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CFO 2019 First Quarter Financial Markets Review and Outlook

U.S. stocks rallied strongly starting the New Year and continued to trend upward right through the end of first quarter. The S&P 500 (the 500 largest publicly traded companies) was up +13.7% following last year's fourth quarter -14% decline. The S&P 500 ended the first quarter just -3% below the market peak of 2931 recorded last September. NASDAQ and growth-oriented stocks performed even better with the NASDAQ Composite up +16.5% for the quarter. The dramatic dive in global stock markets during the fourth quarter was caused by investor capitulation that fed on itself manifesting in a mini-panic that accelerated during December. Other events in the past have caused similar market disruptions, for example the 1990 Kuwait invasion, the 1998 Asian currency conflagration, and more recently the 2010-2011 European debt crisis all triggered sizable downturns in equity prices. Despite however real and powerful investor concerns seemed at all three of those periods of time, investor fears proved to be unfounded, and the global financial markets recovered strongly within six months following each of those mini-panics. Caution was warranted at the end of 2018, but investors also needed to guard against emotions causing an over-reaction that would lead to missing out on the subsequent recovery rallies that unfolded shortly after the equity markets bottomed.

Source: Google Finance

Global stock markets rallied as well (table below) however most overseas markets continued to underperform the U.S. stock market. Both developed and emerging markets partially made progress in recovering from very disappointing performance in 2018. Bond markets also rallied as interest rates generally traced lower around the world. High yield (non-investment grade) bonds rallied in tandem with the stock market. High yield bonds tend to be more closely correlated to stocks compared to investment grade bonds that comprise the Bloomberg Barclays Aggregate Bond Index.

Total returns	2019 Q1	2018
S&P 500	**13.7%**	(4.4%)
NASDAQ Composite	**16.5%**	(2.8%)
Russell 2000 (small cap)	**14.6%**	(11.0%)
MSCI EAFE Index (non-U.S. developed markets)	**10.0%**	(13.4%)
MSCI Emerging Mkts Index	**9.6%**	(14.3%)
Morgan Stanley US Real Estate Index	**16.4%**	(4.2%)
Bloomberg Barclays Aggregate Bond Index	**2.9%**	(0.1%)
ICE BofAML US High Yield Index (bonds)	**7.4%**	(2.3%)
S&P GS Commodity Index	**15.0%**	(13.9%)
Dow Jones Industrials	**11.8%**	(3.5%)

Sources: Morningstar & Bloomberg

First quarter equity performance was driven by strong reported earnings and the perception that earnings growth will remain strong the remainder of the year and into 2020. At a more macro level concerns over trade wars and higher tariffs appear to have subsided for the time being.

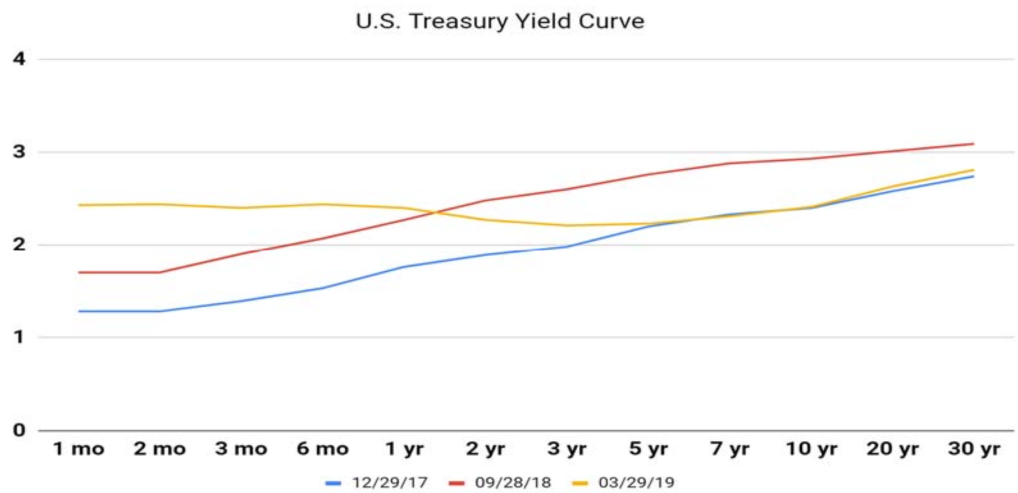
Morningstar U.S. equities sector performance	First quarter 2019 total returns
S&P 500	+13.7%
Basic Materials	+11.3%
Consumer Cyclical	+14.5%
Financial Services	+10.7%
Real Estate	+16.4%
Consumer Staples	+11.7%
Healthcare	+7.9%
Utilities	+10.7%
Communications Svc	+16.7%
Energy	+16.5%
Industrials	+17.7%
Technology	+19.6%

Source: Morningstar

Technology, the largest U.S. stock sector, outperformed all other sectors and was up nearly +20% for the quarter. Technology has been by far the best performing sector over the last five years, up +17.3% annually versus +10.9% for the S&P 500 over the period. The technology sector's first quarter performance was driven mainly by a strong showing by semiconductor stocks and a small group of very large cap stocks that included Apple (+28%) and Cisco (+27%). Industrials, energy, communications services, and real estate rounded out the quarter's excellent overall sector performance bolstered by the prospect of a trade agreement with China, lower interest rates, and continued strong earnings growth. Financial services, the second largest market sector, underperformed on a relative basis mainly due to the flattening of the yield curve, which usually contributes to a narrowing in lending spreads and reduced profitability.

Rates and Bonds

The Federal Reserve raised the target Fed funds rate to 2.5% (from 1% in 2017) this past December but hit the pause button during the first quarter. There may be no further rate increases this year especially if economic growth tapers over the next couple of quarters. The yellow line on the next chart shows a much flatter yield curve at the end of March, and the spread between the 10-year and 2-year Treasury bonds briefly went negative a couple of times during the quarter. An inverted yield curve in past cycles has been one of the warning signals for an oncoming recession and we will pay close attention this and other leading indicators over the coming months.



Source: U.S. Treasury

The Treasury yield curve also has important implications for mortgage rates and home sales in the U.S. The 30-year fixed rate mortgage peaked at 4.94% in November 2018 and has since dropped to 4.06% at the end of the first quarter. Lower mortgage rates were likely a major factor in sharp increases in sales of new and previously owned houses over the latter half of the first quarter with both reaching eleven-month highs.

Outlook Heading Toward Mid-Year

Brexit and the China/U.S. trade talks among other issues remain unresolved and pose risks for market performance entering the second quarter of 2019. Global and U.S. growth projections for the remainder of the year have been reduced modestly. World trade has clearly slowed as manifested by a sharp reduction in global shipping rates. The Baltic Dry Index, a composite of container ship prices, experienced a steep decline at year-end (next chart), likely a sign of slowing global demand. Offsetting some of these tensions include what appears to be sustainable economic growth and continuing low inflation with forecasted U.S. GDP growth expected in the 2% to 3% and the Federal Reserve forecasting 1.8% inflation in 2019.

Source: Bloomberg

The S&P 500's projected price to earnings (P/E) ratio for fourth quarter 2019 has risen from 17.2 to 18.8 (source: S&P), still not nosebleed level but revisions to forecasted earnings and actual reported numbers bear a close watching over the next several quarters. Earnings growth is expected in the high single to low double digits, which if manifested support current market levels and the potential to drive markets higher.

Investment Implications and Opportunities

- Value stocks typically trade at lower price to earnings ratios and often pay higher dividends than growth stocks, however value stocks have significantly lagged in performance relative to growth both recently as well as over the last ten years (following table). To place this in context, a $1,000,000 portfolio that earns an extra 1% annually would be worth $104,622 more at the end of ten years with the benefit of compounding. Value-oriented investors could see a swing in their favor if high dividend value stocks were to turn the tables on growth stocks in the coming months. We continue to see attractive high dividend opportunities in value stocks trading with single to low double-digit P/E ratios.

% outperformance in growth stocks over value stocks	First quarter 2019	10 year annualized
Russell 1000 growth/value	4.2%	3.0%
Russell midcap growth/value	5.3%	1.2%
Russell 2000 growth/value	5.2%	2.4%

Source: FTSE Russell

- There remain reasonably valued growth opportunities as well, particularly among companies that are capable of either double digit revenue or earnings growth, and hopefully both in a perfect world. One of our favored portfolio strategies combines generally more stable high dividend stocks capable of generating steady income with stocks that may offer greater growth potential but with much lower dividends. This is what some refer to as a barbell approach to investing, and a portfolio's weightings in value and growth stocks can be shifted in either direction depending on the investor's objectives and risk parameters. Dividends and dividend growth are also important factors for income-oriented investors to consider in the context of the low interest rate world we live in.

- Last quarter's market commentary made mention of special opportunities in bonds due to a widening in credit spreads (difference between similar maturity corporate and Treasury bonds). Spreads have narrowed considerably since December, but we still see attractively priced credit worthy corporate bonds with maturities under ten years and yields in the 5% to 6% range. A diversified portfolio of bonds or bonds combined with stocks can have far less volatility compared to holding an all stock portfolio, important considerations for more risk averse investors.

As always, we strive to make portfolio decisions in your best interest and look forward to working together and meeting to discuss your portfolio strategy, possible changing personal needs, or any other objectives you might have as we make our way through 2019. And of course, please do not hesitate to email or call us directly if you have questions or concerns.

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Notes: Past performance is no guarantee of future results. All investing is subject to risk, including possible loss of principal.