Investment Perspective

A rare meeting occurred on January 3, 2019. Chairman Jerome Powell of the Federal Reserve met with the past two Fed Chairs (Bernanke and Yellen) at the recent American Economic Association conference. During the meeting, the Fed communicated a dovish policy stance and the Dow Jones rallied 550 point that day, signaling that policy makers were tactfully adapting to a decelerating economy. Indeed, as investors digested Powell's message, the markets moved higher in the first quarter with a powerful advance of 11.8% for the Dow Jones and 13.6% for the S&P 500. Equally important, the gathering of Powell, Yellen and Bernanke demonstrated solidarity, proof that the Fed was pivoting for economic, not political, reasons. The boost of confidence propelled the S&P 500 to the best first quarter since 1998 and the best calendar quarter since 2009. This was impressive considering the S&P 500 had its worst December correction since 1931. Last December was a buying opportunity — as are most severe corrections.

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The investment outlook still favors equities due to the favorable combination of moderate earnings growth, low interest rates and mild inflation. Confidence has been restored with a reaffirmation of pro-growth policies. The odds favor further advances ahead. A summary of index returns for the quarter ending March 31, 2019 is as follows:

Dow Jones Industrials	11.8%	Russell 2500	15.8%
MSCI EAFE	10.0%	S&P 500	13.6%
NASDAQ Composite	16.8%	Wilshire 5000	14.2%

GLOBAL ECONOMY

World economic growth (ex. U.S.) is moderating toward 3.3% in 2019 after two years of 4% or greater growth. On balance, the global economic situation is constructive, although several factors cloud the outlook. China and the U.S. are engaged in trade discussions that seem to be improving. This progress has diminished the downside risk of a tariff-induced economic slump, which was clearly on investors' minds in the fourth quarter. China's growth is expected to slow to 6% and authorities have responded with a combination of easier credit, incentives and tax cuts. Japan is growing slowly in the 1% range and the Euro area is also expected to grow 1.0% this year after 1.8% in 2018. In Europe, accommodative monetary policies continue to support those economies. However, the global decoupling of monetary policies is generating increasing confusion and volatility. Fear of deflation and slow growth caused the German 10-year bond yield to decline to nearly zero again and the spread between German and U.S. bond yields is the widest in 30 years. Meanwhile, the Federal Reserve has pivoted to a more accommodative stance after several years of tightening. The tightening cycle may be over in America, but it never began in other major regions. These differences in monetary policy might exacerbate movements of capital, foreign exchange and interest rates.

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The U.S. economy is expected to grow 2.2% this year following 2.9% in 2018. This deceleration in growth is related to the government shutdown, some moderation in consumer spending, a soft housing market and an unsettled international trade situation. However, the economic cycle is maturing and a pause may be helpful. Positively, the employment situation remains robust with the unemployment rate at 3.8%, the lowest level since 1969. Average hourly earnings rose 3.2% y/y in March indicating a tighter labor market. Strong employment supports confidence, spending and consumer balance sheets thereby broadening the foundation of this expansion. Offsetting this, residential investment may not be a strong contributor to growth, as housing remains a soft spot for the second consecutive year. The weakness stems from a slowdown in existing home sales due to affordability, real estate tax law changes and higher mortgage rates. For example, the 30-year mortgage rate climbed from 3.95% to 5.00% last year weakening demand for housing. But the recent decline in mortgage rates since December is helping to stimulate demand and better affordability may convert renters to buyers. Despite speculation of a lurking recession, the economy has a balanced and moderate growth profile. The Fed's revised approach to monetary policy will put wind in the sails and refresh this expansion.

THE FEDERAL RESERVE PIVOTS

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The Fed recently pivoted from its prior stance of monetary tightening to a neutral position. In fact, some market participants believe the current cycle of Fed rate hikes is over and the next move may be accommodative. This represents a substantial change in tone from last fall and the stock market has responded strongly. Also, the 10-year Treasury yield declined to 2.49% from 3.24% six months ago. The last 25-basis point increase in December 2018 brought the federal funds rate to 2.50% — the ninth hike since December 2015. In addition, the Fed is modifying the pace at which bonds are reinvested from the quantitative easing program. It is too early to know if economic conditions will warrant a rate cut in 2020, but this is a possibility. The relatively flat yield curve is receiving investment attention as historically, it is a sign of tight financial conditions. The 90-day Treasury bill is 2.43%, the 2-year Treasury note is 2.35% and the 10-year Treasury bond is 2.57%. Despite this flatness, financial conditions are not that tight, leading many commentators to wonder if this time may be different. The shape of the curve may be a response to global growth decoupling and the desynchronized nature of global monetary policy as evidenced by exceptionally low interest rates in Germany and Japan. Importantly, inflation trends in the U.S. are favorable with modest indications of pricing power. Almost all inflation measures are in the Fed's target range of 2%, which suggests future policy actions will be aimed at keeping inflation in the range. The consumer price index (CPI) is up 1.9% y/y and core inflation (excluding food and energy) is 2.0% y/y. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.8% y/y. The Federal Reserve is successfully engineering an expansion with low inflation and strong employment.

TECHNOLOGY REFRESH

The fastest growing areas are software and technology investments by businesses and governments

The growth in business equipment spending continues to outpace the general economy. This reflects years of under-investment, demand for newer technologies and favorable tax reform changes. The fastest growing areas are software and technology investments by businesses and governments. This growth makes sense as software and applications continue to become more prevalent for businesses, governments and households. Cyber-security software, online shopping, personal communications, productivity tools, and social media usage in the workplace are all driving growth. The software component of GDP accounts has grown 10.3%, 9.7% and 8.1% in real terms, respectively, over the last three years. This is considerably faster than overall real GDP growth of 1.6% – 2.9% during this period. In addition, the Federal budget and national defense spending include increasing amounts of software content growing at above-average rates that are not included in the business equipment spending data. This type of capex cycle may not have the same robust visibility as a "big iron" infrastructure build-out of yesteryear, but it does provide the required productivity enhancements needed to remain competitive in the information age.

Recent Fed actions have given investors confidence that growth can decelerate without significant recession risk

INVESTMENT OUTLOOK

Recent Fed actions have given investors confidence that growth can decelerate without significant recession risk. The outlook for equities remains favorable based upon the combination of moderate earnings growth with low inflation and interest rates. The stock market is reasonably valued at 17.4x estimated 2019 S&P 500 operating earnings of $168 per share, especially considering a 10-year Treasury yield of 2.57% and core PCE inflation of 1.8%. Looking ahead, the market is trading at 16.1x next year's operating earnings estimate of $180. Additionally, the S&P 500 dividend yield of 1.92% is competitive with both long-term Treasury yields and core inflation and has room to grow. In contrast, global fixed income yields are experiencing unprecedented lows with nominal German and Japanese 10-year bond yields near 0%. This past decade of global monetary accommodation is unprecedented and will likely continue to suppress yields favoring growth assets. Growing businesses continue to enjoy relatively easy access to capital via bank lending, bond markets, private equity and public equity (IPOs).

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Technically, the equity markets have been repairing the damage sustained in the fourth quarter. The S&P 500 has surged 24% from the December lows and new highs are within reach. Additionally, market breadth has significantly improved. The S&P 500 is trading above its 50 and 200-day moving averages (DMA) and the 50 DMA recently crossed above the 200 DMA to form a "Golden Cross" (GC) for the first time in three years. The last 10 GC's produced an average return of 2.9% in the next month and 12% within 12 months. Furthermore, 84% of S&P 500 constituents are trading above their 50 DMA – up from 1.5% on Christmas Eve. The NYSE advance/decline ratio is making new highs confirming the secular uptrend. The market has been fluctuating in a 20% trading range since late 2017 with two meaningful corrections in the last 16 months. Occasional downdrafts are normal as we transition through a period of consolidation. Investor sentiment remains "skeptical" but this healthy skepticism enables the market to strengthen as key resistance levels are navigated without incident.

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It is difficult to gauge the impact of sentiment vs. fundamentals, but a "crisis of confidence" may have caused the recent December decline rather than a change in fundamentals. "In the short-term, the market is a voting machine, but in the long-run, it is a weighing machine." This famous adage aptly depicts recent market action. Fortunately, confidence has been restored by the Fed. The last four months demonstrate that the stock market is successfully climbing the "wall of worry." U.S. equities, particularly small and medium-sized growth companies, remain likely to achieve double-digit returns over the next few years. A few key risks include: Brexit, China's recent slowdown, disappointing earnings, inflammatory presidential tweets, military conflicts, political feuding in Washington, terrorism, trade wars and unexpected inflation. Today, we believe the risks are sufficiently discounted. Above-average earnings growth with modest valuation expansion should support appreciation consistent with past trends. However, the market may experience a pause or correction after its recent strength.