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The financial markets roared back to life in this year's first quarter. Can the markets continue this stellar performance?

In the included commentaries, we review the first quarter and suggest how investors should position themselves.

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First Quarter 2019 Market Commentary

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Equities

Stocks Stage Broad Recovery

James P. O'Mealia – Head of Equity Portfolio Management

Yeah, they say the great economic boom's over
Oops out of time
So for now we're gonna buy tech like it's 1999
Yeah

-Apologies to Prince, 1999

In the first quarter of 2019, stocks staged an impressive rebound with the S&P 500 posting its best quarterly advance since 2009 and almost completely erasing the losses suffered in 2018. Progress on trade talks with China and a pause in the Federal Reserve's rate hike policy caused equity investors to breathe a sigh of relief and ignore conflicting economic data in the U.S., weakness in Chinese demand and the continued uncertainty of Brexit negotiations. While gains in technology and growth stocks dominated performance once again, it is reassuring that market breadth was strong and value stocks of all sizes participated in the first quarter rally.

Even though all eleven S&P economic sectors achieved gains for the quarter, there were plenty of industries and companies which sat out the market rally. Indeed, five of the thirty mighty Dow Industrials fell during the period led by Walgreens (-7.4%), Pfizer (-2.7%) and Coca-Cola (-1.6%). Three of the top five Dow performers were technology issues (i.e. Cisco, IBM and Apple) and were joined at the top of the heap by United Technologies and Exxon Mobil.

Economic activity was lackluster in the first quarter due to horrific weather conditions in parts of the U.S. and business uncertainty over global trade demand. The worries over global demand are real, as Eurozone factory activity in February posted its worst reading in six years, German manufacturing has slumped and Chinese trade has slowed. In the U.S., the issues causing economic weakness seem more transitory, as weather conditions will normalize and the deceleration in the economy has caused interest rates to fall, spurring a rebound in housing activity. Indeed, existing home sales surged 11.8% in February and weekly mortgage applications rose in late March as new home buyers jumped back into the market. Buyers were no doubt enticed by the drop in 30-year mortgage rates to near 4%, dramatically lower than the 4.7% rate offered at the beginning of the year and the 5% peak of last November. Mortgage buyer Freddie Mac noted that the late March drop in mortgage rates from 4.28% to 4.06% was the steepest weekly drop in a decade, which we think will cause strong homebuying activity in upcoming quarters. That is why we have revisited and invested in the homebuilder industry in the past month.

Federal Reserve Chairman Jerome Powell stated in late March, "It may be some time before the outlook for jobs and inflation calls clearly for a change in [interest rate] policy." Obviously, the Federal Reserve members are aware of the softening economic data, the continued low level of inflation and the signals from the bond market that investors are sensing weaker global demand. The Institute of Supply Management's manufacturing purchaser's managers index declined in February and railroad activity in the U.S. was negative on a year-to-date basis through March 23. Auto sales have stalled and while home prices continue to rise versus a year ago, according to the S&P/Case-Shiller Index, the January 2019 gains slowed to only 4.3%.

Some of the government data doesn't gibe with reports from companies and other government agencies, further muddying the picture, but the undisputed conclusion from fourth quarter corporate earnings reports was that the economy was strong through year end. That's pretty amazing when you remember that most of us were wondering how long the government shut-down would be and the impact it would have on the economy. In late March, the Census Bureau reported that services growth had risen by a lackluster 1.2% in the fourth quarter, the slowest pace of growth in five quarters. At times like this we need to focus on the basics: the economy is continuing to create about 200,000 jobs on a monthly basis (Bureau of Labor Statistics), inflation remains in hibernation, interest rates are back to relatively low levels and the Federal Reserve's rate hike program has been put on pause, effectively ending the threat of higher interest rates in the near future.

One of the biggest hurdles is the economy and the equity markets are still coming off the "sugar high" of tax reform which caused GDP growth to accelerate by 2.9% in 2018 and after-tax corporate profits to leap 14.3% in the third quarter of 2018. (source Commerce Department) Estimates of GDP growth for 2019 are more subdued, with the Federal Reserve Bank of New York forecasting first quarter growth of just 1.1%. Economic activity remains strong, but is unable to maintain the heady growth of last year, especially when you throw in bad weather, a late Easter and weak demand from China and Europe. Therefore, it's not surprising some are worried that we are at peak earnings and are questioning what price they should pay for those earnings. While we expect a reasonable resolution to the many issues facing international businesses, you cannot assume that the resolution of Brexit in the UK, or Chinese trade talks with the U.S. will go forward without a hitch and as such, we remain cautious regarding worldwide equity markets. That does not mean we are giving up on stocks or that you should sell everything and move into bonds, just that a more defensive positioning in your asset allocation might be appropriate.

Short-term risk-free U.S. Treasuries yield in excess of 2% and provide investors an alternative to higher risk equities. But for those seeking capital growth, equities continue to provide a reasonable opportunity for capital appreciation. We would use bouts of market volatility to invest opportunistically in equities. One of the best current opportunities to achieve capital growth while still achieving a high current level of income is the major international oil companies. Oil prices slumped badly last year on concerns about excessive domestic shale oil production and weak global demand for oil and investors shunned the group. However, renewed production discipline by Saudi Arabia, greater financial discipline for U.S. producers and dwindling production from Libya and Venezuela due to U.S. sanctions have restricted supply. As such, crude oil prices gained more than 10% in the first quarter and ended the quarter in excess of $60 per barrel. With some of the majors offering mouthwatering yields in excess of 5%, we think the group is an excellent opportunity for new investment.

Investors in recent months have become increasingly wary of business conditions and many have flocked to their old favorite growth companies, the majority of which are in the technology sector. The problem is the technology sector is cyclical, a fact many have chosen to ignore. Furthermore, IPO activity has perked up dramatically and the money raised by companies going public needs to come from somewhere. These unicorns, a term used for new age private companies with market valuations in excess of $1 billion are slated to flood the equity markets in coming months. For now, it appears value stocks have become a source of funds as investors allocate more assets to Internet-related businesses or “New Economy” issues, regardless of the profitability of these new companies. Not to pick on Lyft, but in its public offering memorandum, it admitted its average revenue per ride was $13.00, while the average expenses per ride were $14.47. I guess they’ll make it up on volume! Sadly, it is beginning to feel more and more like 1999, an era that ended badly for those investors who came to the stock market party late and stayed too long.

We are confident in the outlook for the economy over the intermediate term as job growth continues at a solid pace, housing has begun to rebound, mortgage rates have fallen and trade tensions appear to be dissipating. Consumer confidence rose in February and remains at relatively high levels and the ISM non-manufacturing services sector index continued to expand at a robust level. While the average gain for stocks in the second quarter of this bull market has been only 1.3%, the third year of a Presidential term (the year before an election year) has historically been the best performer of the cycle. (source: Argus Research) We have invested in an eclectic mix of equities whose risk/reward should enable us to outperform the broad market averages when rational investing returns. We have exposure to most of the broad market sectors in the economy but have often found well-managed mid-sized niche companies able to gain market share in their industry selling at more attractive valuations than those larger companies purchased by passive managers investing in an index. We're not in a Nifty Fifty era yet, but investors and the indices are slouching toward it. We don't have any problem with technology issues and have owned our share of the sector for years. We just think now is the time to take some profits in the sector and invest in the leaders of the next bull market, not chase the winners of the current bull market. As such, we have begun to establish positions in a gold mining company and a gaming industry supplier due to their resiliency and lack of correlation to economic cycles. Both companies are selling at historically low valuations based upon their free cash flow generation capabilities in the year ahead and provide solid dividend income. In the old days, things like that mattered. Our guess is those days will come again sooner than most think.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five private limited partnerships.

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High Yield Bonds

<u>That was Quick</u>

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

If you blinked, you could have missed it. The financial markets freaked out in the fourth quarter of 2018, fueled by anxiety over the economy, an unaccommodating Federal Reserve, trade wars, corporate earnings, and you name it. The calendar flipped to 2019, and lo and behold, the financial markets rebounded like Zion Williamson. Only those with quick trigger fingers were able to buy the dip. Corporate earnings and guidance were not nearly as bad as feared, commodity prices jumped, and it seems that a resolution of the US-Chinese trade dispute is likely. Most importantly, the Federal Reserve turned dovish, quickly pivoting on the pace of rate hikes and its balance sheet reduction plans. The fourth quarter losses in equities and high yield were quickly regained. In fact the high yield market had its best quarter in 10 years in the first quarter of this year.

When I put together my 2019 outlook back in January, I wrote that I expected high yield to post returns “in the 7% to 8% range” in 2019. Guess what? The ICE Bank of America Merrill Lynch High Yield Master II index (BAML HY II index) posted a total return of 7.40%.... in the first quarter. This kind of performance begs the question as to what does high yield have left in the tank for the rest of the year. From a valuation perspective, the high yield market does not seem rich based on recent history. With a yield to worst call of 6.42%, the BAML HY II index is sitting very close to its one and five year averages. And spreads over comparable Treasuries (high yield’s risk premium) were just over 4% at first quarter end, 30 basis points more than where the market stood at the end of 2017. In a world where interest rates are turning negative again and ten year US Treasuries are yielding 2.5%, this doesn’t look bad on the surface. Moreover, the high yield market continues to be aided by its shrinking size: the face value of high yield bonds in the BAML HY II index is 12% below its 2016 peak.

Although high yield valuations look reasonable on the whole, the higher quality part of the market has outperformed the lower tiers of the market (particularly CCC-rated bonds). While spreads of BB bonds in the BAML HY II index are now just 15% wider than October’s 12 month tights, CCC spreads remain 39% wider. Many high yield bellwether bonds are trading near or above their last twelve month highs. So in short, it remains difficult to find reasonable high yield credit stories at reasonable prices.

And let’s not forget there is a reason why the Fed pivoted to a dovish stance and government bond yields have dropped around the globe. Global economic growth (particularly in Europe) is slowing down and economic data is running below expectations here in the US: the Citi US Economic Surprise index is sitting at -44.8, down steadily over the last twelve months from +46.8 a year ago. I personally am not of the opinion that the US economy is ready to roll over into a recession anytime soon. I would also caution not to be alarmed when first quarter GDP numbers are released later this month (estimated at 1.5% growth versus 2.2% in the fourth quarter). It seems that seasonal factors are not fully baked into the GDP calculations: in seven of the last ten years, the lowest quarterly GDP reading was in the first quarter. Still, there are enough warning signals out there- slowing auto sales, mixed signals in housing, (and did I mention the inverted yield curve?) to indicate that now is not time to play the hero in risk markets. We have let cash build in our high yield portfolios as bonds get called or mature. Finding suitable replacements has been difficult. With the inversion of the Treasury curve and near-cash substitutes (Treasury bills, very short investment grade bonds, ultrashort bond funds) yielding more than 10 year Treasuries and just 2-2.5% less than the BB index, we can afford to be selective and patient about buying high yield at current levels.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Seelaus Asset Management in January 2014 He is also a Senior Portfolio Manager on the firm's long-only private credit fund.

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Intermediate Municipal Bonds

The Locomotive of Muni Bond Demand

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

From a total return perspective, municipal bonds in the first quarter had the strongest start to a year since 2014. While Treasury bond yields fell throughout the quarter, municipal bond yields generally declined to a greater extent. Ten year Treasury bond yields fell from 2.68% in early January to 2.41% by the end of March (a decline of 28 basis points or 10.4%). In the same period, high grade ten year muni bond yields declined from 2.31% to 1.88% (43 basis points or 18.6%). The total return of the Merrill Lynch 3-7 Year Muni Index in the first quarter was a sprightly +2.09% compared to the return of Barclays 3-7 Year Treasury Bond Index of +1.82%. By quarter-end, the ratio of ten year high grade muni bond yields to ten year Treasury bond yields – a measure of muni bond attractiveness relative to Treasuries – had fallen to 78%, a level not seen since 2007. This ratio, now reflecting historically rich valuation levels, had been trending in the 82 to 88% range for most of 2018.

All of the numbers mentioned above illustrate in detail the impressive strength of the municipal bond market in the first quarter. What were the muni-specific reasons for that strength? In a word -- demand. Throughout the first three months of 2019, net inflows into muni bond funds and ETFs were consistently strong, producing one of the strongest three-month periods in several years. High net worth investors sought out tax-exempt income with greater intensity as the impact of new limitations on the deductibility of state and local taxes finally hit home. Another factor boosting demand for munis – presently and likely in the future – is the spread of proposals, at both the state and Federal level, to raise taxes (or institute new ones) on upper income investors. From the perspective of high net worth investors, tax-exempt income from munis became even more highly valued. Even an increase in first quarter new issue muni bond supply (compared to last year) wasn't enough to slow down the powerful locomotive of unusually high demand.

From the present vantage point, municipal bonds have had a fairly strong run and are rich by some valuation measures. This has been a pleasant experience for those already invested in municipal bonds as they have watched their portfolio values ascend rather nicely so far in 2019. For those looking for an attractive entry point into munis, the first quarter muni price action has been a bit frustrating to say the least. No one enjoys watching merchandise you need to buy just get more expensive each day. How does one proceed from here?

The temptation to wait for a pullback in muni bond yields is understandable given what investors experienced in the first quarter. Treasury bond yields in early April went through a partial retracement, the kind you might expect when markets digest previous periods of sustained, one-way moves. Muni bond yields have risen a bit from the lows of late March as well. This retracement could continue. I would, however, caution against being too cute at the waiting game. While the strong demand for munis may adjust to a lower level, will that decline be large enough for a large reversal in muni bond yields? New issue muni bond supply may pick up as issuers take advantage of attractive conditions for debt issuance but will that increase in supply be large enough to result in substantially higher muni bond yields? I am doubtful on both counts. The overall forecast for the muni bond market in 2019 remains one of a slightly shrinking market (supply is expected to be less than bond maturities and reinvestment of interest).

The Fed appears to have paved the way in 2019 for a benign environment of no rate hikes. The demand for municipal bonds will likely to back off a bit from historically strong levels but remain robust given the pervasiveness of higher tax rate proposals being offered by government officials at various levels. Future bond supply is always a wildcard but prospects this year of a moderating economy and tax receipts are likely to temper ambitious debt issuance plans. While some further, gradual retracement of muni bond yields from these levels seems appropriate and likely, a substantial and abrupt reversal of the municipal bond market's strong first quarter would be surprising given broader forces at work.

We continue to focus on uncovering value in the short/intermediate maturity part of the muni bond market. That modest maturity focus combined with the use of spread product and defensive bond structures should work together to soften any unexpected and abrupt reversal of recent muni bond market strength, should it occur.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

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