IM&R Economic and Market Review Q1 2019

Steve Mayhew CFA, CIO

Economic Review

Federal Reserve Chairman Jerome Powell surprised the market by signaling the Fed may not raise rates this year after all, slashing interest rate projections for 2019 from two hikes down to zero. Reasons for the dovish turn include more subdued growth, stabilizing unemployment, slowing global economic activity and lower inflation expectations. Fed officials also said they would end the drawdown of central bank bond holdings by September. Together, the moves indicate a significant pivot from just three months earlier. This patient pause left the target federal funds rate at a range of 2.25%-2.50%.

Closing a year of strong economic growth on a softer note, the economy slowed in the fourth quarter to an annual rate of 2.2% from 3.4% in the third quarter, according to the Commerce Department real gross domestic product (GDP) release. Economists project growth to moderate further in the first quarter with the latest Atlanta Fed GDPNow forecast at 2.1%.

The Conference Board Leading Economic Index (LEI) increased in February for the first time in five months driven by accommodative financial conditions and a rebound in stock prices. Nevertheless, the LEIs growth rate has slowed over the past six months, suggesting that while the economy will continue to expand in the near-term, its pace of growth could decelerate by year end.

Personal Consumption Expenditures (PCE), the Fed's preferred inflation gauge, fell to an annual rate of 1.37% in the latest BEA release. Core PCE (less Food and Energy) at 1.79% has remained persistently beneath the Fed's 2% annual target for inflation.

Manufacturing activity expanded in March, supported by gains in new orders and employment, and the overall economy grew for the 119th consecutive month, say the nation's supply executives in the latest *Manufacturing ISM® Report On Business*

Existing-home sales rallied 11.8% in February, the largest monthly gain since December 2015, according to the National Association of Realtors. New home sales also increased 4.9% suggesting that falling mortgage rates were starting to boost the housing market.

Consumer confidence improved in March on rising incomes and lower inflation expectations according to the University of Michigan Survey of Consumers. The last time a larger proportion of households reported income gains was in 1966.

Financial Markets Review: Domestic Stock Market

Following a harsh fourth quarter 2018 selloff, U.S. stock markets rebounded sharply to start 2019 with the S&P 500 posting its best quarter since 2009 and the best first quarter in 21 years. The S&P 500 vaulted 13.07% excluding dividends to 2,834.40. The Nasdaq closed at 7,729.32 with a torrid return of 16.49%. The Dow Jones Industrial Average also finished the quarter up 11.15% to 25,928.68.

All eleven S&P 500 sectors displayed positive returns for the quarter with information technology (+19.86%), real estate (+17.53%) and Industrials (+17.20%) leading the group. The bottom three sectors were health care (+6.59%), financials (+8.56%), and materials (+10.30%).

After a fourth quarter reversal, growth stocks resumed their lead over value in both the large and small market-cap space. The growth style continues to outperform value over the past one, three, five and 10 years.

IBM was the strongest holding in the Dow Jones Industrials Average for the quarter leaping 25.51%, followed by Cisco Systems (+25.36%) and United Technologies (+21.74%). On the losing end were Walgreens (-6.75%), Pfizer (-1.88%) and United Health Group (-0.39%).

The best performing S&P industry groups for the quarter were consumer electronics (+75.7%), general mining (30.9%), and renewable energy equipment (30.1%). The worst performers were tires (-10.2%), platinum & precious metals (-5.1%) and drug retailers (-2.8%).

Looking ahead, the economic expansion continues to decelerate, but remains fairly positive even as tax-cut effects fade. The on-going Brexit mess, European fragmentation and bogged down trade talks with China are exacerbating a global economic slowdown. And the prospect that existing tariffs will remain in place for a substantial period as well as additional trade disputes including potential tariffs on European autos and a delayed passage of the U.S. Mexico Canada Agreement (USMCA) are of concern. Corporate profits are also a major cause of investor anxiety with the potential for a profits recession after eight consecutive quarters of double-digit earnings growth.

But the details in the data do not make us think the expansion is going to end anytime soon. And although we expect increased market volatility in the near term, the supportive stance of the Fed and other global policy makers, low inflation, a strong labor market, reasonable market valuations, and a slowing but still growing economy leave markets in a position to grind higher in the quarter ahead.

	Total Returns (03/31/19)			Annualized Returns (03/31/19)		
Category/Style	**1st Quarter**	**Year-to-Date**	**One Year**	**Three Years**	**Five Years**	**Ten Years**
S&P 500	13.65	13.65	9.50	13.51	10.91	15.92
S&P Midcap 400	14.49	14.49	2.59	11.24	8.29	16.28
S&P Small Cap 600	11.61	11.61	1.57	12.55	8.45	17.00
Russell 1000 Large Cap Growth	16.10	16.10	12.75	16.53	13.50	17.52
Russell 1000 Large Cap Value	11.93	11.93	5.67	10.45	7.72	14.52
Russell 2000 Small Cap Growth	17.14	17.14	3.85	14.87	8.41	16.52
Russell 2000 Small Cap Value	11.93	11.93	0.17	10.86	5.59	14.12

Source: Standard and Poor's, Frank Russell Company

International Stock Markets

The JP Morgan Global Manufacturing PMI report showed the performance of the global manufacturing sector remained weak in March, signaling a further lackluster improvement in operating conditions in the global manufacturing economy. PMI readings were above the neutral 50.0 mark in China, the U.S., Brazil and the U.K. Sub-50.0 scores were registered for the euro area, Japan and South Korea.

Pointing out that risks to global growth still tilt to the downside, the IMF's latest *World Economic Outlook Update* projects that global economy will grow at 3.5% in 2019, down from last October's projections.

Nevertheless, for the first quarter the MSCI EAFE Index of developed markets climbed 10.59%. Emerging markets as measured by the MSCI Emerging Markets Index were close behind with a gain of 9.91%. Frontier markets advanced 6.87%.

In the Eurozone, the Euro Stoxx Index leaped 14.18% in local currency to 366.94. Among Euro members France's CAC-40 Index vaulted 16.35% to 5,350.53, Germany's DAX Index gained 11.02% to 11,525.04 and the UK's London FTSE 100 Index was higher by 10.55% to 7,279.19 in spite of continuing Brexit uncertainty.

Asia-Pacific markets also advanced strongly in the first quarter. In developed markets, Japan's Nikkei stock average added 5.62% to 21,205.81, while India's emerging market S&P BSE Sensex index gained 6.67% to 38,672.91. And China's economic stimulus measures propelled the Shanghai Composite Index 23.9% to 3,090.76 in local dollars.

Erasing much of the fourth quarter loss, the DJ Americas index rebounded 13.35% for the quarter to 672.94. Canada's S&R/TSX index increased 12.42% to 16,102.09 and Mexico's S&P/BMV IPC Index was up 3.94% to 43,281.28. Brazil's Sao Paulo Bovespa Index climbed 8.56% to 95,414.56 in local dollars.

The dollar edged up a modest 0.51% against world currencies in the first quarter according to the WSJ Dollar Index. The dollar strengthened 1.05% against the yen to 110.85 (JPY/USD) and was 2.14% higher versus the euro at $1.122 (USD/EUR).

World Bond Markets

Currently, the yield curve is on the hot seat with the 10 year/3-month Treasury spread having briefly inverted near the end of the first quarter. A yield curve inversion is a well-known precursor of a recession. The U.S. 10-year note yield fell another quarter percent to 2.42% at the end of the quarter. As a result of the yield drop, bond prices rose and the Barclays U.S. Aggregate Bond Index gained 2.94% for the quarter. Likewise the Barclays Municipal Index added 2.90% and the Barclays U.S. Treasury TIPS Index added 3.19%. The average money market yield was steady at 2.25% according to the Crane 100 Money Fund Index at the March close. Yields on foreign bonds also continued to fall across the board in the first quarter, with the 10-year bond yield sliding 0.25% in the U.K. to 1.01%, and 0.46% to 1.53% in Canada. Yields in Germany and Japan went negative with Germany down 0.33% to -0.08% and Japan lower 0.09% to -0.07%.

Commodities

In a mirror image reversal of the fourth quarter loss of 8.40%, commodities moved 8.40% higher in the first quarter of 2019 to 620.98, as measured by the DJ commodity index. Gold was relatively tame for the quarter gaining $14.70 or 1.15% during the period to 1,293.00. On the other hand, crude oil gushed ahead 32.44% or $14.73/barrel to $60.14. According to the American Automobile Association (AAA), the national average price of gas surged 44 cents in the first quarter to $2.69 on increasing oil prices and refinery capacity issues as many refineries go off line in the spring for repairs and the retooling necessary to produce more gas for the summer. In four states the price is in excess of $3 with the highest average price in California at $3.61

Mutual Funds/Exchange-Traded Funds

According to the Investment Company Institute (ICI), for the 12 months ended February 28, 2019 net mutual fund total assets increased $199.6 billion to $19.1 trillion, and the number of funds increased by 100 to 8,074. Exchange-Traded Funds (ETFs) gained $248.4 billion in assets to $3.7 trillion and 124 new funds to cross over 2,000 to a total of 2002.

MUTUAL FUNDS OVERVIEW AS OF MARCH 31, 2019

	Total Returns			Annualized Returns		
Category	**1st Quarter**	**Year-to-Date**	**One Year**	**Three Years**	**Five Years**	**Ten Years**
Municipal Bond Interm-Term	2.68	2.68	4.53	2.10	2.99	4.08
Short-Term Taxable Bond	1.71	1.71	2.94	1.86	1.43	2.70
Interm.-Term Taxable Bond	3.13	3.13	3.98	2.39	2.53	4.62
Long-Term Taxable Bond	5.67	5.67	4.94	4.26	5.12	7.82
High Yield Bond	6.37	6.37	4.37	7.00	3.47	9.49
World Bond	2.81	2.81	0.34	2.22	1.19	4.08
Small-Cap Blend	13.30	13.30	-0.08	10.09	5.59	14.64
Mid-Cap Blend	13.91	13.91	2.21	9.60	6.24	14.45
Large-Cap Blend	12.93	12.93	6.79	11.78	8.83	14.52
World Large Stock	12.28	12.28	1.81	9.93	5.86	11.79
Foreign Large Blend	10.22	10.22	-5.21	6.55	2.06	8.45
Natural Resources	11.75	11.75	-5.02	7.82	-1.81	7.27
Real Estate	16.21	16.21	16.89	5.86	8.19	17.31

Source: Morningstar Category Returns, Morningstar, Inc.

Important Definitions and Disclosures

The opinions and material presented are provided for informational purposes only. No person or system can predict the market. Neither asset allocation nor diversification guarantee a profit or protect against a loss. All investments are subject to risk, including the risk of principal loss. There is no assurance that the investment goals and process described herein will consistently lead to successful investing. Asset allocation and diversification do not eliminate the risk of experiencing investment losses. The investment return and principal value of an investment will fluctuate, and an investor's shares, when redeemed, may be worth more or less than their original cost. Funds that invest in stocks of small-cap or mid-cap companies involve additional risks. The securities of these companies may be more volatile and less liquid than the securities of larger companies. Funds that invest in international securities involve special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investment in emerging markets may accentuate these risks. Alternative strategies, including those used in mutual funds, have risks that may substantially increase the potential for loss. Bonds are subject to interest rate risk. Bonds have interest rate risk and credit risk. As interest rates rise, existing bond prices fall and can cause the value of an investment to decline. Changes in interest rates generally have a greater effect on bonds with longer maturities than on those with shorter maturities. Funds that hold bonds are subject to declines and increases in value due to general changes in interest rates. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and/or interest payments.

The information shown does not constitute investment advice and does not consider the investment objectives, risk tolerance or financial circumstances of any specific investor. The information provided is not intended to be a complete analysis of every material fact with respect to any portfolio, security, or strategy and has been presented for educational purposes only. Data obtained from the sources cited is believed to be reliable and accurate at the time of compilation. Nothing contained herein should be construed as a recommendation to buy or sell any individual securities. It should not be assumed that an investment in any of the securities identified was or will be profitable.

Gross Domestic Product (GDP) is a measure of output from U.S factories and related consumption in the United States. It does not include products made by U.S. companies in foreign markets. **Real Gross Domestic Product** (real GDP) is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation). The **Federal Open Market Committee** (FOMC), a committee within the Federal Reserve System is charged under United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasury securities). The **Atlanta Fed GDPNow** estimate is a model-based projection not subject to judgmental adjustments. It is not an official forecast of the Atlanta Fed, its president, the Federal Reserve System, or the Federal Open Market Committee. **Personal Consumption Expenditures** (PCE) is a measure of price changes in consumer goods and services and consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, non-durables and services. The **S&P/Case-Shiller Home Price Indices** are the leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate both nationally as well as in 20 metropolitan regions. The **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM). The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys. The **unemployment rate** percentage of total workforce who are unemployed and are looking for a paid job. Unemployment rate is one of the most closely watched statistics because a rising rate is seen as a sign of weakening economy that may call for cut in interest rate. A falling rate, similarly, indicates a growing economy which is usually accompanied by higher inflation rate and may call for increase in interest rates. Labor force participation rate is the percentage of working age population that is part of the labor force. It is a measure of what proportion of a country's population is employed or actively looking for employment. The index of leading economic indicators is intended to predict future economic activity. Typically, three consecutive monthly LEI changes in the same direction suggest a turning point in the economy. **Inflation** is the rise in the prices of goods and services, as happens when spending increases relative to the supply of goods on the market. Moderate inflation is a common result of economic growth. Hyperinflation, with prices rising at 100% a year or more, causes people to lose confidence in the currency and put their assets in hard assets like real estate or gold, which usually retain their value in inflationary times. **Treasury Yield Curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. **The Conference Board Leading Economic Index® (LEI)** for the U.S. are the key elements in an analytic system designed to signal peaks and troughs in the business cycle. The leading, coincident, and lagging economic indexes are essentially composite averages of several individual leading, coincident, or lagging indicators. They are constructed to summarize and reveal common turning point patterns in economic data in a clearer and more convincing manner than any individual component – primarily because they smooth out some of the volatility of individual components. **The Michigan Consumer Sentiment Index** was created in the 1940s is conducted by the Survey Research Center and consists of at least 500 telephone interviews posed to a different cross-section of consumers in the continental U.S. each month. The survey questions consumers on their views of their own personal finances, as well as the short-term and long-term state of the U.S. economy. Each survey contains approximately 50 core questions, and each respondent is contacted again for another survey six months after completing the first one. The answers to these questions form the basis of the index. **S&P 500 Index** is an index of 500 of the largest exchange-traded stocks in the U.S. from a broad range of industries whose collective performance mirrors the overall stock market. The **Dow Jones Industrial Average** is a widely watched index of 30 American stocks thought to represent the pulse of the American economy and markets. The **NASDAQ** is an index that tracks the cumulative results on a market capitalization basis of all stocks trading in the NASDAQ system. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment. The **S&P SmallCap 600 Index** (S&P600) covers roughly the small-cap range of U.S. stocks, using a capitalization-weighted index. The index covers roughly three percent of the total U.S. stock market. The **S&P MidCap 400 Index** (S&P400) is a stock market index from S&P Dow Jones Indices. The index serves as a barometer for the U.S. mid-cap equities sector and is the most widely followed mid-cap index in existence. To be included in the index, a stock must have a total market capitalization that ranges from roughly $750 million to $3.3 billion. The **Russell 1000 Index** is a capitalization-weighted price-only index, which is comprised of 1000 of the largest capitalized U.S.-domiciled companies whose common stock trade in the United States on the New York Stock Exchange, American Stock Exchange and NASDAQ which are included in the Russell 3000 Index. This large cap market-oriented Index is highly correlated with the S&P 500 Index. **Russell 2000 Index** is a market-value-weighted index representing the 2,000 smallest companies in the Russell 3000 index, representative of the U.S. small capitalization securities market. **NAREIT Equity Index** is comprised of real estate investment trusts which own or have an equity interest in rental real estate (rather than making loans secured by real estate collateral). REITs involve risk, including the loss of principal and the possible lack of liquidity. **Morgan Stanley Capital International** (MSCI) All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. **MSCI EAFE Index** is a market capitalization-weighted index of the leading stocks in Europe, Australasia and Far East. Membership of the index is selected by MSCI and designed for leading stocks roughly to match market sector weights. The **MSCI Emerging Markets Index** is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. The **MSCI Frontier Markets Index** provides broad representation of the equity opportunity set while taking investability requirements into consideration within each market. MSCI classifies 34 countries as Frontier Markets, 26 of which are included in the MSCI Frontier Markets Index. The **STOXX Europe 600 Index** is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. The **CAC 40 Index** is a benchmark French stock market index. The index represents a capitalization-weighted measure of the 40 most significant values among the 100 highest market caps on the

Paris Bourse (now Euronext Paris). The **DAX Index** is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The **FTSE 100** is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization. The **DJ Asia-Pacific Index** represents the leading stocks by dividend yield traded in the Asia/Pacific region.

The **Nikkei Index** is a stock market index for the Tokyo Stock Exchange (TSE). The **Shanghai Composite Index** is a stock market index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange. **S&P BSE Sensex index**, is the benchmark index of the Bombay Stock Exchange (BSE). It is composed of 30 of the largest and most actively-traded stocks on the BSE, providing an accurate gauge of India's economy. The **BM&F Bovespa**, also known as the Sao Paul Stock Exchange, is Brazil's stock exchange. It is the third largest stock exchange in the world by market value with over 500 companies traded on the exchange. The IBOVESPA is an index of about 50 stocks and is the main indicator of the Brazilian stock market's average performance. **S&P/TSX 60 Index** is a stock market index of 60 large companies listed on the Toronto Stock Exchange. Maintained by the Canadian S&P Index Committee, a unit of Standard & Poor's, it exposes the investor to ten industry sectors. **S&P/BMV IPC Index** seeks to measure the performance of the largest and most liquid stocks listed on the Bolsa Mexicana de Valores. The index is designed to provide a broad, representative, yet easily replicable index covering the Mexican equities market. The constituents are weighted by modified market cap subject to diversification requirements. In exchange for greater growth potential, investments in foreign securities can have added risks. These include changes in currency rates, economic and monetary policy, differences in auditing standards and risks related to political and economic developments. The **S&P Global BMI (Broad Market Index)** comprises the S&P Developed BMI and S&P Emerging BMI, is a comprehensive, rules-based index measuring global stock market performance. **Barclays Aggregate Bond Index** is made up of the Lehman Brothers Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. The **Barclays Municipal Bond Index** is a market value weighted index of investment grade municipal bonds with maturities of one year or more. The **Barclays Capital U.S. Government Inflation-Linked Bond Index** (U.S. TIPS) measures the performance of the TIPS market. TIPS form the largest component of the Barclays Capital Global Inflation-Linked Bond Index. Inflation-linked indices include only capital indexed bonds with a remaining maturity of one year or more. Treasury notes (T-notes) are intermediate securities with maturities of 1 to 10 years. Denominations range from $1000 to $1 million or more. The notes are sold by cash subscriptions, in exchange for outstanding or maturing government issues, or at auction. **Barclays Capital Global Aggregate ex-U.S. Index** measures the performance of the global bond market, excluding U.S. securities. **Bloomberg Commodity Index:** is a world-production weighted total return index, including reinvested dividends, measuring investor returns from a fully-collateralized commodity futures investment. Due to market fluctuation, the commodities represented by this index may experience loss of invested principal and are subject to investment risk. An exchange-traded fund (**ETF**) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. Indexes are unmanaged and investors cannot invest directly in an index.

Morningstar Category Returns are composed of the average return for the funds in each Morningstar category over the indicated time period. Categories are defined by Morningstar based on holdings statistics. The category returns are adjusted for survivorship bias, meaning they include all investments even if liquidated, merged or otherwise now obsolete. The returns also include funds that were in a given Morningstar category, but have since changed to another category.