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Economic and Market Environment

Second Quarter 2019

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The Economy

- After producing its best annual real Gross Domestic Product (GDP) growth in a decade, the U.S. economy appears to have slowed sharply in the first quarter.
- The Federal Reserve (Fed) has taken note of the slowing trend and has made a major adjustment to monetary policy. No further federal funds increases are expected this year.
- While recession indicators have deteriorated, we place higher odds on the current economic softness giving way to faster growth later this year.
- Inflation remains well-contained, and the consumer has ample resources to maintain spending. These two factors provide support for the economy.
- We believe an extension of the near record-long economic recovery/expansion is plausible. We expect a recession at some point, but not yet.

Stocks and Bonds

- The stock market declined sharply in fourth quarter 2018 but staged a strong recovery in the first quarter. The driving force in the recovery was the change in Fed policy.
- Corporate earnings expanded sharply in 2018 and are expected to continue growing this year, but at a much slower pace.
- Stock valuations are slightly higher than long-term averages but seem reasonable given the outlook for inflation and interest rates.
- Sluggish global growth and fears of disruptive trade policies remain the chief concerns among stock investors.
- High-quality bonds provided positive total returns in 2018 and are expected to do so again this year.
- Many bond investors are assuming the current interest rate cycle has seen its peak. Time will tell, but the expectation of rising interest rates has diminished.

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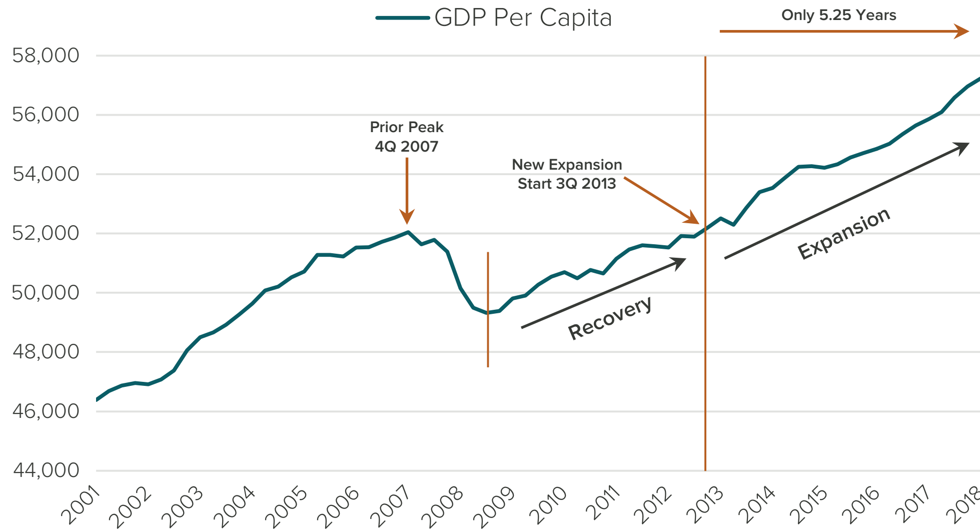
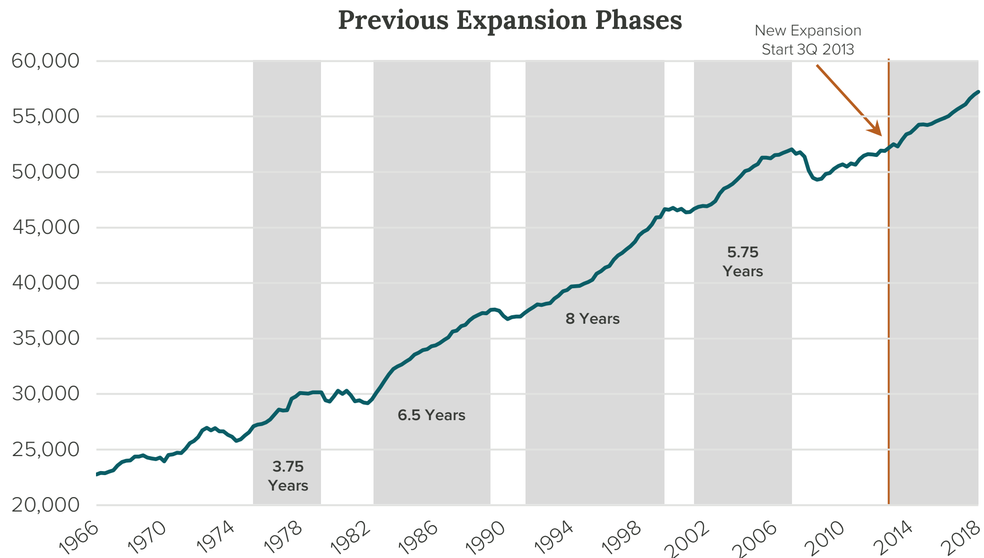
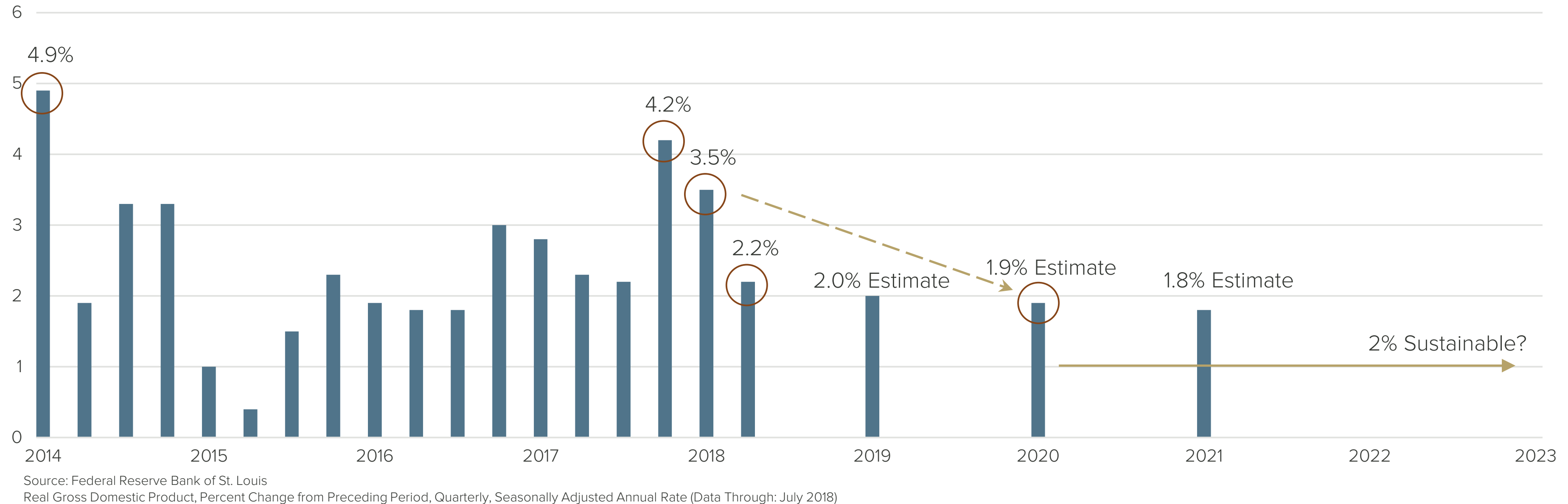




Real gross domestic product per capita, Chained 2012 Dollars, Quarterly, Seasonally Adjusted Annual Rate
Source: Federal Reserve Bank of St. Louis (Data Through: December 2018)

- If the U.S. economy can avoid a recession between now and July, it will be the longest recovery/expansion in U.S. history, a notable achievement.
- The length of the overall recovery/expansion is less important than its two parts. Recovery ends when a previous peak in GDP is reached, and expansion represents true growth.
- The current expansion phase is 5.25 years old. This is shorter than the three previous expansions and suggests the cycle is not as old as first appears.
- We believe underlying economic factors suggest further extension of the expansion. Sources of demand are adequate to sustain economic expansion.



Source: Federal Reserve Bank of St. Louis
Real Gross Domestic Product, Percent Change from Preceding Period, Quarterly, Seasonally Adjusted Annual Rate (Data Through: July 2018)

- Both the Fed and International Monetary Fund (IMF) forecast a long-term, sustainable growth rate of around 2% for the U.S. economy.

- Through monetary policy, the Federal Reserve appears to be attempting to manage the U.S. economy towards the sustainable growth rate over the next several years. The goal is to extend the expansion without causing disruption. This is an ambitious undertaking, but the chances for success are improved by easier Fed policy and low inflation expectations.

- Sources of demand seem adequate to support further expansion of the economy.

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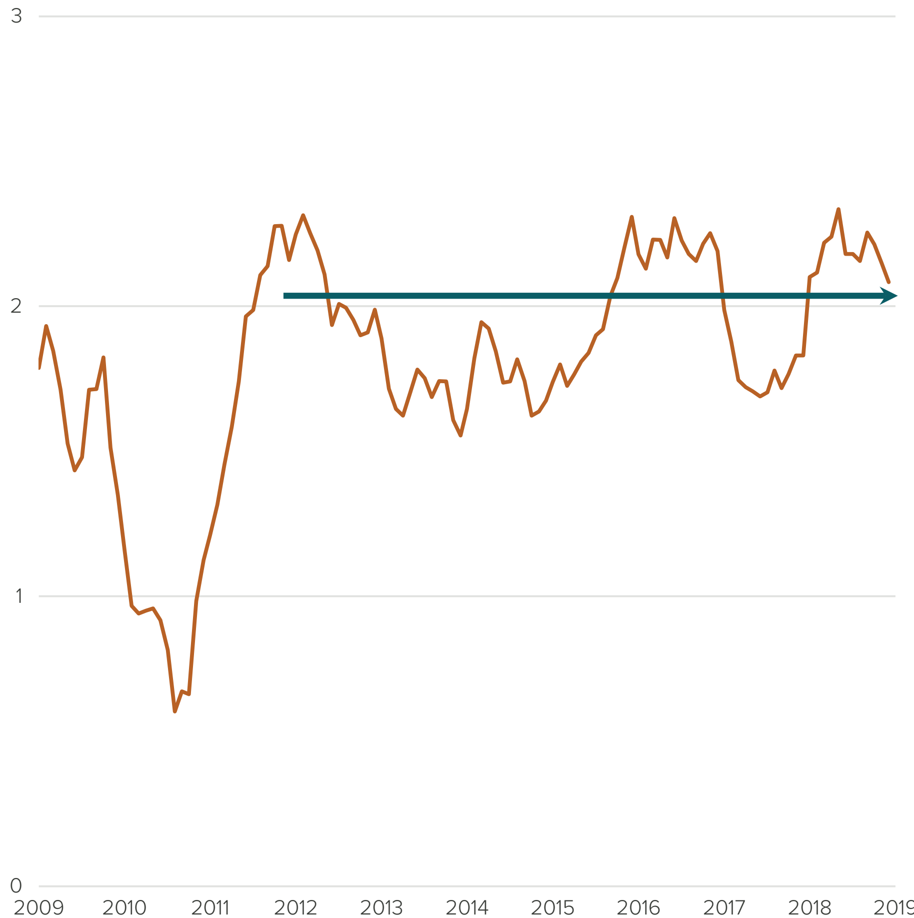
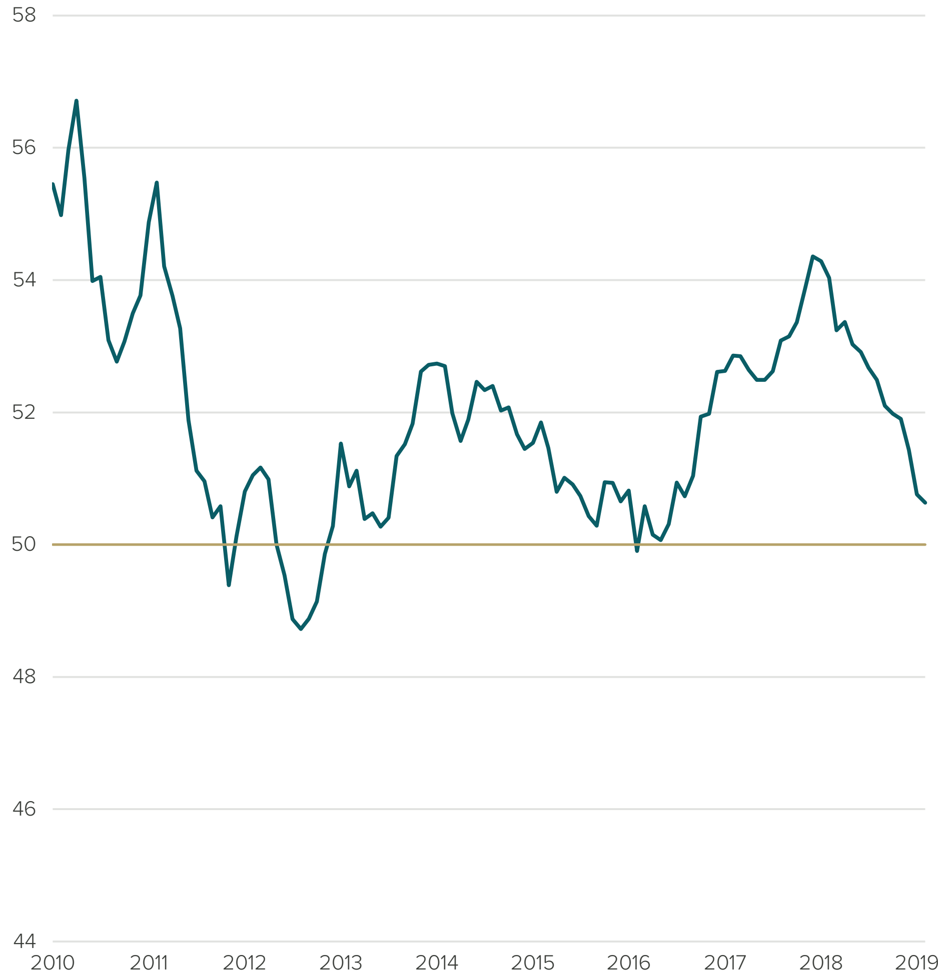


Source: Federal Reserve Bank of St. Louis
Consumer Price Index for All Urban Consumers: All Items Less Food and Energy, Percent Change from Year Ago, Monthly, Seasonally Adjusted
(Data Through: February 2019)

- Stable, low inflation is one of the more important economic elements. It helps foster consistent and enduring economic progress.
- High inflation is disruptive to planning and usually reduces confidence. To curb it, severe monetary policy in the form of higher interest rates is required.
- Fortunately, inflation has remained low and stable within a narrow band, and inflation expectations remain well-anchored.
- Low inflation is very favorable for bond investors, as it limits the potential for sharply rising interest rates.



- Equities are performing well, indicating further economic expansion, but recession fears are also rising.
- One of the chief concerns is the slowing trend in global growth.
- Europe and Japan are in near-recession territory, and China, while still growing, is also slowing.
- Global manufacturing, which includes the U.S., is a good measure of global economic momentum. How long can the U.S. economy be immune to this trend?

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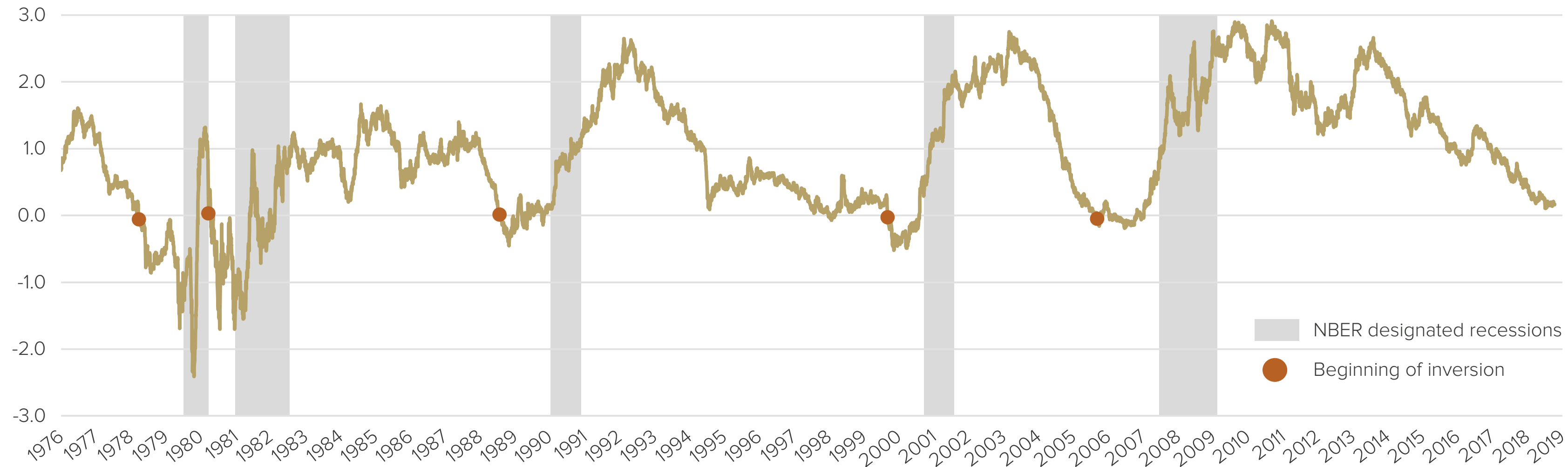

Source: Federal Reserve Bank of St. Louis
10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity, Percent, Daily, Not Seasonally Adjusted (Data Through: March 2019)

- The yield curve is very flat from federal funds out to 10 years, as almost all maturities provide the same yield.
- The chart above illustrates that when the 10-year to 2-year maturities invert, a recession has always followed, not immediately, but within six months to a year.
- Notice that an inversion was narrowly avoided in 1994. A sharp reversal in Fed policy saved the day, and perhaps history will repeat itself this year.
- Yield curve inversions are dangerous because they reduce the willingness of banks to lend, thereby restricting credit growth.
- How sharply the curve inverts and how long it stays inverted are important considerations in terms of its predictive power.
- We believe it is too early to panic over the yield curve.

Recessions

Recession Start Date	Federal Funds Rate %
April 1960	3.92
December 1969	8.97
November 1973	10.03
January 1980	13.82
July 1981	19.04
July 1990	8.15
March 2001	5.31
December 2007	4.24
Current Rate	2.40

Source: The National Bureau of Economic Research (NBER), Federal Reserve Bank of St. Louis
Effective Federal Funds Rate, Percent, Monthly, Not Seasonally Adjusted (Data Through: February 2019)

Start Date	End Date	Duration
February 1945	October 1945	8 months
November 1948	October 1949	11 months
July 1953	May 1954	10 months
August 1957	April 1958	8 months
April 1960	February 1961	10 months
December 1969	November 1970	11 months
November 1973	March 1975	16 months
January 1980	July 1980	6 months
July 1981	November 1982	16 months
July 1990	March 1991	8 months
March 2001	November 2001	8 months
December 2007	June 2009	18 months
	Average	10.8 months

- Federal Funds are now at 2.40%. In the post-war period, the U.S. economy has never entered a recession with federal funds this low. Recessions are generally brought on by high and rising interest rates.
- If a recession were to begin soon, how bad would it be? While never pleasant, the good news is that recessions have lasted from six to eighteen months in length, an average of eleven months.
- Recessions tend to correct economic extremes. By contrast, current economic conditions appear reasonably balanced, suggesting a recession of shorter duration, should one occur.

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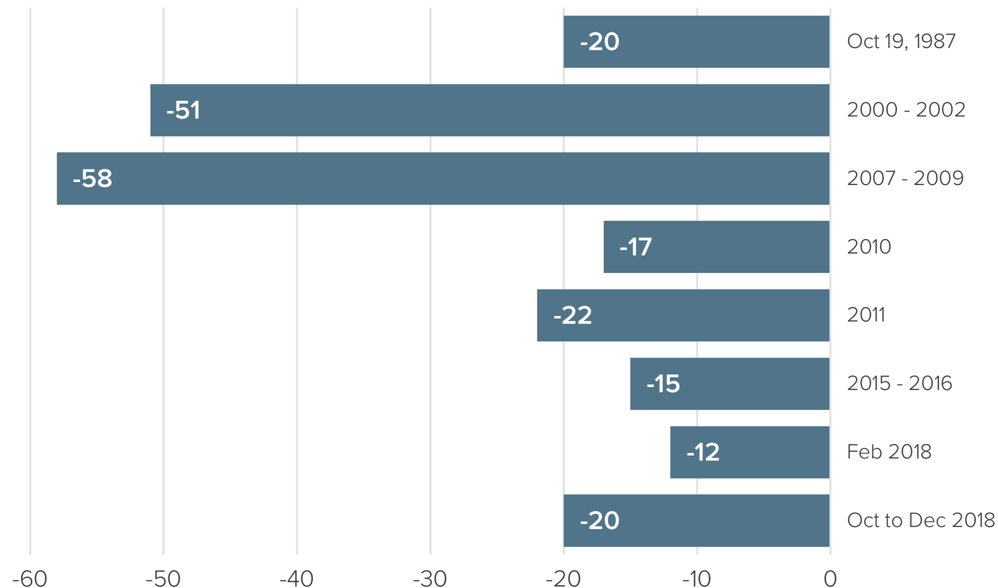
Source: Bloomberg
S&P 500 Price, Quarterly (Data Trough: December 2018)



Source: Wall Street Journal, Rifinitiv
Drops are from intraday peak to trough

- Stocks have been rising consistently, although with interruption since the 1930s.
- In general, the compound return for stocks has been 10%.
- In our opinion, the best way to access these returns is to stay invested for the long term.
- The market has given investors a number of reasons to sell out based on fear and loss of value. Note the table opposite.
- The danger in trying to avoid corrections is that reentry into the market is so difficult to time. Fear only fades after the market has recovered substantially, leaving easy gains behind.

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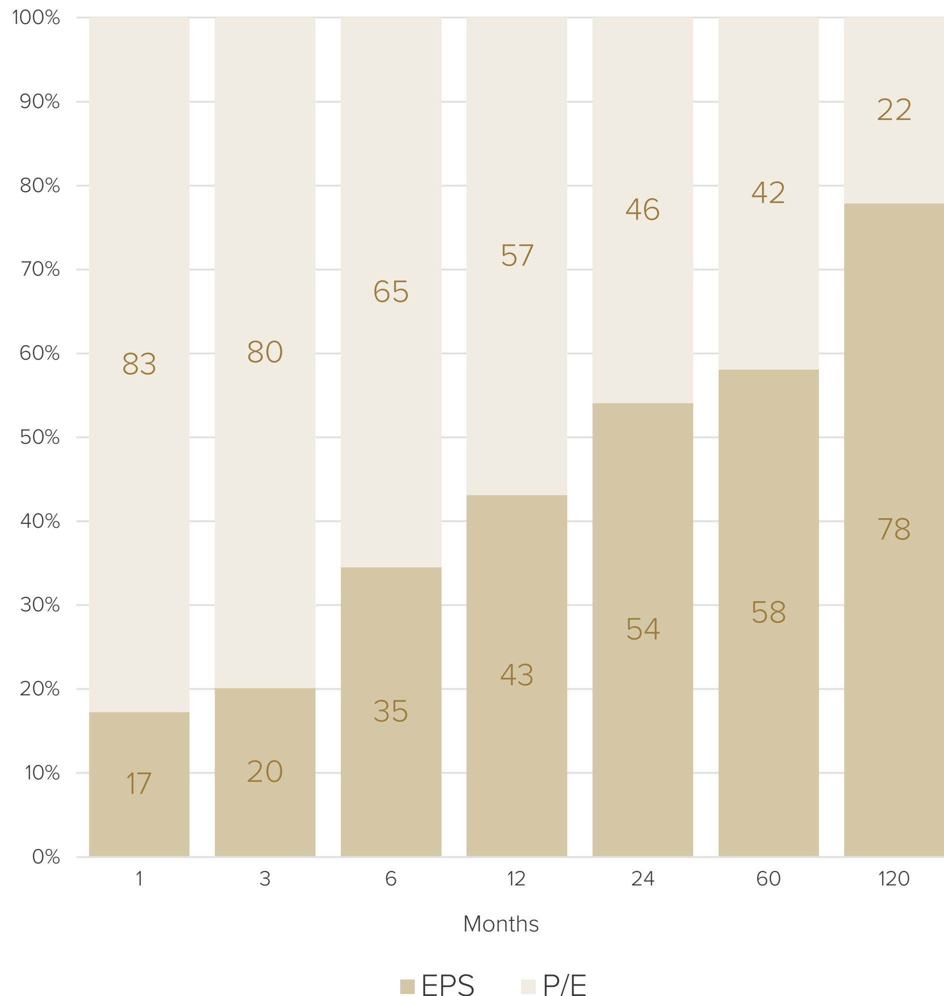

Source: Credit Suisse, Standard & Poor's, Thomson Financial, FactSet

- We recommend that long-term equity investors stay fully invested at all times, in line with policy guidelines.
- The longer one is invested, the more important the underlying earnings become, and the less important changes in valuation become.
- Note that over short periods of time, changes in price-to-earnings (P/E) ratios dominate returns, but, over time, earnings become the more important element.
- This is important because changes in P/E ratios are very difficult to predict while earnings growth is less volatile and more predictable.
- We re-emphasize the virtue of long-term investing.

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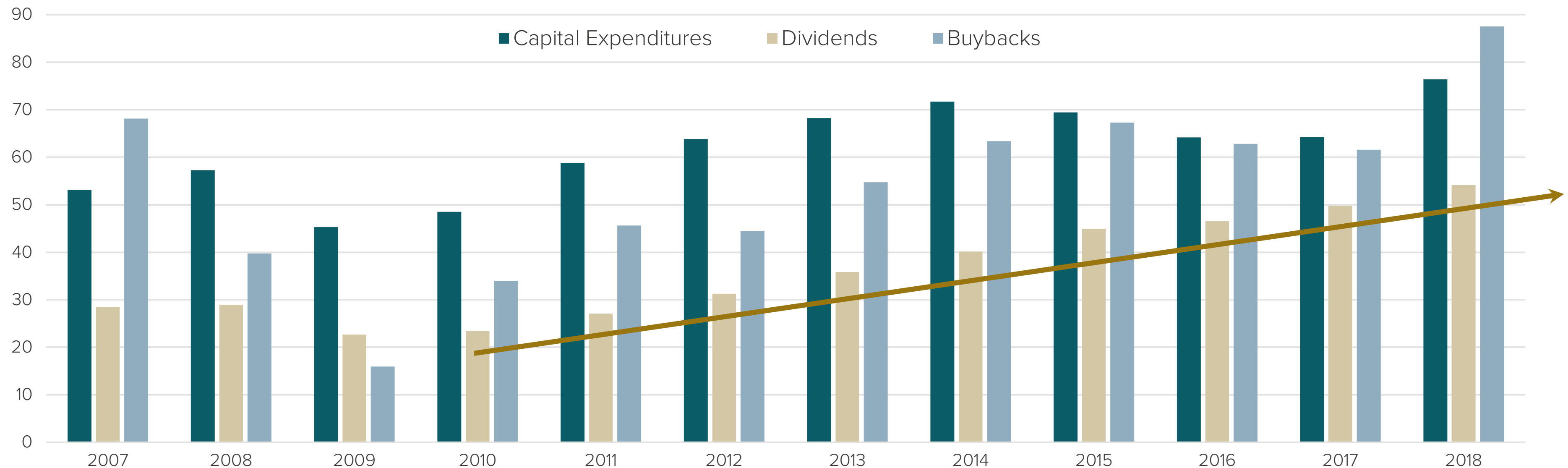

Source: S&P Indices, Bloomberg
S&P 500 Uses of Cash Per Share (Data Through: 2018)

- Investors are interested in how corporate managers allocate capital. There are three principal uses: capital expenditures, dividends, and share buybacks.
- We happily note that dividends have risen each year since 2009, although in each of these years both capital investment and buybacks were larger.
- Capital investment is critical to the future prosperity of a business. In each year depicted above, with the exception of 2007 and 2018, capital investment was the largest commitment. This is proper.
- The huge increase in buybacks in 2018 can be attributed to the reduced corporate tax rate and windfall to profits that followed.
- Share buybacks are a relatively new phenomenon, having begun in the early 1980s. Management prefers buybacks since they are discretionary and can be initiated or abandoned easily. Dividends are considered more sacrosanct, and a dividend cut is usually greeted very unfavorably by investors.

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- Bond investors should monitor credit spreads on corporate bonds. Credit spreads are the difference in yields on corporate bonds relative to comparable-maturity U.S. Treasury securities. As such, they measure the compensation to investors paid for taking the additional credit risk relative to risk-free Treasury securities.
- Credit spreads can swing sharply, as demonstrated above, and are often a good indicator of relative overvaluation or undervaluation.
- A good example of the volatility that can be experienced is illustrated in the graph above. Over the relatively short period of time between February 2018 and January 2019, spreads moved from 85 basis points to 155 basis points.
- History has indicated that higher quality bonds tend to be less volatile. This often makes them a good complement to a portfolio that may experience more volatility due to equity exposure.

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