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BCA Q1 2019 Review and Outlook

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Summary Outlook

- After a sharp dip and recovery, the investing environment today looks like that of recent years: slow but positive growth, little inflation and policymakers afraid of spooking financial markets. Our best guess is that recession is a 2021 event.
- Near-term, we think stocks and other risk assets will be rangebound with potentially higher volatility before grinding higher by year-end, as growth in Emerging markets and then Europe enjoys a modest cyclical recovery.
- This scenario implies investors should overweight global equities, underweight high quality bonds, and maintain a neutral allocation to cash.
- We think no new rate hikes mean the US dollar may weaken, boosting international currencies and investment returns in a relative sense.
- The most significant risk is still economic weakness, especially in the developed world outside the U.S. We think emerging market fundamentals are better than generally appreciated.

First Quarter in Review

Total Index Return	2018	Q1 2019
S&P 500	-4.4%	13.6%
Russell 1000 Growth	-1.5%	16.1%
Russell 1000 Value	-8.3%	11.9%
Russell Small Cap	-11.0%	14.6%
MSCI EAFE (International)	-10.5%	10.1%
MSCI Emerging Markets	-9.7%	10.0%
US Aggregate Bond	0.0%	2.9%
High Yield Bonds	-2.1%	7.3%
Crude Oil	-24.8%	32.4%

Source: Factset Research; data through 3/31/2019

Note: Int'l market returns reported in U.S. Dollars, not local currency

Well, that was fast. The first quarter of 2019 was a mirror image of the last quarter of 2018, a recovery whose rapidity surprised investors. Last year, cash outperformed stocks, bonds and commodities; this year most asset classes are showing heady gains. We believe a combination of factors triggered the "risk-on" rally. First, the Fed clearly pivoted from a tightening to an easing bias, indicating at its last meeting that it would not raise rates again this year and would halt the unwind of Quantitative Easing. Second, both the U.S. and Chinese governments have signaled their desire to reach a compromise agreement to end the ongoing trade dispute. These two factors were the most important negative weights on the market last quarter, even more important than signs of a global growth slowdown. Thinking twice, fundamental investors realized the outlook just hadn't deteriorated that much. With volatility easing, algorithmic trading, i.e. the computer models, shifted from net selling to net buying.

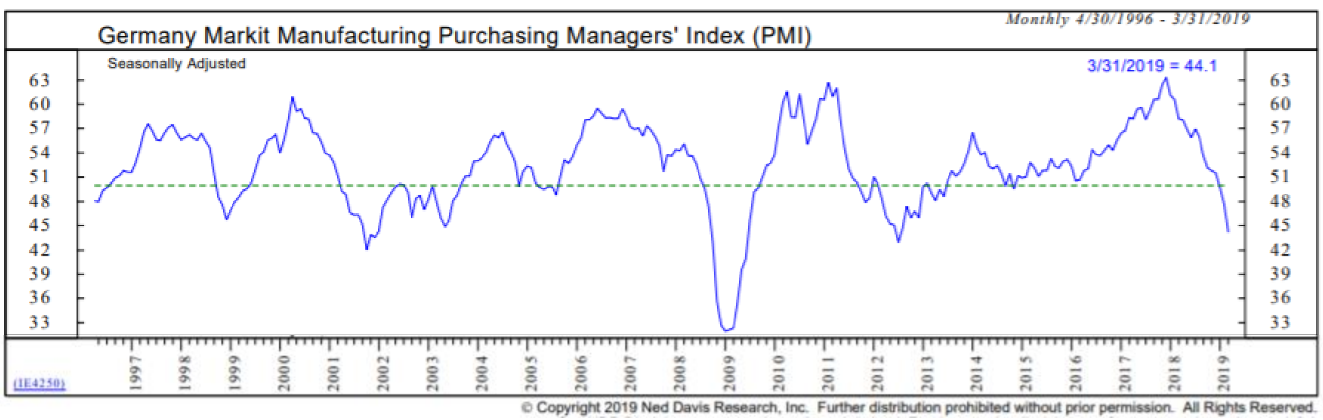
The S&P 500 Index enjoyed the best start to the year since 1998. Since 1926, the S&P has tended to rise over the full year when the first quarter has been strong. While history may not repeat, we also think the fundamental outlook supports moderate gains from here. Growth stocks again outpaced value, although small caps outpaced larger cap stocks. High quality stocks (high profitability, low debt) also performed well.

International equities gained, but again trailed the U.S., although with a much smaller gap. The MSCI EAFE Index and MSCI Emerging Markets Index both gained about 10% in Q1. Commodities were mixed as the 30%+ surge in crude oil masked weakness elsewhere. The equal-weighted Reuters-CRB Index gained 3.7%, while gold rose 1.1%. Bonds enjoyed tailwinds from both credit and interest rates in Q1. High yield bonds rose smartly as credit spreads over Treasuries fell rapidly, while flat to falling longer term interest rates boosted longer maturity bonds.

Major Issues for 2019

Global Growth:

Investors' top-of-mind worry is the risk of global recession, which they fear will be led by Europe. Exhibit A is Germany, whose manufacturing PMI recently hit a six-year low, with the new orders component registering the weakest reading since the Great Recession. This took the 10-year German government bond yield into negative territory for the first time since 2016. As Europe's largest economy, this is a valid cause for concern.



However, there is evidence the slowdown is a soft patch rather than an imminent recession. The overall European PMI remains positive, with the service sector recently rebounding. Given global uncertainties, it's perhaps unsurprising that trade in manufactured goods has slowed. Resolution of the U.S. trade disputes with China and Europe would go a long way to restoring confidence and economic activity would likely follow.

Inverted Yield Curve:

Partly dragged down by European yields, the U.S. 10-year Treasury yield recently fell to a 15-month low, causing the 10-year Treasury yield to fall below the 3-month yield, an "inversion." Because of the historic association of inversions with recession in the following year, this caused a great deal of concern and news headlines. We think this concern is overblown for a few reasons.

First, the curve is severely distorted by a negative term premium. Essentially, the term premium is what investors demand as compensation for having their money at risk for longer periods of time. Right now, it is extremely low or even negative. BCA Research* notes that if the 10-year Treasury term premium were back to where it was in 2004, the 3-month/10-year slope would be more than 200 bps steeper, i.e. no inversion. The Fed's recent comments show it has turned toward easier money, which is supportive of inflation, not deflation. The intermediate to long end of the yield curve (10 to 30 years) has actually steepened. In general, monetary conditions are loose, not tight, and are not likely to cause a recession.

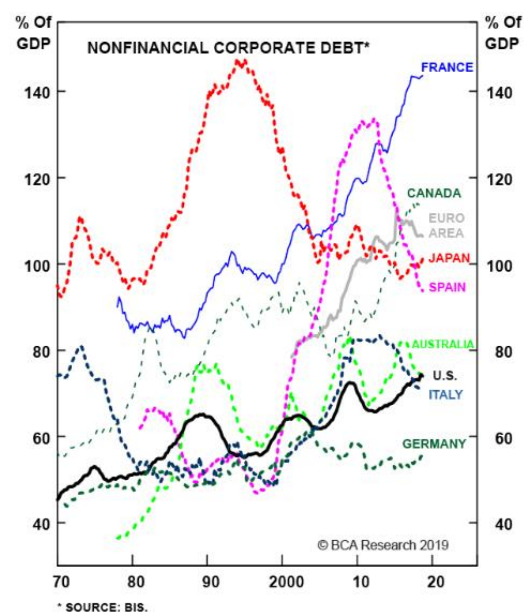
Emerging Market Growth / China:

The trade conflict remains a risk, but both sides have sent positive signals, greatly reducing worry. For his part, President Trump would like to have the U.S. economy firing on all cylinders going into the 2020 election. He can also claim that the trade deficit will shrink after the deal has had time to work, which conveniently would be 2020 or later. China wants to negotiate from a position of strength, and thus they have already begun to reverse the credit slowdown they had previously implemented. Expect a steady dribble of stimulus measures from China.

More broadly, we think Emerging Markets are likely to be a theme that gains traction this year. The dollar should be less of a headwind, commodity prices are stable or rising (still helpful to many EM countries), China is likely to grow more strongly, and valuations are cheap both absolutely and relatively.

U.S. Corporate Debt:

U.S. Corporate Debt Is Not Extreme By Global Standards



Among others, the Wall Street Journal has published a series of articles pointing out the expansion in U.S. corporate debt. The arguments typically move along two lines. First, that the number of lower-rated (BBB) companies within the investment grade universe has increased significantly. Second, that many private corporate loans are being made with covenant-lite features. These are facts and we certainly consider the implications for asset allocation and in our manager selection decisions. However, it's important to note the overall corporate debt level of the U.S. is low, at least compared to other economies (see chart at right).

While more debt has been issued, companies are also more profitable than ever before. Thus, the interest coverage ratio is well above its historic average. In addition, corporate assets have also risen significantly over the past few years, which has kept the corporate debt-to-asset ratio broadly in-line.

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Conclusion

All in all, we see a good but not great outlook for risk investments in the near term. First quarter economic reports will be weak, but that is well anticipated by the market. Stronger growth in the second half could finally help equities outside of the U.S. We see the risk of recession, and thus credit defaults, as low. We are concerned with valuations in places but don't see a systematic problem in the near term. The outlook for bonds is muted because current yields are low and it's hard to see the term premium going lower. High quality bonds should be used for defense and portfolio ballast rather than return drivers.

Given muted expectations overall, we continue to turn to more esoteric investments within the alternative space to enhance both diversification and returns, depending on the specific investments.

We thank you for trusting Berman Capital to be your investment advisor and encourage you to contact your Wealth Advisor with any questions or concerns.