THE FED’S DOVISH PIVOT SPARKS A RALLY IN GLOBAL RISK ASSETS

When global stock markets declined by more than double-digits in the fourth quarter of 2018, the message to the Federal Reserve was clear. Investors feared that their proposed path of rate hikes and balance sheet run-offs would choke the U.S. economy and cause a recession in 2019. A trade war between the U.S. and China was also putting pressure on an already slowing Chinese economy, the second largest in the world. Investors feared that the synchronized global economic recovery of 2017 would turn into a synchronized global slowdown in 2019.

Heeding the message of the markets, the Fed began their pivot to a more dovish policy in January 2019 by not raising interest rates. In March, the Fed surprised the markets by indicating they do not expect to raise rates in 2019, and that they would end their quantitative tightening policy in September of this year (much sooner than earlier projections). This shift in policy, along with a fiscal stimulus by the Chinese government to its slowing economy, and improving sentiment around U.S. China trade talks helped spark a rally in global stocks, bonds and commodities in the first quarter.

STOCKS: BEST QUARTER IN TEN YEARS

During the first quarter of 2019, stocks of large U.S. companies represented by the Standard & Poor’s 500 index gained 13.6 percent. The Russell 2000 Index of small company stocks fared even better with a gain of 14.6 percent. This was an impressive reversal for U.S. stocks, after a tough fourth quarter, and the best quarter for equity performance in a decade. This performance was driven by the Federal Reserve’s pivot to a more dovish monetary policy, a fiscal stimulus to the Chinese economy and positive sentiment around the trade talks between the U.S. and China.

International stocks also staged a rebound in the first quarter, but continued their relative underperformance to U.S. stocks. The MSCI All-Country World Index-ex U.S. IMI returned 10.3 percent during the quarter. Canadian stocks
leverage oil prices did well among developed international markets. European stock performance was constrained by concerns around Brexit and slowing domestic economies. Emerging markets also rebounded with 9.9 percent returns. Within emerging markets — China was the principal contributor to the index’s strength while most other constituents lagged behind both the U.S. and the international markets.

Within equities, sectors tied to an economic recovery such as technology, consumer discretionary and industrials outperformed; while defensive sectors such as utilities and staples lagged the broader market. Health care was the worst performing sector in the first quarter, with a gain of just 6.6 percent. Political and legislative headlines such as Medicare for All and attacks on high drug prices and the pharmacy delivery system by the President and candidates running for President, negatively impacted the sector. The financial sector was hurt by the Fed’s dovish pivot, which caused interest rates to fall and the 3M-10Y portion of the yield curve to briefly invert during the quarter. Low rates and a flattening or inverted yield curve negatively impact bank profits.

Coty was one of the best performing U.S. stocks, with a 77.3 percent return in the quarter. A large, private shareholder significantly increased their stake in the company to take control of its operations. Other notable winners include Chipotle Mexican Grill and Xerox Corporation. Kraft Heinz was one of the worst performing S&P 500 stocks during the quarter as the company slashed its revenue forecast. Other notable losers included Biogen and Macy’s. Growth continued to outperform value, and small companies did better than their larger counterparts during the quarter.

**BONDS: THE YIELD CURVE INVERTS, BRIEFLY**

As the Fed pivoted toward a more dovish monetary policy stance, yields fell across the yield curve. The 10-year U.S. Treasury yield fell 24 basis points and the 2–10 year spread fell to a low of 16 basis points; the 3 month – 10 year spread briefly inverted for the first time since 2007, sparking fears of an oncoming recession. The Bloomberg Barclays U.S. Aggregate Bond index returned 2.9 percent in the first quarter. Riskier assets such as corporate high-yield and investment grade bonds and emerging market debt outperformed U.S. government bonds. We expect rates to stay low due to low inflation and slowing growth. The markets expect the Fed to cut rates later this year.

Municipal bonds benefited from strengthening technicals, fundamentals, and continued solid demand from individual investors. The Barclay Municipal index returned 2.9 percent for the quarter similar to the broad taxable market. High yield municipal bonds was the top performing sector with a 3.8 percent return.

**COMMODITIES: OIL PRICES SOAR**

Oil prices soared by over 29 percent in the first quarter as a result of improving sentiment due to the Fed’s dovish pivot, but also because Russia joined OPEC to curtail production to balance the oil markets. Production in U.S. shale fell for the first time in eight months and the number of oil-targeted rigs fell to the lowest level in over a year. The Bloomberg UBS commodity index, which tracks 22 commodities, rose a more muted 6.3 percent in the first quarter.

**OUTLOOK 2019: SIGNS OF STABILITY**

While the U.S. economy is slowing in 2019 as the impact of corporate tax cuts fade, we believe that the Fed’s dovish pivot should prevent a recession. Additionally, China actively stimulating its economy should not only support the Chinese economy, but also emerging and developed markets that are net exporters to China. Plus, a trade agreement with China remains a potential catalyst. On the other hand the stimulus will eventually fade and with it the pace of growth of the global economy. Corporate earnings growth is also expected to flatten, if not turn negative in 2019. We expect these narratives to duel throughout the second and third quarter. The market expects that eventually the slowdown in the global economy will force the Fed to cut rates later this year. Given the lack of clarity, we are taking a neutral stance toward risk in client portfolios.

Although the yield curve is flat, we are neutral duration to the benchmark until the trajectory of economic growth becomes clearer. While we are underweight U.S. Treasurys and government backed-mortgages, we will look for opportunities to add to these sectors. We maintain our current neutral positioning to long U.S. Treasury bonds as a hedge to falling rates and
positioning portfolios for the next recession. We maintain an overweight investment grade credit and will look for opportunities to reduce that overweight. We maintain our underweight position to high yield and emerging market bonds and will continue to do so until the probability of a recession recedes.

Year-over-year earnings growth in the U.S. is expected to turn negative in the first quarter of 2019 as the impact of the 2017 corporate tax cuts fades and the global economy slows. As the economy enters the later stages of the business cycle, we look for exposure to high-quality companies with strong balance sheets and earnings and valuation support. We will also seek to maintain sector neutrality with the benchmark.

We expect oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, we are unlikely to see prices close to $100 per barrel due to increases in U.S. shale production, which tend to put a cap on prices. We have no position in commodities, but maintain positions in material and energy stocks and energy pipelines.

KEY RISKS:
- Brexit - no agreement with the E.U.
- China - continued slowdown as the stimulus fades
- Corporate Earnings - global economic slowdown, higher labor and material costs results in an earnings recession