MarketPoint

First Quarter 2019 | Issue No. 25

TRUSTPOINT
Investments • Trust • Since 1913

YOU'RE INVITED!

CHARTS 'N CHATTER

Join our team as they present the economic and market outlook for 2019 and discuss topics such as porftolio positioning, estate planning, and government debt and deficits.

April 30 at 12pm
Trust Point Minneapolis

April 30 at 4pm
Trust Point Eau Claire

May 1 at 12pm
Radisson Hotel La Crosse

RSVP by calling 608-791-2261 or email marketing@trustpointinc.com

In This Issue:

Economic and Market Update
Equity Market Update
Fixed Income Market Update

An Economic & Market Commentary from Trust Point

An Economic and Market Update from Trust Point

What a difference a quarter makes! After a steep and sudden equity and credit markets' selloff in the fourth quarter, the first three months of the year have been… well, let's be honest, extraordinary! Most equity markets delivered double digit returns while fixed income markets also performed very well as credit markets recovered. In addition, volatility declined across all asset classes. The U.S. Federal Reserve's (Fed) 180-degree turn around in regards to interest rate changes has been the main catalyst for this dramatic and significant change in market sentiment in 2019.

Yes…It Is All About the Fed

The sustained pace of U.S. rate hikes in 2017 and 2018 made investors start to wonder if the Fed was in tune with the slowing global economy. When Federal Chairman Jerome Powell announced in early October 2018 that the Fed was a "long way" from neutral (meaning that several more rate hikes should be expected), markets reacted negatively (Chart 1). By the end of November, the message had changed to "just below" neutral. However, in the face of slipping global growth, markets didn't respond positively and corrected further in December. Investors' sentiment started to turn in January when the Fed used the terms "flexible" and then "patient" to describe the new mindset on interest rate policy going forward. In March, the Fed took it a step further and officially announced that it didn't foresee any more rate hikes in 2019 and only one potential rate hike in 2020. This important turn in monetary policy was significant, and we believe largely explains the behavior of asset markets in Q4, '18 and Q1, '19.

KEY ECONOMIC DATA	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Mar	97.3	96.2	90.0
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Mar	55.3	54.3	59.3
ISM Non-Manufacturing (>50 = Expansion)	Mar	56.1	58.0	58.7
Non-Farm Payrolls	Mar	196K	227K	182K
Unemployment Rate	Mar	3.8%	3.9%	4.0%
CPI Ex-Food & Energy (yoy)	Feb	2.1%	2.2%	1.8%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Mar	50.6	51.4	53.2
JP Morgan Global Services Index (>50 = Expansion)	Mar	53.7	53.0	53.2

Source: Bloomberg

Chart 1 : Global Equity Markets Closely Following the Cues from The U.S. Federal Reserve

Source: Bloomberg

Growth Has Slowed But Not Collapsed

U.S. economic growth in 2018 benefited from tax reform, but growth outside the U.S. disappointed with noticeably weaker growth in Europe and China (Chart 2). There is a big difference between economic growth decelerating and outright contracting. Decelerating growth (or "growth scares" as they are often called) is a normal part of any economic cycle. Growth scares often are accompanied by short-term market pullbacks and increased volatility as investors recalibrate their expectations. For patient long-term investors, these scares often provide good buying opportunities. On the flip side, contracting growth (or "recessions") is characterized by a general decline in economic activity, decreased access to credit, rising unemployment, and falling profits (Chart 3). While less frequent, these macroeconomic conditions often are associated with sustained equity bear markets frequently extending for more than one year. In 2018 we experienced deceleration not contracting growth. For now, we do not see the signs of a recession, either domestically or globally. In fact, the more accommodative stance from the Fed even further reduces that likelihood.

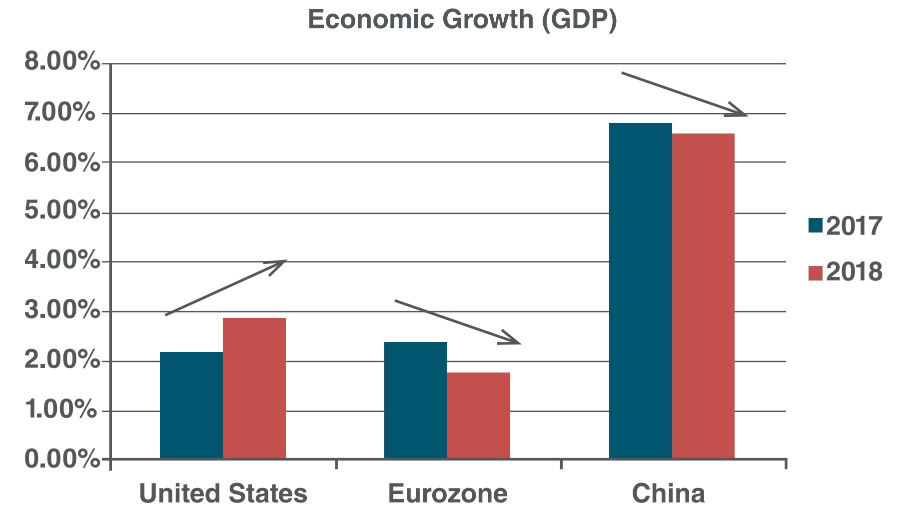


Chart 2 : Solid U.S. Economic Growth Offset by Weaker Growth Abroad in 2018

Source: Trust Point, Bloomberg

2019 - Still on Script

We generally shy away from providing short-term market forecasts but long-term return expectations are important variables for us in modeling portfolios. Long-term return expectations for both equity and fixed income investments are largely a function of current valuations, making them more reliable estimates. We often tell our clients that it is time in the markets that matters not market timing—as we know that the certainty of outcome increases as the time horizon increases. Having said that, markets are not perfectly efficient all the time and as a result, mispriced securities may allow us to add value through shorter-term tactical decisions.

As we formulated our road map to 2019, we concluded that some segments of both the equity and fixed-income markets may be underestimating the impact that a more dovish Fed and the prospect for better economic activity in the second half of 2019 may have on their returns. So far, our road map has panned out as expected. While we are not convinced inflation will stay low for long, we believe it will remain subdued over the short-term. As a result, we believe that this combination should provide a good floor for risk assets in general. Our portfolios are positioned to take advantage of a more rewarding environment for investors in 2019.

Chart 3 : The Various Phases of a Normal Economic Cycle

Early Recovery	Mid Expansion	Late Expansion	Recession
Growth rebounding	Growth peaking	Growth moderating	Growth falling
Inventories low; sales improve	Inventories and sales in equilibrium	Inventories grow; sales fall	Inventories & sales fall
Policy still stimulative	Policy neutral	Policy contractionary	Policy eases
Credit begins to grow	Credit growth strong	Credit tightens	Credit dries up
Profits grow fast	Profits growth peaking	Profits under pressure	Profits decline
Unemployment rate remains high	Unemployment rate falls	Unemployment rate falls slowly	Unemployment rate rises
Output/Employment gap is wide	Output/Employment gap narrows	Output/Employment gap closes	Output/ Employment gap widens again
Inflation stable to falling	Inflation picks up	Inflation accelerates	Inflation decelerates with a lag

Source: Trust Point

An Equity Market Update from Trust Point

Global equity prices experienced a dramatic bounce in the first quarter after the difficult end to 2018. The MSCI EAFE index increased 10.0%, while the S&P 500 climbed 13.7% (its best start to a year since 1998). While equity prices have moved higher despite a continued slowdown in global growth, we remain overweight equities in our modeled portfolios as we believe better economic growth is likely over the next six to twelve months.

EQUITY BENCHMARK TABLE

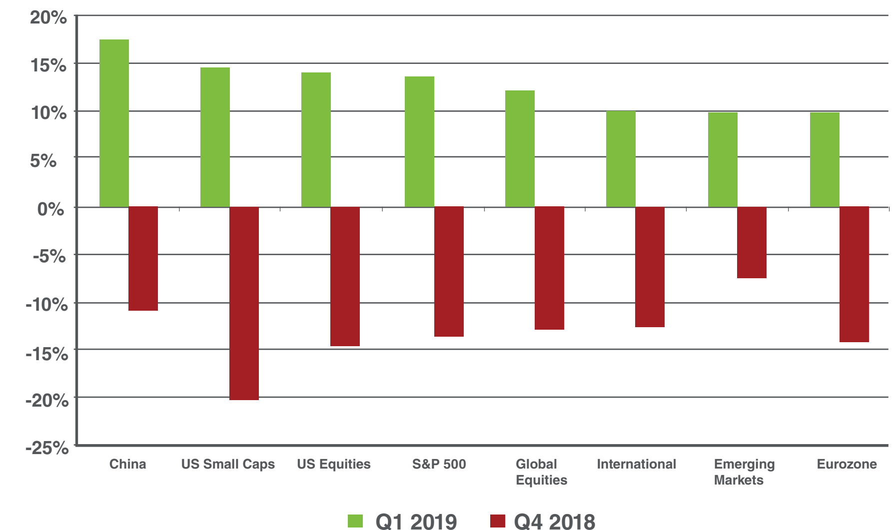
US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	2,834	2,507	2,641	2,060	1,872
Dow Jones Industrial Average	25,929	23,327	24,103	17,685	16,458
NASDAQ	7,729	6,635	7,063	4,870	4,199

Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	16.1%	16.1%	12.7%	16.5%	13.5%
US Large Cap Value	11.9%	11.9%	5.7%	10.5%	7.7%
US Mid Cap Growth	19.6%	19.6%	11.5%	15.1%	10.9%
US Mid Cap Value	14.4%	14.4%	2.9%	9.5%	7.2%
US Small Cap Growth	17.1%	17.1%	3.9%	14.9%	8.4%
US Small Cap Value	11.9%	11.9%	0.2%	10.9%	5.6%
International Large Cap Developed (US Dollar)	10.0%	10.0%	-3.7%	7.3%	2.3%
International Small/Mid Cap Developed (US Dollar)	10.7%	10.7%	-9.4%	7.5%	4.5%
Emerging Market (US Dollar)	9.9%	9.9%	-7.4%	10.7%	3.7%

Source: Bloomberg, Morningstar

Q1 Global Equity Returns Rebound

After a more than 13% decline last quarter, global equities managed to rebound by 12.2% in Q1 (Chart 4). Despite a continued slowdown in the global economy, stock prices nearly erased all of the Q4 decline. The significant change in market sentiment was mostly driven by easier monetary conditions that resulted from a suddenly dovish U.S. monetary policy turn. International equity returns participated almost on par with U.S. stocks in Q1, with China up 17.5% and the Eurozone up 9.8%. These returns came amid continued slowing global growth, measured by slowing manufacturing activity, likely exacerbated by the U.S.-China trade war, and continued Brexit turmoil in the U.K. In response to this economic backdrop, the European Central Bank (ECB) has added more monetary assistance to support banks, and China has said it expects to continue to use fiscal (and some monetary) tools this year to support its economy, much like what the Fed has done in the U.S. As noted earlier, these actions should support a risk-on environment through the rest of 2019 and help global equity prices grind higher. We caution, however, that it would be unreasonable for the velocity of increasing equity returns to continue at the recent pace.

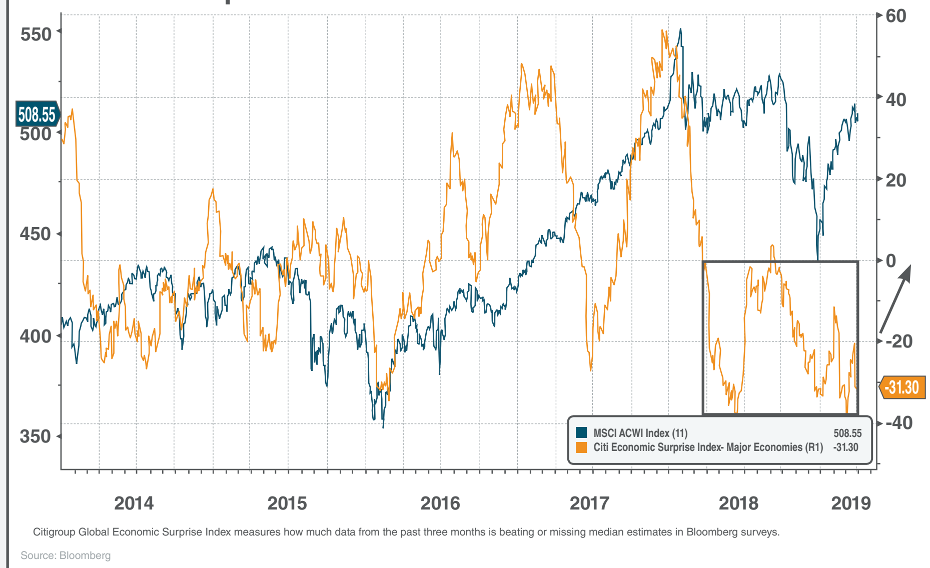


Thesis Is Not Complacent

We are often asked how high stock prices can go before there is another correction or an unfolding recession. Our thesis for 2019 is a scenario much like the equity actions of 2015-16 when financial conditions tightened and the Fed became overly assertive with rate hikes before changing course. The ultimate outcome of the current year thesis is for equity prices to move higher, but our scenario acknowledges the challenges that have been impacting equity markets lately. As discussed, global growth has continued to slow as the U.S.-China trade war continues to experience several "false-starts" to an agreement. Geopolitcal risks, including Brexit and upcoming elections across Europe have also unnerved investors at a time of increased protectionism and flattening yield curves. However, there may be indications that global economic data (which has been worse than expectations for most of the past 18 months) is due for a bounce (Chart 5). If the data can have more "positive surprises" relative to expectations, (reflecting stabilizing economic conditions), it should provide a positive backdrop for equities.

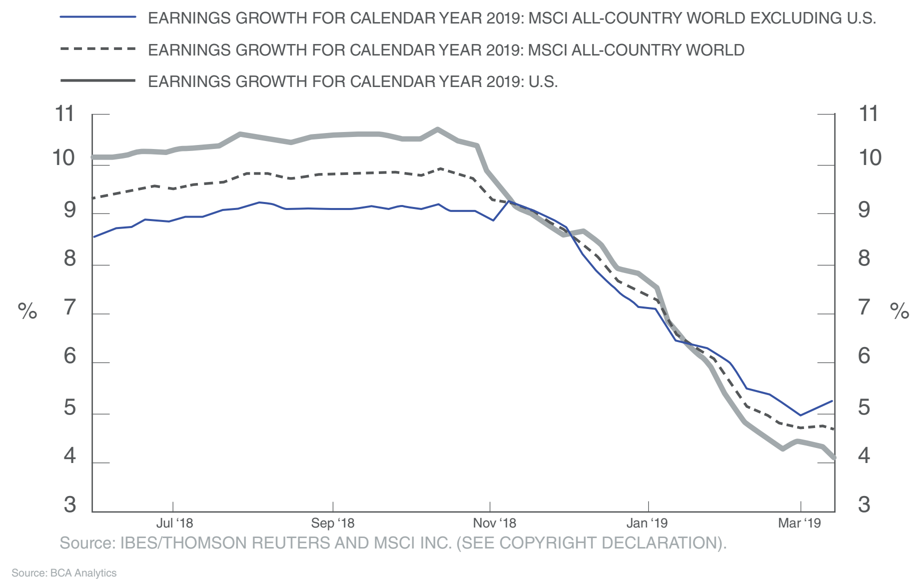
Equity Allocation Biases

We have long discussed the merits of investing in international equities, from the current state of attractive relative valuations to the long-term benefits of diversification. As the global economy has slowed and earnings growth expectations have fallen, international equities' earnings growth outlook appears to have hit bottom and are once again increasing (Chart 6), up to more than 5% growth expected this year. This contrasts analysts' expectations for the financial performance of U.S. corporations where they see financial results softening compared to 2018. Our confidence in international equity outperformance is unchanged, if not more bullish. Emerging market countries appear to be making a case for greater broad investor inflows. Examples include stimulus measures being taken in China, a pro-business government in place in Brazil, and a more stable or even a potentially weakening U.S. dollar. Furthermore, cumulative GDP growth in countries such as China, India, South Korea, and Taiwan, which make up almost 70% of the broadly-followed MSCI EM index, has grown in excess of 20% in each country since 2000. These same countries also have low external-debt-to-GDP ratios, solid foreign exchange reserves, and current account surpluses (India has a very small deficit). Emerging markets are largely a more constructive place to invest than ever before, which should provide a sustainable international-equities growth environment for the foreseeable future.



Citigroup Global Economic Surprise Index measures how much data from the past three months is beating or missing median estimates in Bloomberg surveys.

Source: Bloomberg



Source: IBES/THOMSON REUTERS AND MSCI INC. (SEE COPYRIGHT DECLARATION).

Source: BCA Analytics

A Fixed Income Market Update from Trust Point

The first quarter was welcomed as most sectors of the fixed income market posted higher returns in Q1 than they were able to achieve in all of 2018. Falling yields propelled bond prices to new highs as the U.S. Aggregate Bond Index rose 2.94% for the quarter. Corporate bond indexes fared even better, strongly supported by a shift in monetary policy that exceeded even the most optimistic expectations.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	2.4%	2.4%	1.7%	0.2%	0.0%
2 Yr US Treasury	2.3%	2.5%	2.3%	0.7%	0.4%
10 Yr US Treasury	2.4%	2.7%	2.7%	1.8%	2.7%

Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	2.4%	2.4%	5.3%	1.0%	2.7%
US Treasury Inflation Protected Sec.	3.2%	3.2%	2.7%	1.7%	1.9%
US Mortgages	2.2%	2.2%	4.4%	1.8%	2.6%
US Short-Intermediate T/E Munis	2.1%	2.1%	4.5%	1.8%	2.2%
US Investment Grade Corporates	5.1%	5.1%	4.9%	3.6%	3.7%
US Senior Bank Loans	4.0%	4.0%	3.0%	5.7%	3.6%
US High Yield	7.4%	7.4%	5.9%	8.7%	4.7%
US Convertibles	10.3%	10.3%	7.8%	12.1%	7.1%
Int'l Bonds Ex-US (Hedged)	3.1%	3.1%	5.2%	3.3%	4.6%
Int'l Bonds (Unhedged)	2.2%	2.2%	-0.4%	1.5%	1.0%
Emerging Market Debt (US Dollar)	6.6%	6.6%	3.5%	5.2%	4.8%

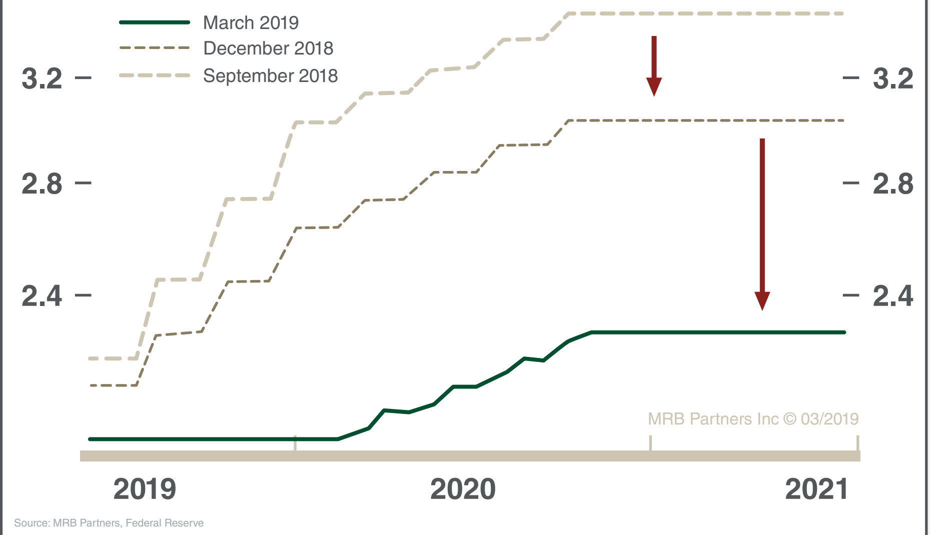
Source: Bloomberg, Morningstar

The Fed Delivers

In early January, the Fed committed to an easier policy stance following the Q4 correction in financial markets. In addition, the Fed indicated a willingness to adjust the pace at which their balance sheet was shrinking. Both of these commitments represented a dramatic shift in tone from previous quarters, injecting optimism into markets while easing investors' worries that Fed policy was becoming overly restrictive. The Fed doubled down at their latest March meeting by delivering a new and powerful message that essentially brought its three-year tightening bias to an abrupt halt (for now). In light of lower expectations for U.S. growth, the Fed abandoned projections for more rate hikes this year. The next and last forecasted rate-hike is not expected until 2020 (Chart 7). If that wasn't enough, the Fed said it would halt the consistent decline of the balance sheet in September while beginning to reduce the runoff as early as May. This balance sheet runoff has not gathered much attention but has been a meaningful tightening tool, running behind the scenes since late 2017. The outcome from the latest meeting is encouraging and the message is clear: the Fed will not hike rates again until it sees clear signs of a sustained recovery in growth. It will be difficult for the Fed to reverse course on this type of announcement for at least the next six months and a Fed "on hold" has historically been supportive of stronger economic activity.

Chart 7 : The Fed Has Shifted Significantly Dovish

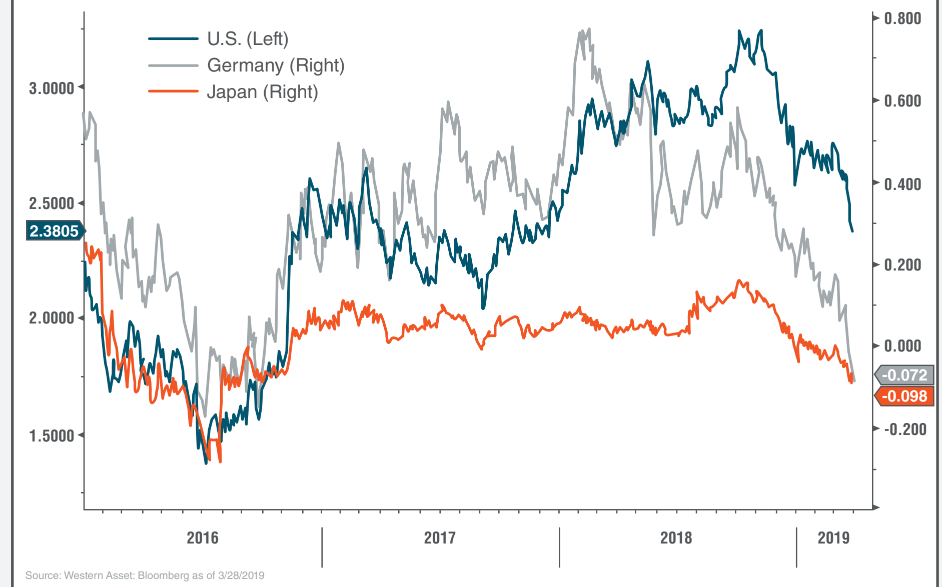
U.S. Federal Funds Rate Median Dot Plot (%):



Source: MRB Partners, Federal Reserve

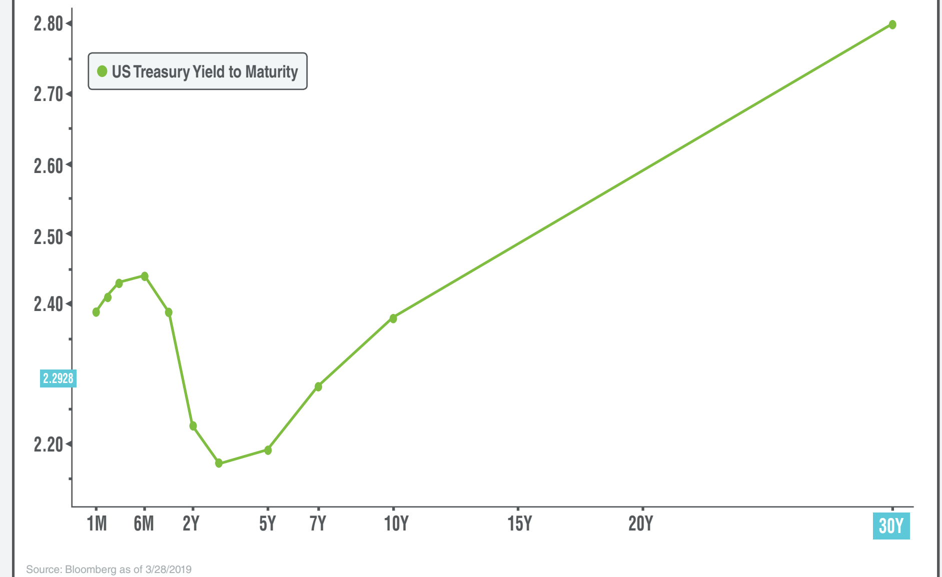
Negative - Yielding Bonds On the Rise

Growth scares and credit market meltdowns have a way of forcing a response from policy makers. The year 2018 was similar to 2015-16 when a slowdown in global growth caused global central banks to rethink tightening biases. In addition to recent dovish actions from the Fed, the European Central Bank (ECB) also responded to Eurozone economic weakness by eliminating prior statements of a potential 2019 rate hike. Japan authorities have indicated they are ready to ease further, as well. All in all, global authorities are attempting to provide another round of stability to rebuild investor confidence much like they did in 2016. One of the short-term beneficiaries of easier global monetary policy in the bond market has been government bonds. Treasuries and sovereign debt yields have tumbled over the past six months, causing prices to rise to new highs. In Germany and Japan, 10-year government bond yields have fallen back into negative territory for the first time since 2016 (Chart 8). Central banks are again attempting to encourage lending by cutting the cost of debt through ultra-low yields, with the intention of boosting economic growth. Buyers of this negative-yielding debt mostly come from central banks, institutions, and investors constrained by mandates. If central banks are able to succeed in stimulating economic activity, which would force market rates higher, government bonds may not display the typical defensive characteristics most expect out of safe-haven bonds.



Portfolio Positioning - New Opportunities Emerge

The flattening of the yield curve has been a highly debated topic lately. At the end of March, the yield on a 3-month T-Bill exceeded that of a 10-year Treasury note (Chart 9). We have adjusted portfolios to take advantage of the yield offered by short-term bonds, while reducing interest-rate risk at the same time. We have continued to position portfolios with less interest-rate risk than the benchmark as rate-sensitive bonds have become distorted by massive central bank intervention. Lastly, we remain cautiously optimistic and positioned for pro-growth monetary policy to remain supportive of corporate bonds and other credit-sensitive asset classes. In Q1, corporate bonds and other economically sensitive bonds were the biggest winners given the fresh policy support provided by the Fed and other monetary policy authorities. This pro-growth policy backdrop propelled Investment-grade corporates, high-yield corporates, and emerging-market debt returns well past 5% for the quarter. Diversification in the fixed income portion of portfolios has continued to pay off as having exposures to these markets resulted in strong fixed-income returns to start 2019.



MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment management team. The individuals contributing to Market Point are Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA, Brandon Hellenbrand, CFA®, Steve Brudos, Ryan Bergan and Christine Doll. Please feel free to contact any team member with questions.

Pictured top row left to right: Randy Van Rooyen, Yan Arsenault, Ryan Bergan
Bottom row left to right: Steve Brudos, Brandon Hellenbrand, and Christine Doll.

The opinions herein are those of Trust Point Inc, are made as of the date of this material, and are subject to change without notice. Trust Point uses its best efforts to compile its data from reliable sources, however, it does not warrant the accuracy, completeness or timeliness of any of the information provided. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. All investing involves the risk of loss, including principal, a reduction in earnings, and the loss of future earnings. Past performance is no guarantee of future results. Individual client portfolio performance and transactions therein can vary greatly based on factors including investment strategy, objective, limitations, risk tolerance, time horizon, asset composition, asset allocation and tax implications.

La Crosse, WI | P: 608-782-1148
Minneapolis, MN | P: 612-339-2343
Eau Claire, WI | P: 715-461-7018

www.trustpointinc.com

©Copyright Trust Point Inc. | La Crosse, WI | All Rights Reserved

230 FRONT STREET NORTH I PO BOX 489
LA CROSSE, WI 54602-0489

Standard
U.S. Postage PAID
Mailed from
Zip Code 54601
Permit No. 125