of 2015. All the while, the U.S. stock market moved sideways in about a 10% range until breaking out to new highs at the end of 2016. At that time, stimulus in China was a major driver in getting the global economy moving again.

While it was great to see the stock market's enthusiasm in the 1st quarter, reported earnings for the quarter are expected to fall slightly on a year over year basis. And, while it is great to see the stock market back near an all-time high, the rally has also driven the stock market's valuation right back up near its all-time high, as measured by the price-to-sales ratio of the S&P 500. For now, the stock market is looking beyond a weak 1st quarter and hoping for stronger growth in the rest of the year. From a fundamental perspective, it is difficult to see stocks moving materially higher from here until earnings growth can resume, or at least until future earnings estimates start rising in anticipation of growth. If earnings continue to weaken, I would expect stocks to follow 10-year interest rates lower.

It will be 10 years since the current U.S. economic expansion began in June (the bull market in stocks passed its 10 year mark in March). The U.S. economy grew 2.2% in the 4th quarter of 2018 and the Atlanta Fed is currently estimating 2.2% growth for the quarter that just ended, so it looks like we should have enough momentum to make it across the finish line. That would make it the longest period of uninterrupted growth in our history, surpassing the previous March 1991 to March 2001 record. In terms of rate of growth, it looks like our average growth rate since the bottom in 2009 will come in just a bit over 2% compared to an average of 3.3% in the March 1991 to March 2001 stretch. While I think it is fair to say we face many obstacles to growing at a more robust rate (from demographics to debt levels to division of wealth), if the global economy's growth rate can turn up once again, it looks like we have a good chance of extending the current streak for at least another year or two. If slow and steady growth is what we've got, I will gladly take it.

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We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA