Market Update

January 14, 2019

A Rebound of Sorts to Start 2019

Major Market Driving Themes

1. Federal Reserve Interest Rate Policy Decisions
2. China-Trade Negotiations and Economic Slow Down
3. Yield Curve Flattening

- U.S. equity markets moved higher again last week, firming up for the second consecutive week. Seemingly fruitful trade negotiations between the U.S. and China offered notable support.
- With respect to data, both the ISM non-manufacturing index and small business confidence have eased from recent highs, but remain in healthy territory. Inflation data came in as expected, with core CPI holding steady at 2.2% y/y.
- The government shutdown, which is on track to become the longest in U.S. history, may test the Fed's wait and see approach to monetary policy, given data distortions and delays. If it ends soon, we expect its impact to be quite modest. But each passing week has the potential to amplify the impact.

On January fourth, a strong December jobs report provided support for a reversal of market sentiment, as 2018 ended and 2019 began. Federal Reserve Chairman Jerome Powell's well thought out written prepared remarks at the American Economic Association's annual meeting in Atlanta that day further improved market sentiment. Of note, the volatility in the market seems to have calmed down to more normal ranges since the Christmas Eve trading session which was awful, to say the least. Some investment banks and brokerage strategist are suggesting the markets could re-test the December lows, as often happens after a sharp rebound. This tends to be a very conservative stance, as these institutions like to try and get out ahead of market moves, if possible. They do not want to be caught being too constructive on the markets. Many feel it is better to be wrong about re-testing lows so that when it happens they can say they were prepared for it. Should the re-test not materialize, these institutions can always say they were cautious and happy to see that their worst-case scenario was not realized. Trade negotiations with China are the next big theme that the markets are concentrating on and hoping for a good outcome. China's economy has been significantly impacted by the trade war, and many indicators suggest the impact is more significant than the impact on the United States. Bottom line, trade wars have never been good long term. Both countries have plenty of reasons to work on a deal. Hopefully, it can produce some benefits for both sides, especially stopping the intellectual property and technology theft that is a core issue.

The chart below is a 6-month version of the chart that we typically use. We are using a 6-month chart to better show the recent market movements and how these areas of the markets performed. We see the S&P 500 recovering some from the steep 3-month sell-off that started last October. Intra-day the market was down the required 20% to reach bear market territory, however, from a closing high to closing low the S&P 500 was just shy of bear market territory down roughly 19.6%. Since then, we have recovered around 8% of those declines.

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Below, you will find the U.S. Treasury Yield Curve. The benchmark 10-year bond was down 3.0 basis points yielding, 2.71%. However, it's currently trading 16.0 basis points higher than it was a year ago. The 2-year note was down 1.0 basis point, yielding 2.55%, while the 30-year long bond was also down 2.0 basis points, yielding 3.04%. At the short end of the curve, 3-month T-bills were virtually unchanged and yield 2.43%

The Treasury Curve is still sloped positively and has not inverted although the 2-year treasury and 5-year treasury have been moving in an out of inversion in just those two maturity ranges. The treasury curve has flattened and longer rates (2yrs. or more) have actually ticked down a bit during the most recent month of volatility. This happens, as investors seek the security of treasuries during volatility. The Federal Reserve is closely watching the yield curve and financial markets. They have indicated that they will also look at Quantitative Tightening policy. Quantitative Tightening policy has to do with the Federal Reserve's balance sheet, specifically its holdings of Treasuries. They're indicating that instead of a steady academic model-driven approach to selling off their treasury holdings, they will allow economic data and market conditions to influence their decisions. This has a more stabilizing impact, as it helps reduce tightening or the speed of a rising rate environment.

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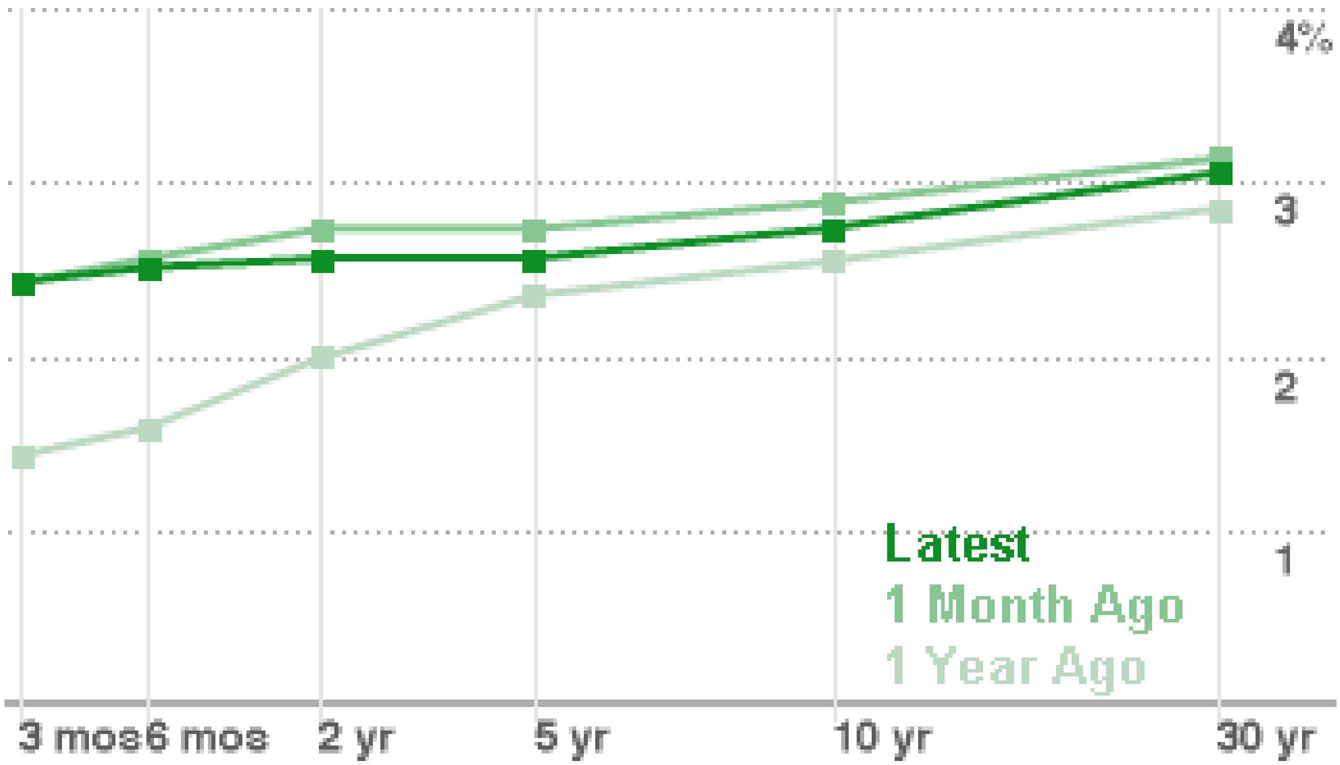

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We continue to feel that there are signs of a later stage economic environment. The biggest concern for the economy in the next 12 months continues to be the Federal Reserve increasing rates too quickly, which can stifle growth. They appear to be more dovish and willing to slow down the pace of rate hikes, and become more data dependent again.

Overall, we prefer domestic equities over international equities although, some international markets may become more attractive as the U.S. economic cycle continues to mature. One area that we have started to make some shifts in domestic equities is between growth and value stocks. Value stocks tend to move more slowly in either direction when the markets react to stimulus. In later stage economic environments, a tactical shift to overweighting value type stocks can reduce portfolio risk. This is an area we are now looking to continue to make tactical changes over the course of the coming months. We are currently neutral to bearish on fixed-income and interest rates. It is important to maintain discipline regarding strategic asset allocation. Tactically, we have started to reposition the cash raised in early and mid-December from equity and bond holdings.

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If you have questions or would like to discuss this further with regard to your personal portfolio, please contact me at 310-433-5378.

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