MARKET MATTERS

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Q2 Market Update – Markets climb a wall of uncertainty

Advisor Group Product Research

	1st Quarter 2019	Year to Date	1 Year
S&P 500	13.07%	13.07%	7.33%
Russell 2000	14.18%	14.18%	0.67%
NASDAQ	16.57%	16.57%	12.12%
MSCI EAFE	8.49%	8.49%	-6.79%
U.K. (FTSE)	10.69%	10.69%	-4.18%
Germany (DAX)	8.94%	8.94%	-4.72%
Japan (NIKKEI)	8.40%	8.40%	-1.16%
MSCI Emerging Markets	9.56%	9.56%	-9.63%
Barclays Aggregate	2.94%	2.94%	4.48%

	January 31	February 28	March 31	Beginning of year
10-year Treasury Yield	2.64	2.71	2.41	2.69
Gold (London pm fixing per ounce in dollars)	$1,325	$1,316	$1,295	$1,285
WTI Crude	$53.79	$57.22	$60.15	$45.80
VIX Index	16.57	14.78	13.74	25.42

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Economic Review

The key themes of the first quarter were increased accommodation by global central banks due to slowing economic growth and geopolitical instability.

After raising its target federal funds rate four times during 2018, the Federal Open Market Committee (FOMC) took a more cautious approach in the first quarter. During the quarter, the FOMC made no changes to the target federal funds rate leaving the rate at 2.25-2.50%, while changing the policy outlook from being restrictive to neutral. Federal Reserve Chair Powell stated that average monthly job growth had fallen off from last year's pace and that slowing growth in consumer spending and business investment had also become clear. Powell also said that, "developments at home and across the world merit further attention." In the post-FOMC news conference, Powell commented that the Fed's outlook is still positive but that they are closely watching economic data as a key factor for future monetary policy decisions. The Federal Reserve has also been shrinking its holdings of mortgage and Treasury securities it had bought after the Great Recession, with holdings falling from $4.5 trillion to below $4 trillion at the end of the first quarter. The Federal Reserve currently allows for up to $30 billion in Treasuries and up to $20 billion in mortgage bonds to mature every month without replacing them. Beginning in May, the Fed will lessen the amount of Treasury bonds it will allow to mature each month to $15 billion and will stop the runoff of all Treasury holdings in October. The Fed will continue to allow the $20 billion in mortgage bonds to mature and will reinvest those maturing bonds into new Treasury securities. In its March 6 release of the Beige Book, 10 of the 12 Federal Reserve districts reported slight to moderate economic growth with two regions reporting flat economic conditions. Six of the 12 districts cited the government shutdown which ended in January as leading to slower economic activity. In the same report, a majority of districts reported modest to moderate gains in employment and reported that labor markets remained tight for all skill levels.

Central banks in other parts of the world remained mostly accommodative. The European Central Bank (ECB) postponed any potential interest-rate increases to 2020, reduced its growth expectation and announced new stimulus measures in the form of new, long-term cheap loans to banks in the euro zone region. The German economy narrowly avoided a recession (as defined by two consecutive quarters of negative GDP growth) by registering output growth of 0.02% in the fourth quarter, following a 0.2% contraction during the third quarter. In the U.K., the Bank of England (BOE) left rates unchanged at 0.75% while citing increased risks for the economy due to uncertainty over the potential U.K. exit from the EU. Meanwhile, the Bank of Japan (BOJ) left short-term interest rates at -0.1%, while citing increased concern over slowing overseas growth.

From a geopolitical standpoint, the two largest items were the continued uncertainty around the trade situation between the U.S. and China and Brexit. As it pertains to U.S.-China trade talks, there was a lot of conflicting information throughout the quarter from both countries with both sides somewhat optimistic as the quarter closed. Both the United States and China cited progress in talks ending on March 29 with the expectation that talks will continue into April. There are a wide range of potential outcomes as to upcoming trade talks with anything from a full-fledged trade war to an agreement possible in the coming weeks and months. In response to slowing growth in China, the Chinese government announced cuts to taxes and fees to attempt to jumpstart their economy; initial indications at the end of March showed that the stimulus may be helping their economy. In the U.K., the British government and lawmakers were not able to come up with an agreement as to the terms of their potential departure from the EU by the March 29 deadline. Late in March, the EU granted the U.K. a short delay to April 12 to decide how it will proceed, although significant uncertainty continued around the eventual outcome.

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Markets Review

Despite all the economic concerns, most global markets were sharply higher during the first quarter. There are likely two primary reasons for the upbeat behavior by financial assets. First, much of the economic malaise was likely priced in based on the large drop in equity markets in the fourth quarter. Second, the realization that global central banks were becoming more accommodative gave market participants hope that the slowdown in economic growth may be temporary.

Domestic equities were up during the first quarter, with the benchmark S&P 500 Index ending the quarter up 13.07%. This marked the biggest quarterly gain since the third quarter of 2009 and the best first quarter since 1998. Small-cap stocks, as measured by the Russell 2000 Index, outperformed the broader market for the quarter, rising 14.18%. Drilling down into sector performance, Technology stocks were by far the best performing sector during the quarter, with the S&P Technology Select Sector Index rising 19.17%. The worst performing sector was Healthcare, with the S&P Health Care Select Sector rising 6.12%. U.S. markets welcomed back an up-trend in the 10-year-old bull market during the quarter after an intense correction at the end of 2018. The Fed signaling it would be more patient with further rate rises, combined with improving rhetoric toward China regarding trade wars, resulted in decreased market volatility – and the U.S. Equity market gaining back some 4Q18 losses. Furthermore, the government shutdown ended at the end of January, which also helped boost market sentiment. While the market was very strong during the quarter, it's worth noting that concerns over a possible economic slowdown have thrown some cold water on the rally. As a result, toward the end of the quarter, global economic data deteriorated. This has pushed down bond yields across the world. Recently, the U.S. Treasury 10-year note's yield hit its lowest level since December 2017 and moved below its three-month counterpart for the first time since 2007. This is known as a yield-curve inversion, which investors interpret as a historical indicator of recession on the horizon.

International stocks were up during the first quarter, with the MSCI EAFE Index returning 8.49%. Looking at developed markets, U.K. stocks, as measured by the FTSE 100, returned 10.69% during the quarter, despite continued uncertainty surrounding a resolution on Brexit. Stocks in Germany, as measured by the DAX Index returned 8.94%. Stocks in Japan returned 8.40% during the first quarter. In emerging markets, stocks, as measured by the MSCI Emerging Markets Index, were up 9.56% for the quarter. Emerging markets stocks outperformed developed markets, while both experienced positive returns during the quarter. This outperformance was led by Turkish shares responding well after their central bank decided against raising short-term rates, as well as showing that Turkey's inflation was easing from its peak of 25% in October. Additionally, Russian shares rallied during the quarter, as their stocks benefited from a rebound in oil prices and a strengthening ruble. Lastly, Chinese stocks were strong, amid hope that the U.S. and China would reach a trade deal. While developed markets were up on an absolute basis, the relative underperformance compared to Emerging was largely driven by weak economic data out of Germany, negative effects of "yellow vest" protests in France, as well as the previously mentioned uncertainty surrounding Brexit in the U.K. markets.

Fixed-income returns were mostly up during the quarter as interest rates declined, with the yield on the U.S. 10-year Treasury note moving down from 2.69% to 2.41%. The benchmark Bloomberg Barclays Aggregate Bond Index moved up 2.94 % for the quarter. High Yield Credit outperformed Investment Grade during the quarter with the iBoxx US High Yield Index up 7.6%, thanks to income seeking investors gravitating to higher coupons as rates decreased.

Commodity returns for the quarter were up with the Bloomberg Commodities Index gaining 5.7% during the first quarter. Oil prices were up for the quarter, as U.S. sanctions against Iran and Venezuela, as well as OPEC-led supply cuts, overshadowed concerns over a slowing global economy. U.S. crude rose 30% during the quarter, posting its best quarter since 2009. While oil prices were impressive, they were not the best-performing commodities during the quarter. Lean hog futures surged around 50%, as China continued to

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fight a swine fever outbreak that cut production by roughly 30% -- a scenario that forced China to use American imports during a potential trade war with the U.S. The majority of that increase happened during March, making it the best monthly performance on record in data going back to 1973, according to Dow Jones Market Data.

Outlook

Our outlook for 2019 remains unchanged from our last update issued in January 2019. Our expectations are that first quarter U.S. GDP will be weaker than the prior couple of quarters due to the lingering impact of the government shutdown in January. We believe the shutdown was a primary contributor to weaker consumer sentiment in the first couple months of the year. Growth figures will also be challenged by difficult comparisons as a result of the Tax Cuts and Jobs Act, which took effect at the beginning of 2018. We anticipate a bounce back in economic growth in the second quarter, though we are keeping a very close eye on geopolitical events such as any developments with Brexit; potential trade wars; and economic conditions in the U.K. and Europe. We still anticipate that the next interest-rate move by the Federal Reserve will be higher rather than lower. But, the balance between the two is much closer than three months ago. From a stock market perspective, we just saw the largest equity market rally in 10 years, so it may be a good time to reacquaint yourself with potential hedging strategies to lock in some of the gains. In March 2019, the U.S. bull market in equities reached the milestone of being 10 years old, which is the longest bull market in U.S. history. This bull market has resulted in gains in the Dow of over 300%, while the S&P is up more than 400% and the NASDAQ is higher by almost 500%. For potential hedging ideas, please read "Hedging your Portfolio," which was published by the Advisor Group Product Diligence team in December 2018. Looking to the intermediate- and long-term, we believe that there is a heightened risk of a U.S. recession in 2020, which we believe may start pressuring stocks in late 2019. If our thesis is correct, we could see some great buying opportunities later in 2020 and into 2021.

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