First Quarter 2019
Courtesy of Miles Capital
Market Commentary

CATCHING THE WINDS OF CHANGE

****THE ECONOMY SHOWED CONTINUED STRENGTH THROUGH THE FIRST QUARTER OF 2019****

Gross Domestic Product (GDP) fourth quarter growth posted at 2.2 percent versus the third quarter 2018 growth of 3.4 percent. However, GDP growth for 2018 was 2.9 percent compared to 2.2 percent in 2017. Fourth quarter corporate earnings increased over 12 percent and sales growth was 6 percent. While this was a decrease from the previous three quarters, it is still high relative to historical levels. Unemployment remained low at 3.8 percent, and consumer spending - including home sales – remains intact. The first quarter of 2019 also saw a more positive economic tone from the U.S. Federal Reserve (Fed). The Fed has raised rates nine times since December 2015 with four of these increases during 2018. While they had previously indicated a potential two rate increases for 2019, the Fed shifted to a more neutral stance on future interest rate hikes. They indicated they'll be more patient in watching economic activity before deciding on their next rate move.
The financial markets rebounded in the first quarter from a strong drop in the last quarter of 2018. The S&P 500 rose over 13 percent for the quarter, but this was a theme across most markets. Oil rose over 32 percent, the strongest first quarter results since 2002. U.S. High Yield was up 7 percent, the best first quarter since 2003, and U.S. Investment grade credit rose 5 percent, the best first quarter since 1995. While we believe continued positive results are likely in 2019, it is possible we could see more volatility. Ongoing challenges to the financial markets include the fear and reality of tariffs, worldwide growth uncertainties, inflation, and continued uncertainty around Brexit.

****THE FED IS NOW ADOPTING A MORE PATIENT STANCE TOWARDS RATES IN 2019 AS THEY ASSESS ONGOING ECONOMIC CONDITIONS****

While 2018 ended with dark clouds over the U.S. markets and a deep freeze over the country, spring has arrived with the markets rebounding in the first quarter by delivering one of the best quarterly performances in nearly six years. A number of factors contributed to the strong performance but perhaps the biggest factor was the changing tone of the Fed. Weaker economic indicators, especially overseas, drove more investors into the U.S. fixed income markets and into the safety of U.S. Treasury securities which pushed longer term interest rates to levels not seen since early 2018.

The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. bond market, rose by 2.94 percent for the first quarter. Falling interest rates and declining risk premiums were the key drivers of performance for the quarter. Interest rates, as measured by the 10 year U.S Treasury note, declined meaningfully for the quarter and ended at 2.41 percent which was 0.28 percent lower than where it ended the previous year. Short term interest rates fluctuated to a lesser degree during the quarter as they tend to follow the Fed Funds Rate which was unchanged for the quarter.

All major investment grade credit and securitized sectors including corporate, municipal, mortgage backed, and agency bonds outperformed similar duration U.S. Treasury securities for the quarter. Within the investment grade corporate sectors, longer duration assets outperformed shorter duration and lower quality sectors outperformed higher Fixed Income quality. Improving sentiment around the trade conflict with China, a more dovish Fed, and decent corporate earnings fueled positive returns for the quarter.

FALLING INTEREST RATES AND DECLINING RISK PREMIUMS WERE THE KEY DRIVER OF PERFORMANCE FOR THE QUARTER

Looking forward, Miles Capital anticipates slower, but still solid economic activity for the upcoming quarters, which should ultimately provide modest upward pressure on interest rates across the curve. These gradual rising rates will tend to drive overall fixed income returns to lower absolute levels. We expect a moderate decline in risk premiums for the major investment grade spread sectors which should offset some of the lower returns due to higher interest rates. Potential risks we are monitoring which could derail our outlook include an escalation of trade wars or an unexpected spike in inflation later this year, which would necessitate a more aggressive Fed and higher short term interest rates.

Equity Stocks Bounce Back

THE FIRST QUARTER OF 2019 WAS THE BEST QUARTER IN ALMOST A DECADE AND THE BEST FIRST QUARTER IN ALMOST 20 YEARS

In the past six months, U.S. stocks have gone from a record high, to nearly entering bear market territory, to back within striking distance of the peak. Following the largest quarterly decline since 2011, U.S. stocks (S&P 500 +13.65 percent) rallied during the first quarter. This was the biggest quarterly gain in nearly a decade and the best start to the year since 1998. All sectors were positive, with information technology leading the way. Health care was the biggest laggard but still posted a strong gain for the quarter. WTI crude increased nearly 32.5 percent following a 38 percent decline last quarter.

Several factors contributed to the rally during the first quarter. The most influential factor was the dovish pivot on the part of the Fed. With a more accommodative and patient Fed, the outlook for equities is much improved from the beginning of the year. Other tailwinds include renewed expectations for a trade deal with China (although that seems optimistic), a low bar for Q4-2018 (most recently reported) earnings that saw double-digit growth, additional share repurchases, and fading fears of a potential earnings recession.

The U.S. economy has as yet been undeterred by the global slowdown and trade disputes, but economic data and first quarter earnings will be at the forefront to determine how much the market has left in the tank. There has been much discussion about the yield curve inversion at the 3M/10Y point during the quarter, but this does not necessarily mean a recession is imminent. For the last four similar curve inversions, the S&P 500 was positive every time with gains of at least 9 percent. Thanks to lower treasury yields, the relative attractiveness of stocks has improved. The S&P 500's earnings yield is about 3 percent higher than the yield on 10Y treasuries, and when the gap is more than 3 percent, the index is positive over 90 percent of the time. Our base expectation is that the equity markets still have room left to run, although risks around trade, a hard Brexit, or unexpected activity by the Fed in response to economic data remain in our forecast.