ASSET STRATEGY CONSULTANTS

MARKET REVIEW

First Quarter 2019

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the First Quarter 2019 and a summary of historical performance for the major asset style passive indices for the period ending March 31, 2019 We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Asset Strategy Consultants

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $9.8 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

What Correction?

With the equity market falling by nearly 20% at one point during the month of December, the worst for the S&P 500 since 1931, suffice it to say that 2018 ended with a thud rather than a bang. However, just as we saw a snap-back from the drawdown in early 2018 (for different reasons), the market once again exhibited a far more “risk-on” mood in January, paving the way for double-digit equity gains as well as robust returns across high yield, bank loans, and a variety of other “plus” sectors within fixed income.

So what changed? Not a whole lot. In hindsight, poor liquidity late in the fourth quarter exacerbated the sentiment-driven sell-off in risk markets (high yield and leveraged loans in particular) while unexpectedly dovish comments from the Fed in the early part of the year acted as a catalyst for a swift reversal. While there is some evidence of softening conditions in the U.S., data do not suggest that a recession is imminent. Corporate fundamentals remain solid, and while after-tax profits moderated in the fourth quarter, EPS was up 14% on a year-over-year (y-o-y) basis. Likewise, unemployment remains low at 3.8%, and wages are rising as average hourly earnings surprised on the upside with a 3.4% increase over the past 12 months (February), the fastest in a decade. Fourth quarter GDP was revised down to 2.2%, but while “sluggish” may be an apt term, this pace is not of recessionary ilk (full year GDP was 2.9%). Manufacturing showed signs of slowing, with the most recent Purchasing Managers’ Index (as of March) indicated that the US remains in expansionary territory (above 50) with the latest reading at 54.2. Consumer spending softened during the fourth quarter and first two months of the year, but the consumer remains in good shape with household debt service as a percentage of disposable income at the lowest level in decades. And inflation remains benign, with the Consumer Price Index (CPI) up 1.5% in February (y-o-y), notably lower than the 2.5% read from just a few months ago as falling energy prices (Energy CPI: -5.1% y-o-y) weighed heavily on the headline number. The Core CPI measure (excluding food and energy) was up 2.1% while the Fed’s preferred inflation gauge, the PCE Deflator, rose 1.8% over the trailing year.

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In March, the Fed's pause was expected, but its dovish language was not, leading to a dizzying plummet in U.S. Treasury yields. The Fed voted unanimously to leave rates unchanged at 2.25%-2.50% and further indicated that no hikes were likely for the remainder of the year, while lowering expectations for 2019 GDP from 2.3% to 2.1%. Finally, balance sheet "normalization" (maintaining the size of the balance sheet by reinvesting proceeds from maturities) was escalated to September 2019, sooner than expected. The yield curve is flirting with inverted status, but as of quarter-end the widely watched spread between the 2-year and 10-year Treasury was +14 basis points. An inversion has been an accurate harbinger recession, albeit up to 20 months out. In a stark reversal from the fourth quarter, Fed fund futures revealed a 65% probability of a fed cut in 2019.

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The picture is more worrisome overseas. With ambiguities regarding Brexit, recession in Italy in the fourth quarter, and surprisingly weak manufacturing numbers (PMI 44.7) out of Germany, the ECB lowered its projections for euro zone GDP growth from 1.7% to 1.1%. It also indicated it would leave rates on hold at least through the end of the year. Further, in early March the ECB announced a new bank lending program to support growth. Euro zone GDP grew 1.1% in the fourth quarter (+1.6% y-o-y), and the OECD estimates growth of just 1% for 2019, down from 1.8%. In Germany, the yield on the 10-year government bond turned negative for the first time since late 2016 and closed the quarter at -0.07%. China was also a worry—it lowered its growth target to 6.0%-6.5%, and the profits of industrial companies fell 14% in the first two months of 2019 versus one year ago, the worst since the Global Financial Crisis. (Spoiler: On April 1 China released its version of the PMI, beating expectations and hitting the highest level in eight months, thus tempering worries over a dramatic slowdown.) ■

EQUITY MARKETS

U.S. equity markets had no problem erasing the pain of the fourth quarter as the S&P 500 rose 13.7% with double-digit gains across cap and style spectrums. On a relative basis, Growth outperformed Value (R1000 Growth: +16.1% vs. R1000 Value: +11.9%), Small Cap outperformed Large Cap (R2000: +14.6% vs. R1000: +14.0%), and virtually all sectors delivered double-digit results with the exceptions being Financials (+8.6%) and Health Care (+6.6%). Volatility returned to more normalized levels, with just a few trading days seeing market movement of more than 2% in either direction (versus nearly 20% in the fourth quarter.)

Non-U.S. developed (MSCI EAFE: 10.0%) and emerging market equities (MSCI Emg Mkts: +9.9%) also rebounded strongly in the first quarter, but trailed their U.S. counterparts (and failed to make up for the pain felt in the fourth quarter). The U.K. (+11.9%), Canada (+15.4%), and Italy (+14.6%) were among the standout performers, while Japan (+6.7%) was a laggard but positive nonetheless. Similarly, emerging market performance was robust across the board with all the BRIC countries up strongly: China (+17.7%), India (+7.2%), Russia (+12.2%), and Brazil (+8.1%). Turkey's GDP dropped 3% y-o-y in the fourth quarter amid economic and political woes and was the worst-performing country (-3.2%). ■

FIXED INCOME MARKETS RESULTS

In the U.S., the Bloomberg Barclays US Aggregate Bond Index rose 2.9% for the quarter, with investment grade corporates (Bloomberg Barclays Corporate: +5.1%) up the most. Yields fell sharply in March as the market digested unexpectedly dovish comments from the Fed. The 10-year U.S. Treasury returned 2.8% and its yield closed the quarter at 2.41%, down nearly 30 bps from year-end and significantly from the multi-year high of 3.24% hit in early November. Portions of the yield curve inverted, but the widely watched spread between the 2- and 10-year Treasury note remained positive at 14 bps. The high yield corporate bond market (Bloomberg Barclays High

Yield: +7.3%) soared and the sector's yield-to-worst ended the quarter at 6.4% after surging to nearly 8% in the fourth quarter. Similarly, leveraged loans were up 4.0% after falling 3.5% (S&P LSTA) in the fourth quarter. While the fundamental picture for corporations remains intact, these returns were driven primarily by a strong technical tailwind on the back of a very weak December. Municipal bonds (Bloomberg Barclays Municipal Bond: +2.9%) outperformed U.S. Treasuries and were also helped by a favorable supply/demand backdrop. Municipal mutual funds absorbed roughly $24 billion in inflows—the best first quarter since data collection began in 1992.

Overseas, yields across developed markets fell. The Global Aggregate Index rose 2.2% for the quarter on an unhedged basis. On a hedged basis, the Index gained 3.0%. The dollar appreciated modestly vs. the euro and yen, but lost ground vs. the U.K. pound and Canadian dollar. In Germany, the yield on the 10- year bond turned negative for the first time since late 2016 and closed the quarter at -0.07%. Emerging market debt also benefited from the reversal in risk appetite. The U.S. dollar-denominated JPM EMBI Global Diversified Index gained 7.0% with none of the index's 60+ countries delivering a negative result. Local currency emerging market debt, as measured by the JPM GBI-EM Global Diversified Index, was up a more modest 2.9%, with notable underperformers being Turkey (-10.2%) and Argentina (-10.5%). ■

REAL ASSETS

Real assets of all varieties enjoyed a strong first quarter of the year, perhaps none more than Crude Oil as the price of WTI extended over +30% through the end of March. Energy as a whole (measured by the Bloomberg Commodity Energy sub-index) was up nearly 16%, while Commodities broadly produced a more modest positive return in Q1 (BCOM TR Index: +6.3%) as gains in Energy and Metals were offset by negative returns for Natural Gas and the Agriculture complex as a whole (BCOM Agriculture sub-index down -3.2%). Other, yield-oriented real asset categories also saw healthy gains. Somewhat influenced by the buoyant price of oil (and equity markets as well), MLPs (Alerian MLP Index: +16.8%) also enjoyed a strong start to the year with the yield spread between the Alerian Index and the 10-year Treasury remained still fairly wide at +500 basis points. Both US and Non-US listed real estate saw double digit gains in Q1 (FTSE NAREIT Equity: +16.3%; FTSE EPRA/NAREIT Global: +15.0%) as did listed infrastructure assets (DJ Brookfield Global Infra: +15.7%). ■

CLOSING THOUGHTS

With such a torrid start to the year for broad asset classes following an almost equally disappointing end to 2018, it will be very interesting to observe how investors react to the next series of potential market events. More periodic bouts of volatility seem almost inevitable, global growth concerns (particularly in Europe) are not going away, and of course there's the plodding and still undetermined outcome on final Brexit deal. Thus, just as we have stated in the past, adherence to an appropriate and well-defined asset allocation remains the best course of action to manage the path to successful attainment of long term investment goals. ■

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 1Q19

	#		January	February	March	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1	Russell:3000 Index	8.58	3.52	1.46	14.04	14.04	8.77	13.48	10.36	16.00	8.68
	2	Russell:1000 Index	8.38	3.39	1.74	14.00	14.00	9.30	13.52	10.63	16.05	8.74
	3	Russell:1000 Growth	8.99	3.58	2.85	16.10	16.10	12.75	16.53	13.50	17.52	9.71
	4	Russell:1000 Value	7.78	3.20	0.64	11.93	11.93	5.67	10.45	7.72	14.52	7.63
	5	Russell:Midcap Index	10.79	4.30	0.86	16.54	16.54	6.47	11.82	8.81	16.88	9.64
	6	Russell:Midcap Growth	11.49	5.86	1.35	19.62	19.62	11.51	15.06	10.89	17.60	9.94
	7	Russell:Midcap Value	10.29	3.18	0.50	14.37	14.37	2.89	9.50	7.22	16.39	9.22
	8	Russell:2500 Index	11.51	4.72	(0.82)	15.82	15.82	4.48	12.56	7.79	16.23	8.88
	9	Russell:2500 Growth	11.91	6.59	(0.25)	18.99	18.99	7.54	15.60	9.72	17.50	9.66
	10	Russell:2500 Value	11.18	3.12	(1.33)	13.12	13.12	1.84	9.85	6.02	15.03	8.00
	11	Russell:2000 Index	11.25	5.20	(2.09)	14.58	14.58	2.05	12.92	7.05	15.36	8.04
	12	Russell:2000 Growth	11.55	6.46	(1.35)	17.14	17.14	3.85	14.87	8.41	16.52	8.71
	13	Russell:2000 Value	10.94	3.89	(2.88)	11.93	11.93	0.17	10.86	5.59	14.12	7.24
	14	S&P:500	8.01	3.21	1.94	13.65	13.65	9.50	13.51	10.91	15.92	8.57
	15	S&P:400 Mid Cap	10.46	4.24	(0.57)	14.49	14.49	2.59	11.24	8.29	16.28	9.52
	16	S&P:600 Small Cap	10.64	4.35	(3.33)	11.61	11.61	1.57	12.55	8.45	17.00	9.55
	17	MSCI:ACWI ex US	7.56	1.95	0.60	10.31	10.31	(4.21)	8.09	2.57	8.85	5.58
	18	MSCI:EAFE	6.57	2.55	0.63	9.98	9.98	(3.71)	7.27	2.33	8.96	5.11
	19	MSCI:EM	8.77	0.22	0.84	9.93	9.93	(7.40)	10.68	3.68	8.95	7.92
	20	MSCI:ACWI	7.90	2.67	1.26	12.18	12.18	2.60	10.67	6.45	11.98	6.80
FIXED INCOME	21	Blmbg:Aggregate	1.06	(0.06)	1.92	2.94	2.94	4.48	2.03	2.74	3.77	3.89
	22	Blmbg:Gov/Credit	1.18	(0.06)	2.12	3.26	3.26	4.48	2.12	2.78	3.92	3.86
	23	Blmbg:Credit	2.16	0.22	2.44	4.87	4.87	4.89	3.48	3.61	6.22	4.66
	24	Blmbg:Corporate High Yld	4.52	1.66	0.94	7.26	7.26	5.93	8.56	4.68	11.26	7.33
	25	Blmbg:Municipal Bond	0.76	0.54	1.58	2.90	2.90	5.38	2.71	3.73	4.72	4.21
	26	Blmbg:US TIPS	1.35	(0.01)	1.84	3.19	3.19	2.70	1.70	1.94	3.41	3.66
	27	Blmbg:Glob Agg ex USD	1.86	(1.04)	0.71	1.52	1.52	(4.13)	0.96	(0.26)	2.46	2.88
	28	S&P:LSTA Levg Loan	2.55	1.59	(0.17)	4.00	4.00	2.97	5.67	3.62	7.97	4.68
	29	ML:US Treasuries 1-3 Yrs	0.27	0.10	0.61	0.98	0.98	2.72	0.99	0.98	1.04	1.98
	30	LIBOR - 3 Month	0.24	0.20	0.22	0.66	0.66	2.56	1.62	1.10	0.74	1.76
	31	3 Month T-Bill	0.20	0.18	0.22	0.60	0.60	2.12	1.19	0.74	0.43	1.35
REAL ASSETS	32	Blmbg:Commodity TR Idx	5.45	1.01	(0.18)	6.32	6.32	(5.25)	2.22	(8.92)	(2.56)	(2.79)
	33	GS Commodity Index	8.99	3.81	1.61	14.97	14.97	(3.04)	6.18	(12.61)	(3.37)	(4.37)
	34	MSCI:US REIT Index	11.78	0.67	3.32	16.27	16.27	20.72	6.00	9.00	18.48	8.47
	35	Alerian:MLP Index	12.64	0.27	3.43	16.82	16.82	15.11	5.69	(4.73)	10.12	7.97
	36	DJB:Glbl Infrastructure	9.36	2.56	3.18	15.73	15.73	12.58	8.72	5.67	13.45	10.65
	37	US DOL:CPI All Urban Cons	0.19	0.42	–	–	–	–	–	–	–	–