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Private Wealth Management

Quarterly Investment Commentary

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Sky Fall?

If you had listened to most of the economists and market strategists on television in the fourth quarter of 2018, you might have thought that the sky was falling, the Earth was about to stand still, and the zombie apocalypse had begun.

After all, the Government was shut down, we were in the middle of a trade war with China, the Federal Reserve Bank seemed intent on raising interest rates while economic data appeared to be weakening, perhaps indicating an impending recession. In addition, the Mueller report was about to be released with dire implications for the president and our whole political system, Chinese economic growth was falling off a cliff and Great Britain was likely going to crash out of the European Union, sink into the English Channel and throw the continent into chaos.

Perhaps we all watch too much television and have too vivid an imagination, and perhaps it is easier to see what can go wrong than what can go right. In addition, fear and alarmism tend to generate better ratings than rational analysis. But, typically, things are rarely as bad or good as they appear on television and it is helpful to turn off the noise and take a longer and more balanced view of things.

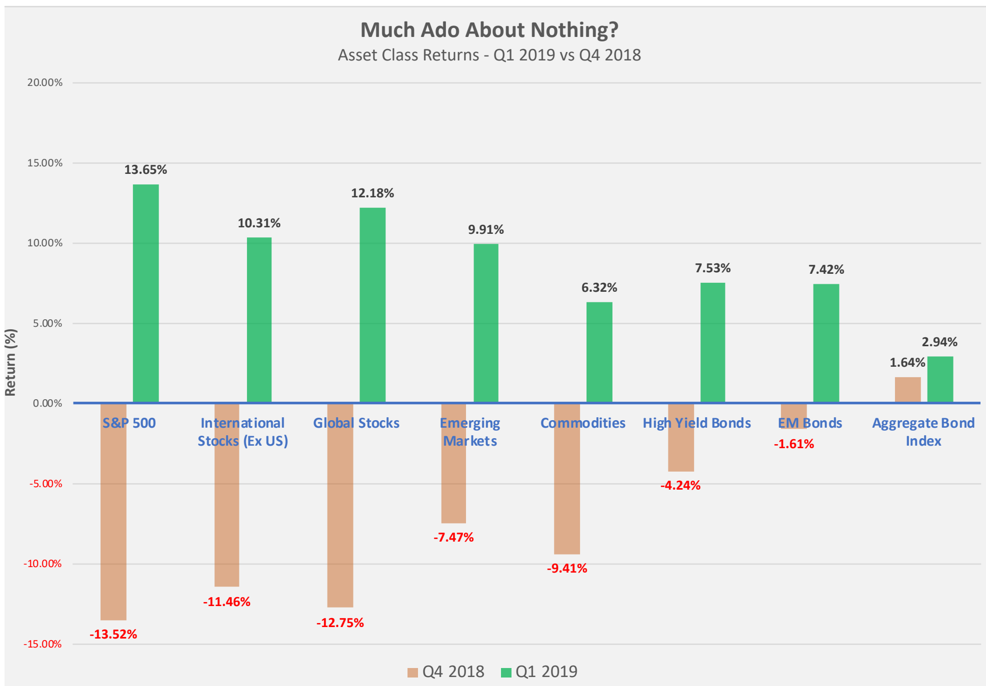
As we wrote in December and January, we did not believe the sky was falling. U.S. economic growth had slowed but was still around 2%, with no signs of an imminent recession. Moreover, part of the weakness in economic data was likely caused by the government shut-down, the cloud of concerns mentioned above, and the rapidly declining stock market.

Our view was that most of these concerns were both overblown and transitory and, that if so, stocks were significantly oversold and due for a rebound. We used the opportunity to add to positions in some of the hardest hit parts of the market including technology, biotechnology and emerging markets.

Miraculously, the sky didn't fall, the earth didn't stop rotating on its axis, and the zombies never rose from the dead. In fact, the government shut-down ended, Federal Reserve Chairman Powell issued comforting words about taking a pause in raising rates, and there were signs of meaningful progress in our trade talks with China. Economic data stabilized and corporate earnings were decent. A whiff of good news was all that was required to reverse the decline in stocks and send markets bounding sharply higher.

In fact, as **Chart 1** below shows, the first quarter of 2019 seems like the mirror image of the fourth quarter of 2018. One could have gone away to a tropical island at the end of September and returned on April 1st and think things were largely unchanged. One might wonder if all that volatility was necessary and served any purpose. The stock market is often given credit for being a rational and efficient predictor of the future, but history suggests it is a far better measure of current investor sentiment which, we have seen, can fluctuate dramatically between unfounded pessimism and unbridled optimism. The truth tends to lie between the extremes.

Chart 1



Source: Morningstar & Jurika, Mills & Keifer

So where are we now?

Our overall economic outlook has not changed much since the beginning of the year.

We think that the U.S. economy is growing at around 2% to 2.5% a year. Incremental economic data in the last few weeks reflects a slight upturn in overall economic activity. The housing sector looks stable, unemployment is below 4%, and we are seeing some growth in wages although overall inflation rates remain benign at about 1.5%.

European economic growth is slow but seems to have stabilized and is showing signs of improvement in the services sector. Industrial and manufacturing data is still weak and is clearly more dependent upon trade but may also be turning the corner. An uptick in demand from China would provide a welcome boost to exports.

China also looks like its economy is stabilizing and improving. Credit growth has started to slowly accelerate again, and the Chinese government is attempting to stimulate domestic consumption in a sustainable way. Elsewhere in other emerging markets we have also seen a small improvement in economic data.

We expect some form of trade agreement to be reached between the U.S. and China in the near future. The agreement will likely be more style than substance, but it will at least lift the current cloud of uncertainty overhanging current U.S. China trade policy, as well as removing the prospect of things getting worse.

Central Banks have moved to a more supportive position as well. The Federal Reserve is pausing on its plans to increase interest rates and the European Central Bank recently reversed course and announced additional economic stimulus.

Although the Federal Reserve has hit the pause button, it would be wrong to assume that it is done raising rates. If economic growth picks up, as we expect it will, and/or we see signs of increased inflationary pressures, we would expect the Fed to respond with additional rate increases.

The biggest known risk is Brexit. We suspect that a deal will be worked out just before the last and final deadline is reached, or the issue will be put back to the British population for a new vote. Brexit has become increasingly unpopular in the U.K. and current polling suggests that in a revote, the majority of Britons would vote to remain in the European Union.

There are always unknown risks, which by definition, are the ones that surprise you and are not reflected in market prices. Examples include natural disasters, terrorist attacks, geopolitical events such as wars, and financial events such as Enron, Long Term Capital, and Bernie Madoff. You cannot predict what they will be ahead of time, but you can predict that they will happen.

Which brings us to valuation. Although our economic outlook has not changed very much since December, prices of almost all asset classes have risen sharply. Overall, stocks are no longer inexpensive, and investor sentiment has moved from abject fear back to hope and even greed. Today, more caution is warranted than at the beginning of the year.

That being said, we still think that the likely path for equities over the rest of the year is higher, especially if we see meaningful improvement in trade, global economic growth and corporate earnings. Interest rates have declined making owning stocks relatively more attractive than bonds. We do not see an imminent recession on the horizon.

In particular, we think emerging markets look inexpensive relative to their history and to U.S. stocks. In fact, most international markets look inexpensive relative to U.S. stocks, supporting the notion that the U.S. stock market is a very nice, but expensive neighborhood. Better bargains can be found elsewhere.

We continue to invest with a global focus, emphasizing U.S.-based markets but also including significant allocations to the rest of the developed and developing world. In addition, we balance investments targeted at areas of long-term growth and innovation with more defensive equity, alternative and fixed income strategies to mitigate volatility and risk.

As always, we welcome your comments, questions and referrals.

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Source for Data: Bloomberg, Morningstar, YCharts, BCA Research, U.S. Government.

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