Quarterly Commentary: Q1 2019

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Equities:

Equity markets bounced back from a tumultuous end to 2018 with one of the strongest quarters in recent memory. Remarkably, the upward momentum in equities was established despite further weakening of the economic backdrop, a lack of real progress in US/China trade negotiations, and the longest government shutdown in US history. So what changed? For one thing, the market likely overshot to the downside when it teetered on the edge of bear market territory back in December, but markets also received a shot of adrenaline from the Federal Reserve, which completely reversed course on its plans for monetary policy normalization.

The market rally during the first quarter has helped to illuminate just how fixated the market has become on the Federal Reserve. The roots of that fixation likely trace themselves all the way back to the financial crisis, when interest rates were pulled down to zero and the great policy experiment known as "Quantitative Easing" began. For ten years now, the market has become accustomed to the artificially high levels of liquidity and easy access to capital that these policies have fostered, and it is becoming apparent that it will take time for markets to be weaned off of that support. All of this has put Fed Chairman Jerome Powell in an unenviable position, where every public appearance he makes has the potential to invoke a meaningful response from markets.

Bonds:

Performance in the bond market was also strong to start the year, as a downward shift in inflation expectations combined with the reversal in rhetoric from the Fed to push yields to their lowest levels since 2017. However, bond yields flashed a bearish signal to markets during the last few weeks of the quarter as the yield difference between the 3-month T-Bill and the 10-year Treasury Note inverted (the yield on the longer dated 10-year note moved below that of the 3-month T-Bill). The inversion has prompted many to point out the historical relationship between yield curve inversions and economic recession, but we believe this is overblown.

The yield offered on US Government bonds is largely dependent upon expectations for economic growth and inflation, both of which have moved lower over the past 6 months. However, at this point in time the US economy appears to be slowing rather than stalling. Expectations for economic growth remain around 2%, which could still provide a stable environment for investors to generate modest returns. In a low inflationary world, modest returns should still be enough to keep investors on track for their long-term goals.

Outlook:

Much of our review of the first quarter has been focused on the Federal Reserve and monetary policy, which remains a key area of focus for markets. But as the calendar rolls over into spring, markets may shift their focus to Q1 earnings, which are expected to be quite a bit lower than in 2018. The extent to which earnings exceed or miss expectations could be a key driver of market performance in Q2.

Furthermore, while President Trump has signaled that he is generally pleased with the progress that has been made with respect to trade negotiations with China, little tangible evidence of an impending deal has emerged. Recent data from Europe has highlighted the impact that the slowdown in global trade has had on the world economy, and this has been a source of unease for global investors. In our view, an eventual deal with China will be important to the extension of this bull market, as it would help to alleviate the concerns permeating through markets regarding the growth rate of the global economy. And it is these concerns that are at the core of the market's anxiety over the future of Fed policy.