

# **CAPITAL MARKET REVIEW**

First Quarter 2019



# The Economy

“The difficulty lies not so much in developing new ideas as in escaping from old ones.”

– John Maynard Keynes

The financial markets are full of old ideas that simply refuse to go away. For example, we simply must have a bear market because one is supposed to happen every five years. Similarly there is an old idea that the economy as a whole must go into recession because a recession is supposed to happen roughly every five years. In the fourth quarter all we heard about was that "everyone knows" we are late in the cycle. Market and economic cycles don't wear watches and they don't know anything about calendars.

There are no actual economic signs of being late in the cycle. Growth remains strong domestically. The job market is strong and wages are rising. Inflation has tamed so even the Fed is back on hold and not raising rates.

Ultimately all these ideas persist because of the fatal flaw of economics as a science. In the hard sciences the scientific method requires a control - this group gets the experimental treatment while this other group gets a placebo. The treatment works or it does not. There is no control group in economics. So what are investors to do?

Keep our eyes on the long-term. Cycles will come and go, we must make prudent decisions based on investment fundamentals. That is easier said than done.



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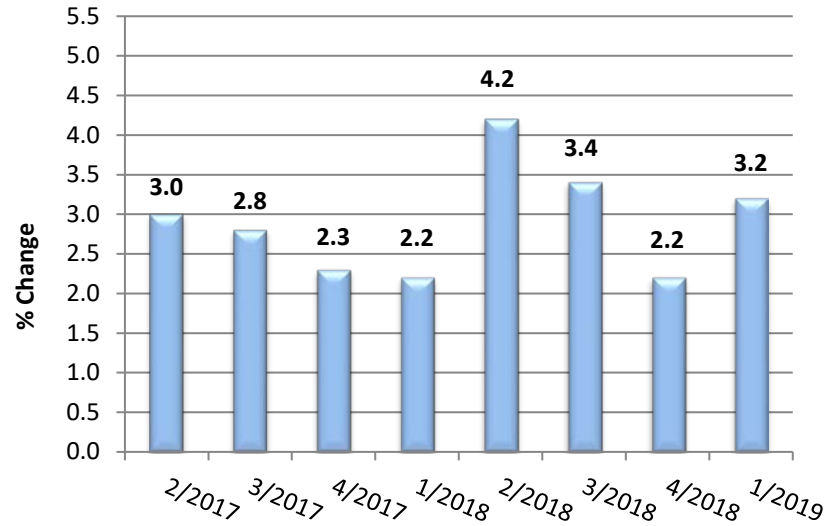
# The Economy

The 4<sup>th</sup> quarter 2019 GDP growth came in at 2.2 percent which meant that we grew 3 percent over 2018 as a whole. The first quarter of the year was estimated to be a little slower, but came in at 3.2 percent. This is the best sustained growth we have seen in the US in a very long time.

The official unemployment rate is 3.8 percent in March. This is the longest sustained under 4 percent rate since the 1960's. Wages are growing at 3.2 percent which means real wage growth.

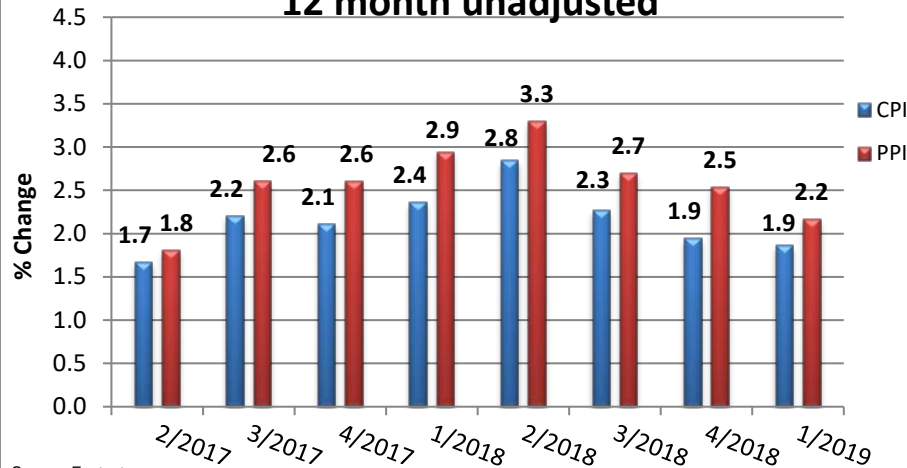
Inflation is 1.9 percent based on the latest consumer price index report. That remains steady from last quarter. Put all together this is simply the best economy we have seen in my professional career.

## Domestic GDP



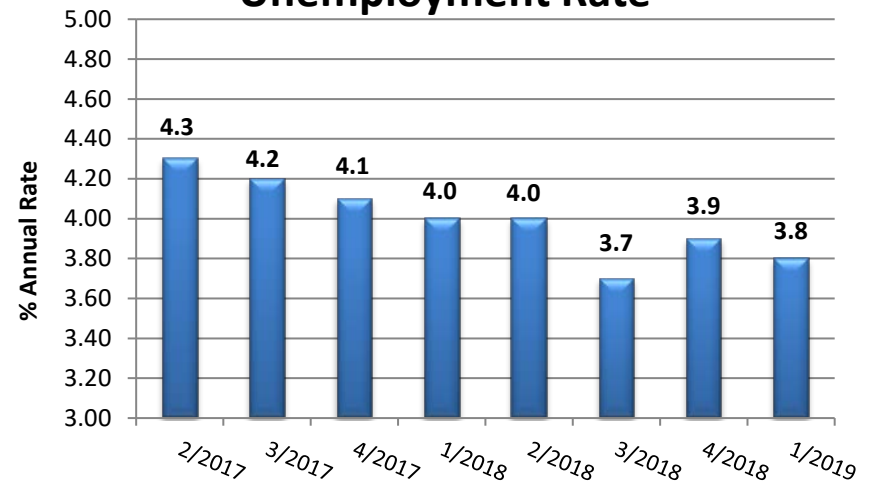
Source: Factset

## Inflation Indicator 12 month unadjusted



Source: Factset

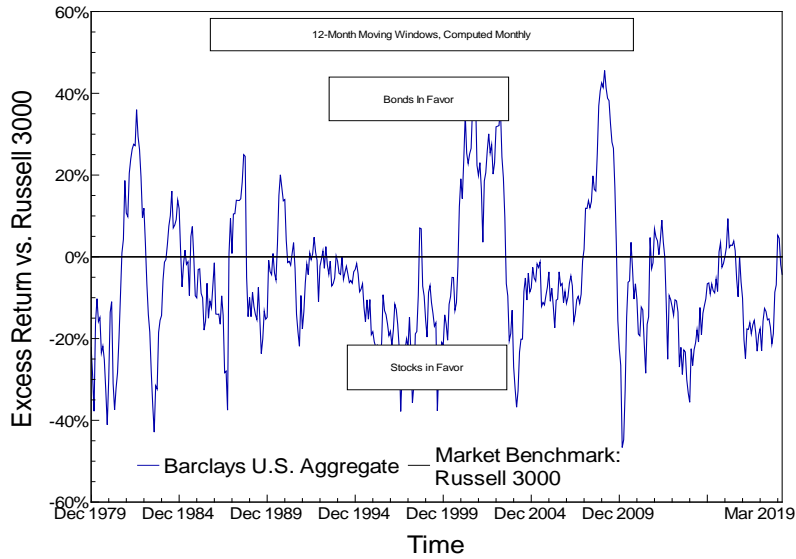
## Unemployment Rate



Source: Factset

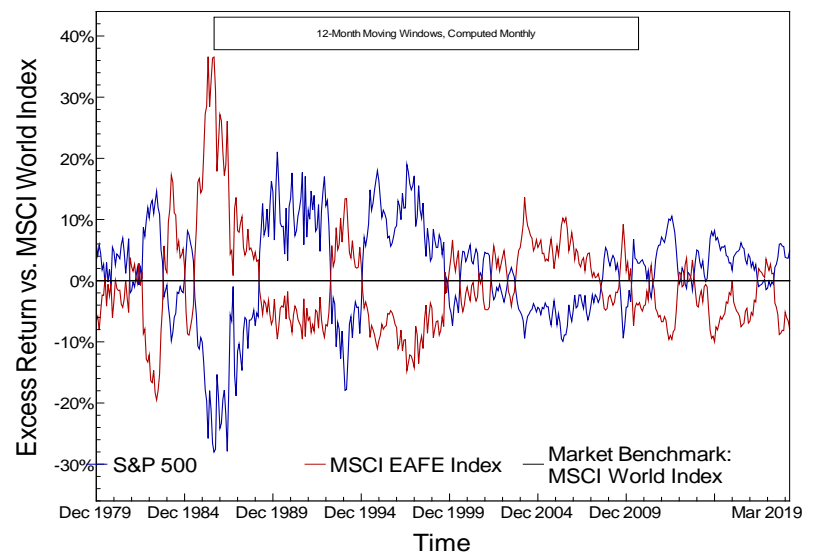
### Bonds vs. Stocks

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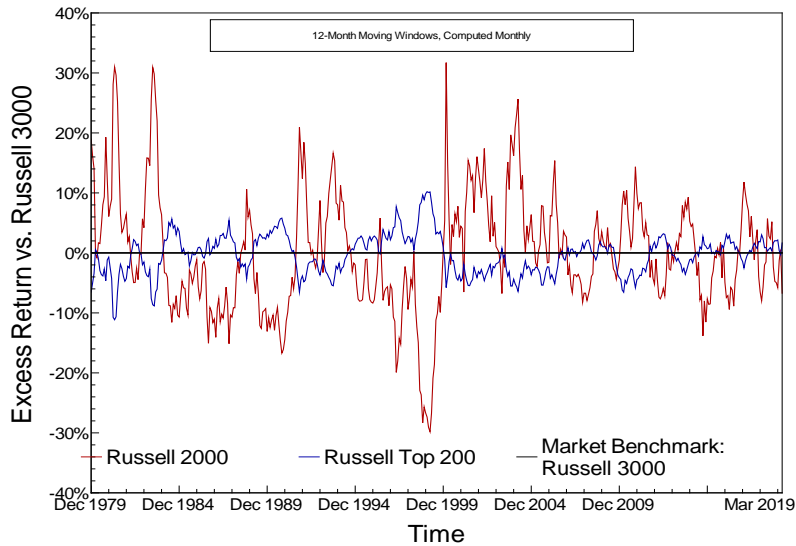
### International Vs. Domestic

Zephyr StyleADVISOR: Iron Capital Advisors

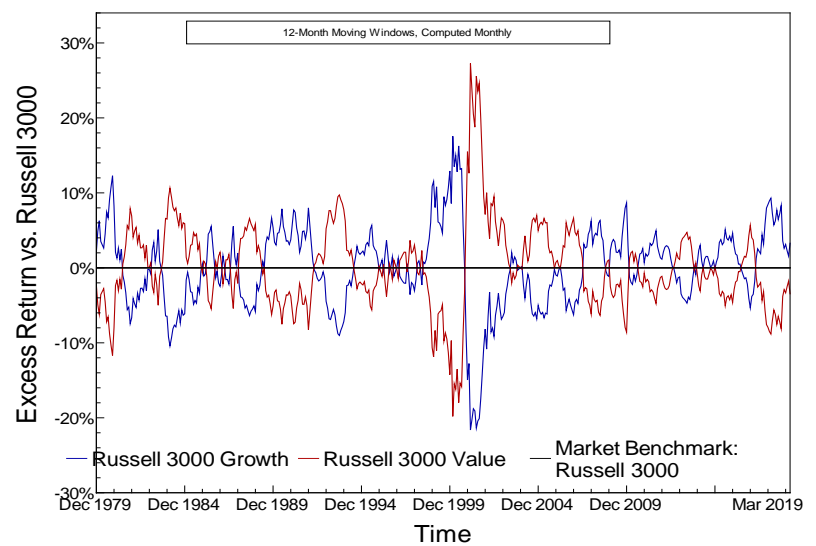


### Large vs. Small

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### Value vs. Growth



# Domestic Equity Markets

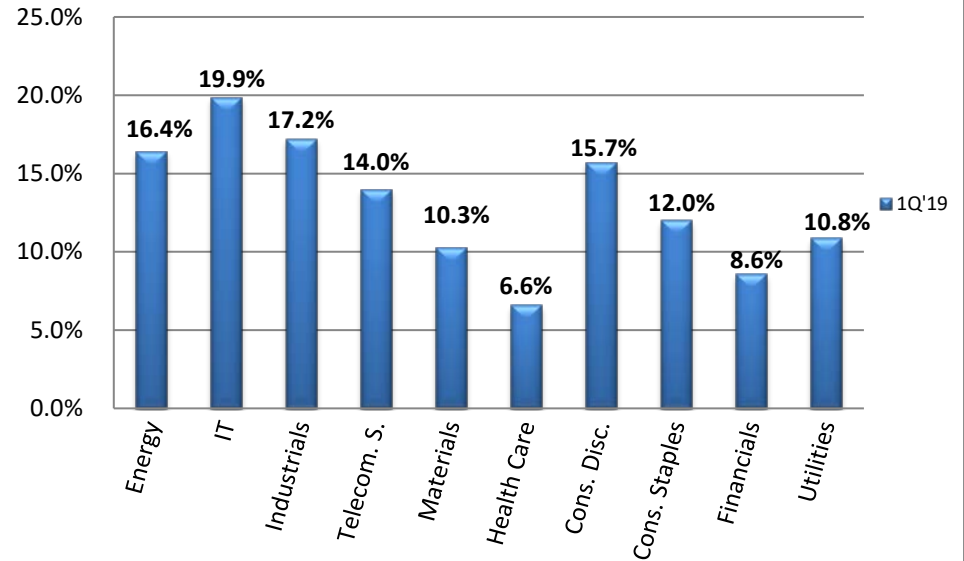
**Markets rebound.** For the quarter the S&P 500 finished up 13.65 percent and small company stocks represented by the Russell 2000 index were up 14.58 percent. Growth once again outpaced value.

Technology was the best place to be, followed by industrials. The easing of trade tensions and the reality that we are not about to drop into a recession boosted equity results. Longer term this rally simply undid the selloff in the 4th quarter. The market is now roughly back to where it was in October and the question is where do we go from here?

## Domestic Indices Three Months Ending March 31, 2019

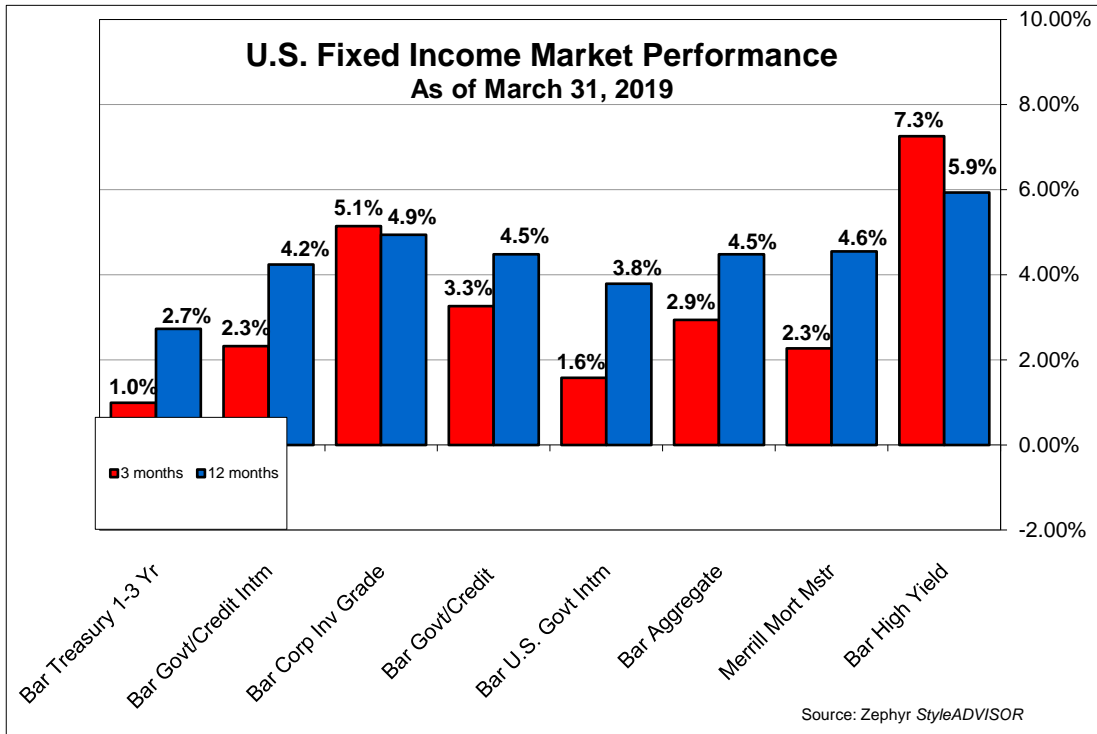
	Yield	Price/Earnings	Price/Book
S&P 500	1.89%	18.7	3.30
Russell 1000 Gr	1.17%	22.9	7.28
Russell 1000 Val	2.52%	16.4	2.04
Russell Midcap	1.64%	20.9	2.76
Russell 2000 Gr	0.62%	62.5	4.06
Russell 2000 Va	2.14%	23.7	1.40

## S&P GICS Sector Returns



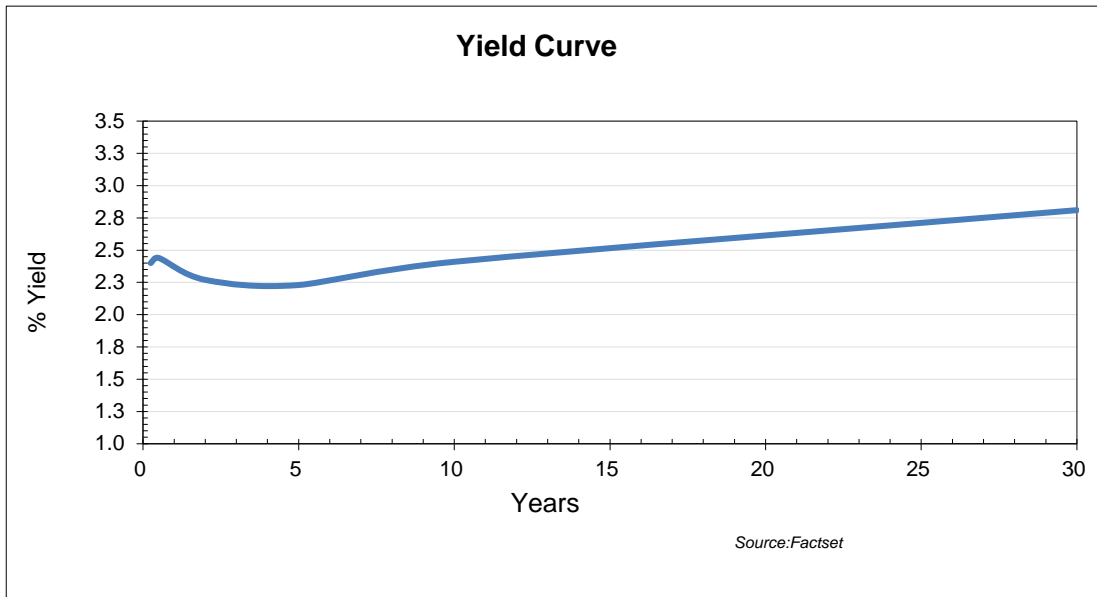
Source: Factset

# DOMESTIC FIXED INCOME MARKET



**Bonds rallied as well.** The Barclays US Aggregate Bond index ended up 2.94 percent. High yield bonds rose 7.26 percent.

A pause in the rate hike cycle led to lower interest rates. Once again the 10 year Treasury is below 2.5 percent and not very attractive to long term investors.



## Yield Curve as of March 31, 2019

Time to Maturity	Interest Rate
3 Month	2.40
6 Month	2.44
2 Year	2.27
5 Year	2.23
10 Year	2.41
30 Year	2.81

# INTERNATIONAL MARKETS

**International stocks were also positive.** The MSCI EAFE index finished up 10.13 percent while the MSCI Emerging Markets index ended the quarter up 9.97 percent.

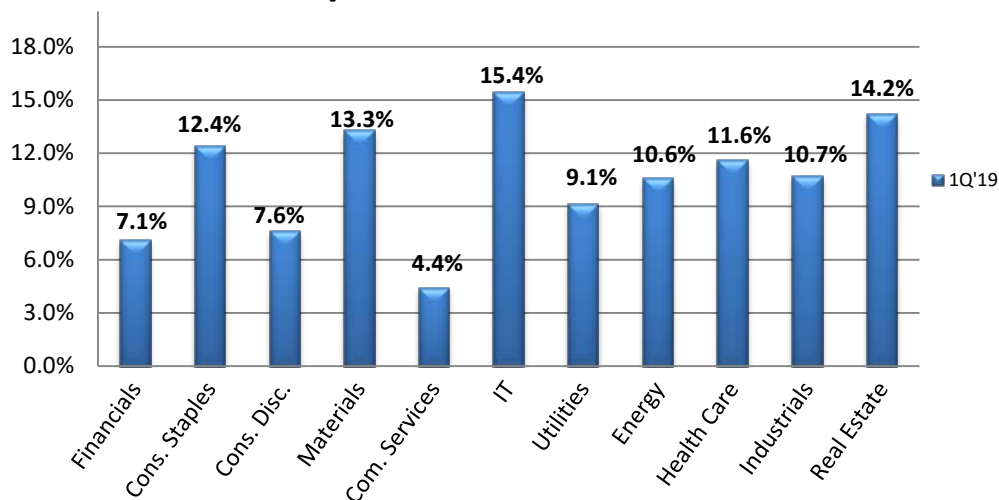
While these are solid results they trail the United states once again. International stocks are looking more attractive in many ways. Emerging market stocks are the most attractive from a valuation standpoint. The question remains, why are they not outperforming?

China trade and Brexit are the two most discussed reasons. China is looking better as the commentary around the trade talks has been mostly positive. Brexit on the other hand leads to lots of uncertainty. I feel funny saying that because the truth is that the future is always uncertain, but an issue like Brexit simply reminds those who forget that from time to time.

## MSCI Country Returns Three Months Ending March 31, 2019

	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Austria	8.56%	10.52%	-1.96%
Belgium	16.25%	18.35%	-2.10%
Denmark	13.23%	15.32%	-2.09%
Finland	8.38%	10.34%	-1.96%
France	10.79%	12.79%	-2.00%
Germany	7.00%	8.93%	-1.93%
Ireland	11.58%	13.59%	-2.01%
Italy	14.71%	16.78%	-2.07%
Netherlands	13.63%	15.48%	-1.85%
Norway	7.18%	6.59%	0.59%
Portugal	10.23%	12.23%	-2.00%
Spain	7.09%	9.03%	-1.94%
Sweden	7.94%	12.93%	-4.99%
Switzerland	13.54%	14.71%	-1.17%
UK	11.91%	9.38%	2.53%
<b>Europe Total</b>	<b>11.00%</b>	<b>11.74%</b>	<b>-0.74%</b>
Australia	11.43%	10.44%	0.99%
Hong Kong	15.58%	15.86%	-0.28%
Japan	6.85%	7.79%	-0.94%
New Zealand	16.86%	14.90%	1.96%
Singapore	6.23%	5.56%	0.67%
<b>Pacific Total</b>	<b>8.66%</b>	<b>9.09%</b>	<b>-0.43%</b>
Brazil	8.22%	8.67%	-0.45%
Canada	15.60%	13.07%	2.53%
China	17.69%	17.86%	-0.17%
Greece	12.78%	14.82%	-2.04%
Hungary	6.01%	8.21%	-2.20%
India	7.16%	6.33%	0.83%
Indonesia	4.27%	3.25%	1.02%
Korea	4.97%	6.79%	-1.82%
Mexico	5.55%	3.96%	1.59%
Poland	-0.58%	1.46%	-2.04%
Russia	12.24%	7.13%	5.11%
Thailand	7.52%	4.80%	2.72%
<b>Emerging Markets</b>	<b>9.97%</b>	<b>9.86%</b>	<b>0.11%</b>

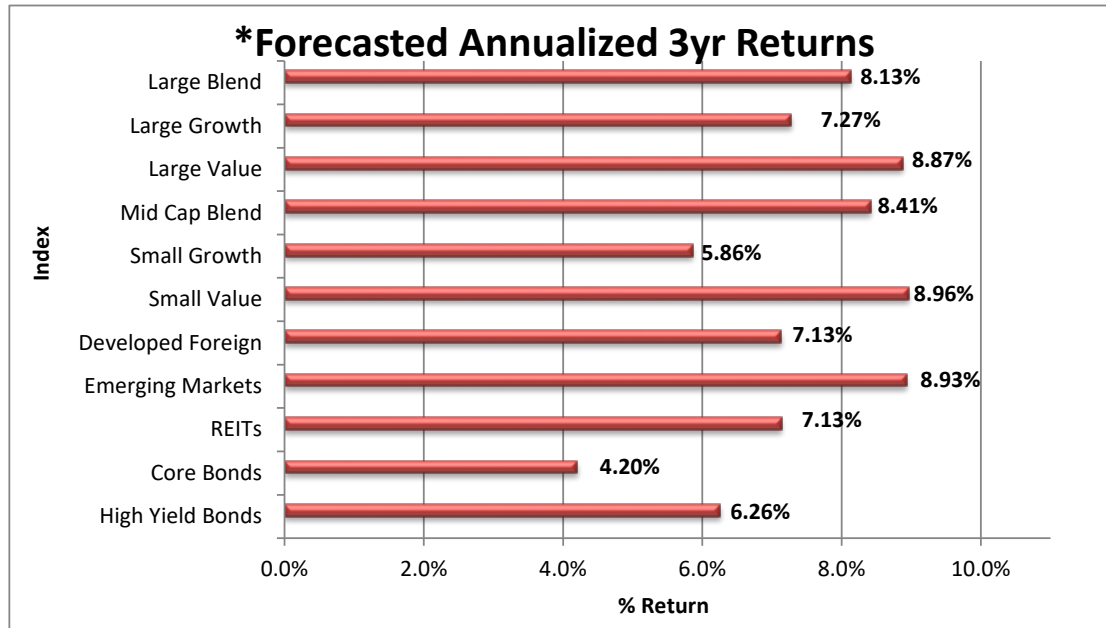
## Developed Int'l Sector Returns\*



Source: Harbor Capital

\* MSCI EAFE Index

# Market Forecast



**Indices Three Months Ending March 31, 2019**

	Yield	Frwd Earnings Yield	**Hist. Return	***Hist. Risk Prem. + RF Rate
Large Blend	1.89%	7.96%	9.95%	6.53%
Large Growth	1.17%	6.05%	9.64%	6.53%
Large Value	2.52%	9.71%	10.09%	6.53%
Mid Cap Blend	1.64%	7.61%	11.36%	6.53%
Small Growth	0.62%	3.39%	7.49%	7.53%
Small Value	2.14%	9.04%	10.27%	7.53%
Developed Foreign	3.11%	10.60%	4.97%	4.66%
Emerging Markets	2.29%	10.57%	9.52%	6.16%
REITs	3.81%	5.80%	10.95%	5.10%
Core Bonds	2.98%	2.98%	6.61%	3.43%
High Yield Bonds	6.10%	6.10%	8.13%	4.60%

**Eventually markets must reflect reality.** The selloff in the 4<sup>th</sup> quarter made no sense and it has basically been undone. Where do we go from here? We are cautiously optimistic.

Small company stocks should do better as should value stocks. Emerging markets also still look attractive. That bodes well. International stocks may carry more risk as the economies are not as strong in Europe and developed Asia.

Bonds are doing their job and reducing volatility by remaining stable in the downturn. Yields have dropped once again and are likely to go back up as stocks rally.

\* Weighted average using 40% earnings yield, 30% historic return and 30% historic risk premium + RF rate

\*\*Annualized 28 Yr return

\*\*\*Hist. risk premium of domestic and international equity as defined by Zyphyr Style Advisor's GFD Long Term Index database except for REITs and High Yield which are based on average 20 year rolling returns of the NAREIT Equity REIT Index and the Barclays Corporate High Yield Index minus the average 20 year rolling returns of the 3-month T-Bill and scaled using proprietary data. The Current 3-month T-Bill yield (as of 03-31-2019) is added back to each risk premium.



## SELECTED INDEX RETURNS - PERIODS ENDING March 31, 2019

	Quarter	Year-to-Date	One Year	Three Years	Five Years	Ten Years
<b>US EQUITIES</b>						
Broad Stock Market - Russell 3000	14.04%	14.04%	8.77%	13.49%	10.36%	16.00%
Large Stocks - S&P 500	13.65%	13.65%	9.50%	13.51%	10.91%	15.92%
Dow Jones Industrial Average	11.81%	11.81%	10.09%	16.37%	12.21%	15.97%
Medium-Size Stocks - Russell Mid-Cap	16.54%	16.54%	6.47%	11.82%	8.81%	16.88%
Small Stocks - Russell 2000	14.58%	14.58%	2.05%	12.92%	7.05%	15.36%
Small Value Stocks- Russell 2000 Value	11.93%	11.93%	0.17%	10.86%	5.59%	14.12%
Small Growth Stocks- Russell 2000 Growth	17.14%	17.14%	3.85%	14.87%	8.41%	16.52%
Large Value Stocks - Russell 1000 Value	11.93%	11.93%	5.67%	10.45%	7.72%	14.52%
Large Growth Stocks - Russell 1000 Growth	16.10%	16.10%	12.75%	16.53%	13.50%	17.52%
<b>US FIXED INCOME</b>						
1-3 Yr Treasury (Gov't) Bonds - Barclays Capital	0.99%	0.99%	2.73%	0.98%	0.98%	1.04%
US Government Bonds Int - Barclays Capital	1.58%	1.58%	3.79%	0.97%	1.65%	2.00%
US Corporate Inv Grade Bonds - Barclays Capital	5.14%	5.14%	4.94%	3.64%	3.72%	6.66%
Government/Credit (Corp) Bonds - Barclays Capital	3.26%	3.26%	4.48%	2.12%	2.78%	3.92%
Int Govt/Credit (Corp) Bond - Barclays Capital	2.32%	2.32%	4.24%	1.66%	2.12%	3.14%
US Aggregate Bond Market - Barclays Capital	2.94%	2.94%	4.48%	2.03%	2.74%	3.77%
Mortgage Master - Merrill Lynch	2.27%	2.27%	4.55%	1.81%	2.65%	3.12%
US Corp High Yield Bonds - Barclays Capital	7.26%	7.26%	5.93%	8.56%	4.68%	11.26%
<b>INTERNATIONAL (Measured in US Dollars)</b>						
Non-US Stocks - MSCI EAFE	10.13%	10.13%	-3.22%	7.80%	2.81%	9.47%
World Stocks (includes US) - MSCI World	12.65%	12.65%	4.61%	11.31%	7.38%	13.01%
European Stocks - MSCI Europe	11.00%	11.00%	-3.10%	7.22%	1.63%	9.61%
Japanese Stocks - MSCI Japan	6.85%	6.85%	-7.50%	8.43%	5.97%	8.23%
Asian Stocks (Ex-Japan) - MSCI Pacific ex-Japan	12.27%	12.27%	4.71%	10.46%	4.01%	11.56%
Chinese Stocks - MSCI China	17.69%	17.69%	-6.08%	16.16%	9.65%	10.14%
Indian Stocks - MSCI India	7.16%	7.16%	6.75%	11.69%	7.87%	11.59%
Emerging Markets - MSCI EM	9.97%	9.97%	-7.06%	11.09%	4.06%	9.31%
Int'l Gov't Bonds -Citi World Gov't Bond (Non USD)	1.52%	1.52%	-4.55%	0.87%	-0.06%	2.02%
<b>REAL ESTATE</b>						
FTSE NAREIT Equity-Reits Index	16.33%	16.33%	20.34%	5.97%	9.03%	18.23%
<b>SHORT TERM INTEREST RATES</b>						
T-Bills	0.60%	0.60%	2.11%	1.17%	0.72%	0.41%

Note: Returns for periods longer than 12 months are annualized.