April 2019

Equities Gain in March Despite Mixed Global Economic Signals

Overview

In March, domestic and foreign stocks and bonds once again generally appreciated. The monthly return for the S&P 500, for instance, was 1.94%, and non-U.S. stocks in the MSCI ACWI ex-USA gained 0.60%. U.S. bond prices were up sharply in response to falling yields as evidenced by the fact that the Bloomberg Barclays U.S. Aggregate Bond Index climbed 1.92%. This positive mood reflects the markets' comfort with the Federal Reserve's more dovish, wait-and-see approach to any future rate increases which began in late December and was reinforced in the Open Market Committee's March meeting statement and Fed Chairman Powell's post-meeting press conference. It also reflects a continued optimism that the U.S. and China will reach a trade agreement sometime in April without any escalation of the dispute in the interim.

Despite the markets' strength, signs of economic growth in the U.S. and abroad were mixed in March, and the U.S. yield curve actually inverted for several days in the month's final week. These two factors make it difficult to evaluate actual investment gains and bear more watching. Our general perspective is that investors should keep their expectations restrained. First quarter returns have been solid, especially following the sharp pull back at the end of December, and it could be tempting to relax into the assumption that such gains will continue throughout the year. While we do not think there will be a recession in 2019, there could be a market pullback given how much higher the markets have moved in just the first three months of the year and the decelerating economic growth and corporate earnings in the U.S. and abroad. In this issue of *Insights*, we share our view on the implications of (1) the yield curve inversion in the U.S. and (2) the current deceleration of global economic growth.

Performance

March was another positive month for most U.S. and foreign stocks, as well as certain bonds (see table below).

	March	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.58	2.90	3.73	4.72	US Muni Bonds
BarCap US Agg Bond TR USD	1.92	2.94	2.74	3.77	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.98	7.40	4.70	11.24	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.42	6.95	5.44	8.52	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.33	2.92	-0.76	4.38	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.79	5.95	0.66	1.90	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.17	11.81	12.21	15.97	US Equity -- Large
S&P 500 TR	1.94	13.65	10.91	15.92	US Equity -- Large
NASDAQ Composite TR USD	2.70	16.81	14.29	18.93	US Equity -- Large
Russell 1000 TR USD	1.74	14.00	10.63	16.05	US Equity -- Large
Russell Mid Cap TR USD	0.86	16.54	8.81	16.88	US Equity -- Mid-sized
Russell 2000 TR USD	-2.09	14.58	7.05	15.36	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	0.60	10.31	2.57	8.85	Int'l Equity -- Comprehensive
MSCI EM NR USD	0.84	9.91	3.68	8.94	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.18	6.32	-8.92	-2.56	Commodities
HFRX Global Hedge Fund USD	-0.17	2.60	-0.30	1.74	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 3/31/2019

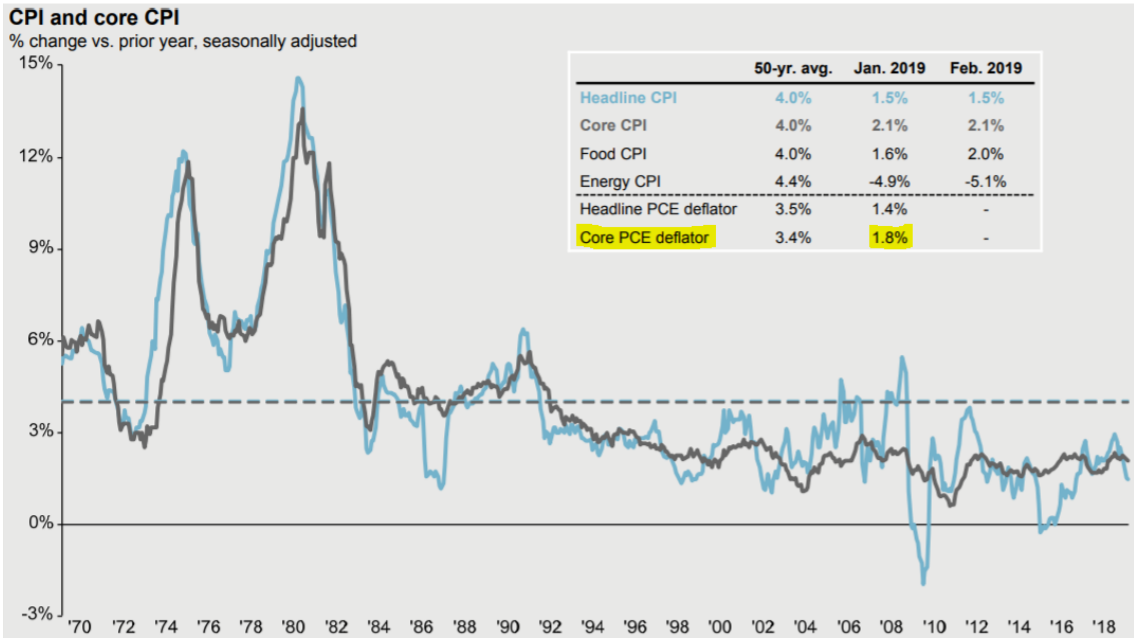
The S&P 500 rose 1.94% on the month, in line with the Russell 1000 Index of large companies (up 1.74%). The Russell 2000 Index of small companies, however, declined 2.09% in March but remains up 14.58% in 2019 through the first quarter, ahead of the S&P 500's 13.65% YTD gain. The MSCI ACWI Index Ex-USA Index, which is a measure of all stocks outside the U.S., is now up 10.31% YTD. The MSCI Emerging Market Index gained nearly a percent (0.84%) for the month and is up nearly 10% YTD through March.

The Bloomberg Barclays U.S. Aggregate Bond Index jumped 1.92% last month, as noted above, because bond yields declined. The yield of the 10-year Treasury Note fell from 2.73% at the end of February to close March at 2.41%. With additional indications of steady interest rate policy from the Federal Reserve, and due to falling yields, high yield bonds gained 0.98% last month. Foreign, U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index gained 1.42% and YTD through March has appreciated 6.95%. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, lost 1.33% in March largely because of U.S. dollar strength. A 50/50 blend of the two EM bond indices continues to have a YTD gain, through March, of approximately 4.94%.

Outlook

Economic growth in the U.S. remains sound but broadly decelerating, and data reports have been mixed. Although the U.S. yield curve inverted (meaning that long maturity bond yields traded lower than yields of short-dated maturity bonds) for 6 days beginning at the end of March, we continue to think, as we explain further below, that the near-term (i.e., in 2019) risk of recession is low. Global economic growth (i.e., in the U.S. and elsewhere) is slowing from prior rates of economic expansion. In the U.S., that slow-down is coming in part from the fading effects of fiscal stimulus via tax reform, which has been widely expected but is still being felt in the economy. Much of this was already known in December when financial markets broadly sold off.

What has changed since late December to ignite the rebound in equity prices in particular is primarily the policy pivot by the Federal Reserve. The Fed and Chairman Powell shifted from saying that interest rate increases "were a long way from neutral" and the reduction of the Fed's balance sheet was on "autopilot" (both mechanisms of financial tightening) to insisting that the Fed would be "patient" and "data dependent" in view of slowing growth and the lack of inflationary pressures. The chart below on inflation shows that the Fed's preferred inflation metric, the core PCE measure, is running below the Fed's long-term inflation target of 2%.



Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

Abroad, China has continued to stimulate its economy, and there are signs that it has recently begun to have some positive effects, as we will discuss below. But economic data out of Europe is less positive, which is more in line with U.S. indicators.

As a result, although our economic outlook does not foresee the occurrence of a U.S. recession in 2019, since growth should remain positive but just slower, our current investment outlook is less certain because of the wide range of potential outcomes. Stocks, in particular, have run up very quickly this year off of the lows reached in late December. We do not think that these gains are unjustified given the sharpness of the 4Q2018 sell-off, but we do wonder to what extent they may be maintained in view of slowing economic growth in the U.S. and in Europe and the possibility that markets have already priced in a coming conclusion to the trade tensions between China and the U.S. As of this writing, the yield curve is no longer inverted, and even if it were to invert again briefly, it would be difficult to base near-term investment decisions on it. It is to a fuller discussion of the yield curve that we now turn.

The U.S. Treasury Yield Curve

The history of interest rates, stock markets, and recessions is complex. Every cycle has different specific characteristics, but the general themes tend to stay the same throughout time. Most recessions, and bear markets for that matter, tend to be triggered by a “financial imbalance.” A financial imbalance could be a commodity spike, extreme equity valuations, irrational behavior in mortgage markets, etc. Currently, in our view there are no such identifiable imbalances.

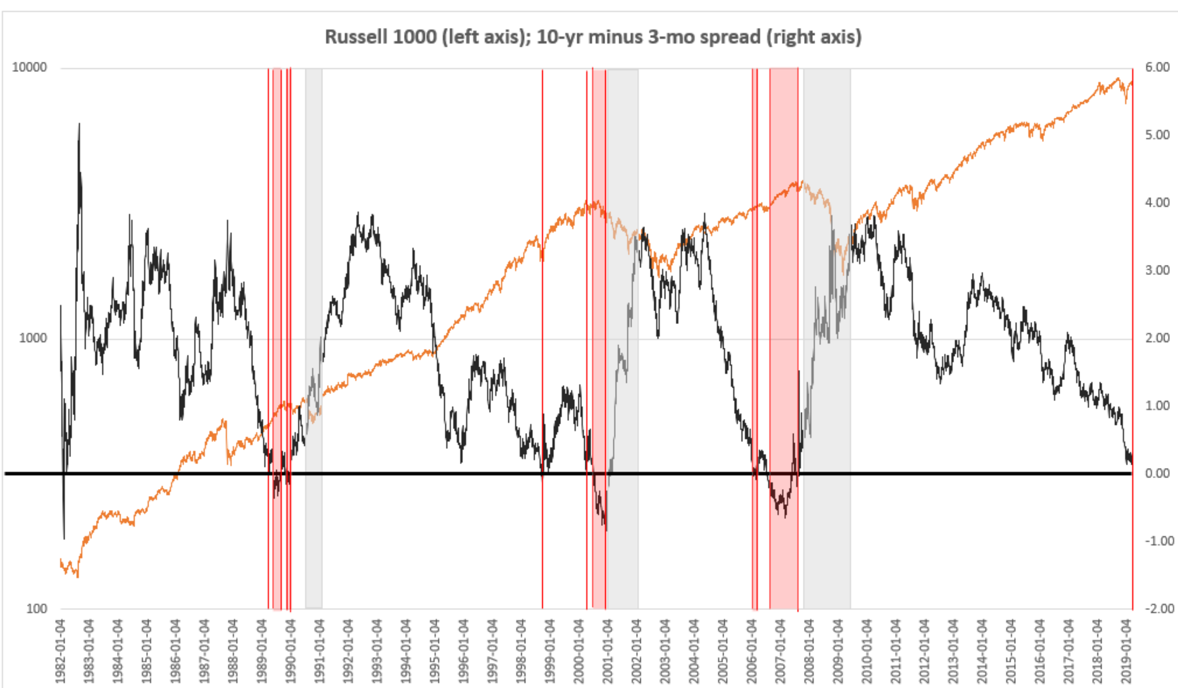
Bond yield inversions, or more specifically U.S. Treasury yield spread inversions, have reliably preceded within 24 months each U.S. recession since the 1970s. Unlike the stock market and other indicators, it has proven to be much more consistent in predicting future growth. The Federal Reserve’s preferred yield spread is the 10-

year minus 3-month spread. In the case of an inversion, the Treasury yield curve is saying that growth is going to decline in the future. Economic activity begins to contract when the curve stays inverted for an extended period of time. This relationship happens for a couple reasons, including:

- Companies see the inverted curve as a sign that the economy is going to grow more slowly in the years to come, and businesses then hold off on hiring, R&D, future expansion plans, etc.
- Banks lend less money because their profitability is pressured due to shrinking net interest margins (banks primarily make money by lending at long-term rates and paying deposits at short-term rates). When banks lend less money (i.e., tighter credit conditions), the growth of the money supply shrinks.

The S&P 500 Index has at present a price-to-earnings (P/E) ratio near its long-term average and so seems fairly valued. Based on history, U.S. large cap equity markets tend to go up while spreads are inverted, and the timing of the upcoming recession varies. Each time the 10y-3mo spread has crossed 0 for the first time, equity markets have afterward continued to rally for some period of time, ranging between 12-24 months. For example, in 2007 the Russell 1000 Index (also a measure of U.S. large cap stocks) peaked approximately 18 months after the first 10-year-3-month Treasury yield curve inversion. Two factors seem to have mattered most in relation to the eventual conclusion of an economic cycle: the (1) duration and (2) magnitude of the inversion. The timing of an inversion prior to a potential economic recession may vary.

The graph below shows the history of the 10-year minus 3-month Treasury yield spread and U.S. Large Cap stocks in the Russell 1000 Index since 1982. The red shading indicates an inverted yield curve, and grey indicates a recession. Each cycle is different from the others, and as more investors pay closer attention to the yield curve slope the exact investment reaction function will change (i.e., stocks may peak sooner one time than another because more investors may discount differently the implications of an inverted yield curve).



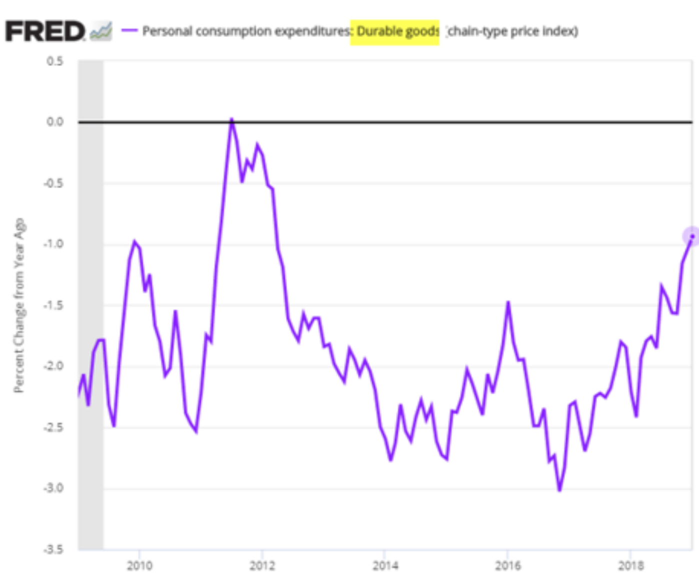
Source: St. Louis Federal Reserve, Sage Financial Group

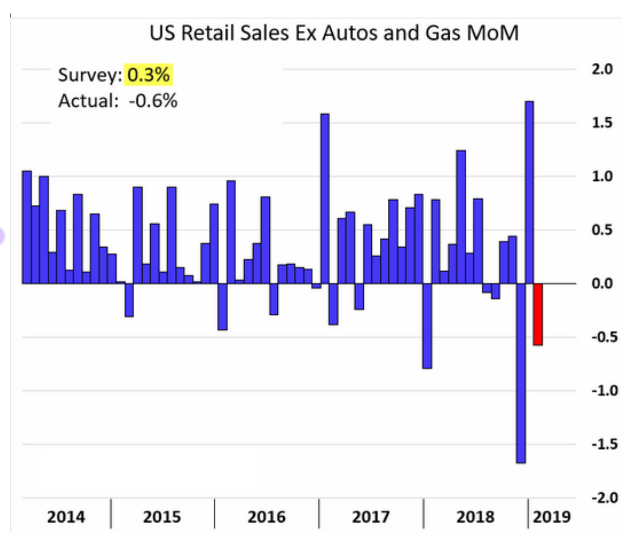
In the early 1990s and late 2000s, the market top occurred about 1 year after the curve inverted for more than a few days. In the late 1990s, perhaps due to excessive valuations, the market top occurred sooner (approx. 3 months) and the bear market lasted much longer. The best parallel to 2019 may be the early 1990s (end of a long, shallow expansion) when markets topped out about a year following the inversion, and the recession induced by the bursting of the tech bubble came about a year after the top, but these events are extremely difficult to predict. The probabilities are difficult to ascertain versus outcomes that are more like 2001 (increased valuations in financial assets leads to a quicker "top") or 1998 (global growth scare that ends without a recession within 12 months). If pressed, we might say that we see the most similarities at present to the 1998 scenario, but we would do so with qualifications that we are not predicting an exact repeat of that timing.

In today's environment, valuations are not excessive by traditional measures after considering historically low interest rates. There are no clear financial imbalances by traditional measures, and banks are exceptionally well capitalized in the United States. Potential imbalances do include corporate credit, which may be a bit stretched, and the deficit of the U.S. government. Cyclical sectors are weaker, but they do not represent a large percentage of the economy. Global growth has been weak and is likely the biggest risk to the U.S. economy and Sage's portfolios, but much of the bad news could already be priced in. The availability of information is much different today than in the 1990s and even in 2007. This difference, as well as the effect of unconventional monetary policy over the last 10 years, could make it more difficult to predict the upcoming economic and investment environment based strictly on past yield curve inversions.

Global Economic Growth and Corporate Earnings

If it were not difficult enough to forecast investment asset movements from the brief yield curve inversion, mixed global economic data make the task even harder. In the U.S., manufacturing activity has been weaker, but still generally positive. What is more, consumer spending on durable goods is in contractionary territory, as you can see from the chart below on the left, which again shows a negative change year-over-year; however, the trend has been upward sloping. Retail sales excluding auto sales and gas can be volatile, and the most recent monthly reading shows a notable decline after the prior month's bounce back from weakness at the end of 2018.

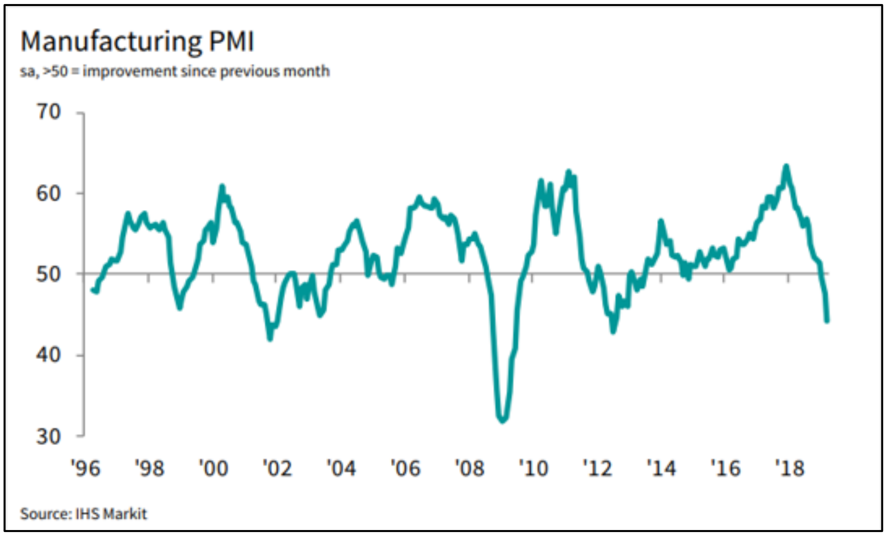




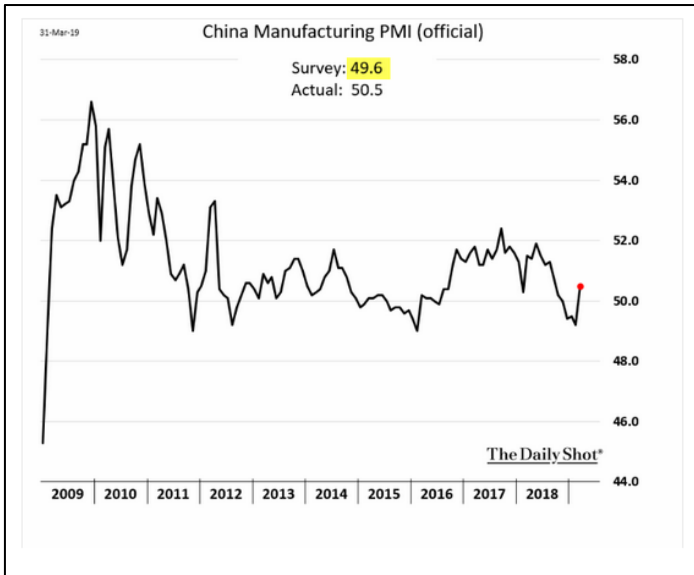
Source: Wall Street Journal

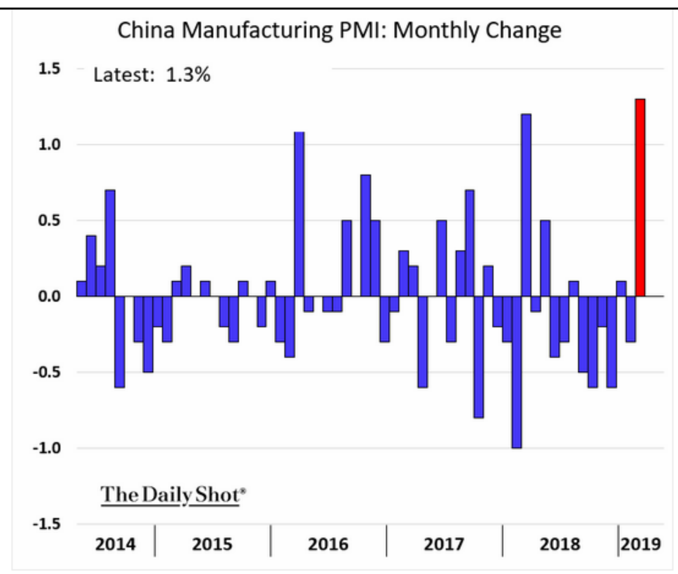
The unemployment rate remains exceptionally low at 3.8%, and most analysts agree that the weak employment gains from February's report were an anomaly skewed by the government shutdown and weather-related disruptions. Consumer sentiment seems to be increasing from its low point earlier this year. In short, the U.S. economy is solid but not uniformly so.

European economic data continues to be weak in the face of political uncertainty and a global manufacturing slowdown. Weakness in the European data is perhaps most notable in Germany, which has typically been Europe's steadiest and strongest economy. The nearby chart shows a sharp decline in German manufacturing activity that has been occurring for some time but that has in recent months turned negative (i.e., below a reading of 50). Germany's economy relies on manufacturing more than almost any other developed country. Some of this decreased economic output is likely related to the slowdown that has been affecting the Chinese economy, since Germany exports a large percentage of its goods to China.



Chinese manufacturing activity throughout 2018 had similarly experienced both a decline and an overall contraction, as you can see from the chart on the left below. Activity has rebounded now back into expansionary territory just above 50, beating the surveyed estimates. The graph on the right shows the magnitude of the monthly upward rebound.





We remain vigilantly optimistic that a trade deal will be reached within the next few months between the U.S. and China. China's practices regarding intellectual property rights remain a major sticking point in negotiations, but recent rhetoric has been positive from both sides. The stakes in the U.S./China conflict are important. A return to more normalized political and trade relations could be positive for both economic growth and investment sentiment. An end to the trade dispute with the U.S. could help return both economic and political stability to China where the two are integrally related. Meanwhile, China seems committed to propping up its economy through various monetary, currency, and fiscal stimulus measures. If recent data is any indicator, such measures appear to be helping. If sustained, this economic improvement and sentiment may help to continue the recent positive momentum in global, and especially emerging market, stocks.

At the same time, corporate earnings have also been declining from prior quarters and year-over-year comparisons, as economic growth has simultaneously declined. It remains an open question which data global equity investors weigh most heavily and the timeframe that they use in considering their investment horizon. Those investors who look at the recent declines in economic and earnings data as likely to continue may not provide any additional support to equity prices and could in fact participate in asset flows out of stocks. On the other hand, investors could view stabilizing and positive data in China as an optimistic sign about additional future improvements from recent past weakness, and those who do could help to boost stock prices further.

Summary and Conclusion

Investment assets have risen strongly, especially in equities, through the first quarter of 2019. Positive returns are always exciting, and we are very pleased with this development. But we do not think that the rate of gains realized in the first three months is likely to continue at the same pace or with the same magnitude throughout the remainder of the year. Domestic economic growth seems durable if decelerating, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow but at a slower pace than it has recently, as fiscal stimulus slows, and the cost of borrowing remains stable but higher than a year ago. Corporate earnings are lower than they were a year ago, and investors may take note. We continue to take a hopeful but realistic view about decelerating economic growth and corporate earnings growth globally, as well as about the uncertain potential effect on additional equity gains.

We remain generally constructive on the global economic outlook despite the unfinished trade agreement and ongoing uncertainties in Europe, including the growth slowdown there and the ever-changing nature of Brexit. We continue to be of the opinion that in time China and the U.S. will strike a trade deal, but the precise path to the goal line may still be filled with ups and downs.

We do not think that the recent temporary and shallow inversion of the Treasury yield curve is overly alarming; however, we also do not think it should be ignored given the consistency of its historical record as a precursor to recessions, even if such an economic recession remains possibly 12-24 months in the future. Currently, the U.S. economy does not show significant evidence of the type of imbalances that typically prompt or coincide with recessions. We remain of the view that an economic recession is unlikely in 2019. At the same time, given how much equity markets have run-up so far in 2019 through March, and given both the yield curve developments and the mixed global economic picture, we also remain of the opinion that a balanced approach to portfolio asset allocations is warranted, rather than skewing allocations toward one type of investment or another.

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