

ECONOMIC OUTLOOK

Summary

The U.S. economy has been enjoying a nice run of “three’s” lately. The first look at Q1 GDP came in at 3.2%, the Unemployment Rate came in at 3.6%, a 49-year-low and average hourly earnings annualized at 3.2%. It seems pretty remarkable that the word “recession” has been debated by economists and market pundits so much this year. But to be fair, the market environment and Fed policy have changed tremendously since the beginning of the New Year. And yes, inverted and flat yield curves still matter, but they seem to be less of a concern with a patient Fed and a significant improvement in overall financial conditions.

Access to and the cost of capital are huge variables that can impact the proper functioning of an economy. There were no high yield bonds issued over the last five weeks of 2018. In early January 2019, leveraged debt financing became available, but the cost to borrow was about 1.75% higher compared to September 2018. Market acceptance to finance investment grade and high yield borrowers in early 2019 brought lower borrowing rates and sharply higher equity prices aided market sentiment. Higher stock prices are generally positive for credit intensive securities, as the market value improvement of the underlying shares reduces the risk on the outstanding debt for a given company.

We all know the wealth effects from higher stock and bond prices and properly functioning capital markets play an outsized role in determining the potential growth rate for an economy. Those factors are very much in our favor today. Although we are approaching the longest business expansion in modern economic

history in America, the trajectory has been one of the weakest as well. That leaves us with the very real possibility that this business cycle can last for multiple years as the Fed avoided a serious policy error, inflation pressures remain well anchored and capital markets behave rationally. There are always unknown exogenous events that can derail a well performing economy, but absent that, we might be able to enjoy a bright and shiny 3% growth rate in GDP this year.

Positives

Nonfarm payrolls advance 263K and unemployment rate drops to 3.6%

Private payrolls advance 236K, 188K expected

New home sales hit 692K (annualized), 649K expected

Negatives

ISM Non-Manufacturing Index hits lowest level in 20 months, but expanding

Personal consumption fell to 1.2% in Q1 2019, from 2.5% in Q4 2018

Personal income increased 0.1% in March, 0.4% expected

EQUITY OUTLOOK

Summary

Equity markets rallied for the fourth consecutive month. The rally advanced the S&P 500 higher by 4.1% for the month of April closing at an all-time high of 2,945.83. The S&P has also gained 18.2% year-to-date, the strongest start since 1987.

The latest global economic readings have broadly shown signals of stabilization and recovery following a brief period of soft data. The results of the Mueller Report seemingly did little to impact the Trump administration and the parting of the clouds that have hovered over that office should allow them to refocus on their pro-business agenda. The United States and China have both hinted at significant progress in trade negotiations over the last several weeks, but in the days headed into one of the most important meetings that progress has seemingly unraveled. While this may simply be negotiation posturing, the equity markets have failed to shrug off the impact this time around.

The rally in equities has been quite broad in terms of equity style, capitalization size and across multiple regions. Growth stocks outpaced value once again with the Russell 1000 Growth climbing 4.5% vs a 3.5% increase in the Russell 1000 Value. The Russell Mid Cap Index and Russell 2000 (small cap) rose 3.8% and 3.4% respectively. International stocks also participated in the continued rally last month. The developed MSCI EAFE Index gained 2.9% and MSCI Emerging Markets Index added 2.1%.

While the momentum of the stock market is certainly positive, we believe there are many reasons to be cautious in the near-term. Equity valuations have bounced back to peak cycle levels. Positive news on the trade front may be already baked into the market and the soaring start to 2019. A significant move higher seems unlikely and increased volatility is likely in the near term. The presidential election may be a year and a half out but the campaigning starts earlier and political bickering gets louder every election season.

Positives

Accommodative Federal Reserve

Negatives

Valuations slightly stretched

Investor sentiment overly optimistic

Unknown

Brexit path and impact

China/U.S. trade progress

FIXED INCOME OUTLOOK

Summary

Following the single best month for bond returns in a few years, and a solid overall first quarter, it seems only natural that bond investors would hit the pause button and allow Treasury yields to creep a bit higher. The 2-year Treasury was nearly unchanged for the month at 2.27% and the 5-year is no longer inverted to it as it increased by almost 5 basis points (bps) to end at 2.28%. The 10-year increased by 10 bps and the 30-year went up by nearly 12 bps to end the month at 2.50% and 2.93%, respectively. While the curve steepened out last month, it should be noted that the entire curve from 2 years to 7 years is still below the 12-month Treasury bill yield of 2.38%. The odd shape of the front end of the yield curve not only reflects the Fed's new patient outlook but also factors in a higher probability of a rate cut than a rate hike in the next 12 months. We would agree with the market's signaling but believe that no change in policy is likely in the near-term.

While government bonds in aggregate delivered negative returns, corporate bonds continued to deliver relatively strong results as investment-grade credit spreads narrowed another 8 bps. With equity markets rebounding to near record levels and risk of a Fed policy error significantly reduced, it makes perfect sense for credit spreads to have narrowed like they have. At about 110 bps incremental spread, the investment-grade corporate bond universe still looks attractive relative to the Treasury bond universe as this represents about 45% more yield. However, on an absolute basis, the spread level is getting a little bit pricey and finding value in the specific credits that we want to own is becoming still more difficult. Investors benefit from wider credit spreads that adequately compensate them for taking the risk of

corporate obligations versus the security of government debt. We are hopeful that spreads will stay near these levels or move slightly wider, unfortunately the supply/demand fundamentals favor spreads continuing to narrow.

Positives

Fed policy on hold for the near term with core inflation below target

Weak economic data out of Europe will keep a lid on their interest rates

Negatives

Rebounding economic data with surprisingly strong 1Q GDP and April payroll reports

Lowest level of unemployment in 50 years could cause further wage pressures

Increasing budget deficits will necessitate greater debt issuance

Unknown

Trade negotiations with China are still a wild card

America's appetite for the new wave socialist reforms