

April 3, 2019

2019 First Quarter Review
“Federal Reserve About-Face”

Near the end of the last quarter of 2018, stocks were in a tailspin and some indexes had dropped as much as 20% from their recent highs, producing the worst December in the financial markets since 1931. The Federal Reserve Board had raised interest rates nine times over the previous few years and planned to continue “QT” (quantitative tapering) in an attempt to undo the massive monetary intervention that had been in place since the financial crisis of 2008. At the December meeting of the Federal Reserve Board, Jerome Powell sounded confident in the need to continue raising interest rates in 2019 based on strength in the economy, and said that the quantitative tapering was going to continue like clockwork. Investors were shaken by his seemingly blithe disregard for the signs of economic slowing that had crept into the data, and they promptly sold stocks into the lows of late December in a near-panic swoon.

There is an old saying on Wall Street that “you can’t fight the Fed.” At least over the short-term, actions by the Federal Reserve Board seem to overwhelm all other influences on the market, such as deteriorating economic activity and earnings outlooks. Someone or something appears to have convinced Jerome Powell and other governors that the economic situation was deteriorating and that they needed to rethink their campaign to move monetary policy back toward normalcy. By March, the Fed had made a u-turn. They put further interest rate increases on hold indefinitely, and slowed their quantitative tapering (tightening of the liquidity levels). The financial markets responded by rallying sharply. This about-face performed by the Fed appears to have been the main catalyst for a rally that took the Dow Jones Industrial Average up 11% for the quarter while long-term US Treasury Bonds rose 4% as fears of interest rate increases eased. International stocks rebounding similarly to the Dow Jones Industrials as the Vanguard Total World ETF gained 11.8% after having fallen 14% in the fourth quarter.

The recent action has been happy but the implications are perhaps less so. As analyst Doug Kass of Seabreeze Partners writes, “The Fed is softer because the economy is softer. That is *bullish*?” The Fed downgraded their GDP projection of growth in the economy to 2.1% for 2019 and 1.9% for 2020. While stocks were rising, FactSet published a *decline* of almost 7% for the estimates of earnings for S&P 500 for this first quarter. (Earnings down, prices up.) Short-term interest rates are now higher than those a few years further out. This is what is referred to as an inversion of the yield curve and it is often touted as a precursor to recession. Whether or not that is true, the decline in the yield of bonds seems to portend less than robust economic activity on the horizon. It would be reasonable to assume that either economic activity will rise to justify the stock market rally, or the “sugar high” of a more accommodative Federal Reserve may wear off and lead to less optimistically-priced market.

We have maintained a relatively conservative allocation to equities which helped cushion the decline in the fourth quarter of last year, but held us back somewhat in the first quarter of this year. Lower interest rates tend to favor the statistically more expensive growth stocks over value stocks, since the lower discount rate makes future earnings more valuable in the present. A number of our “value” stocks have lagged during the recent rally, and a few have been just plain disappointing. We have actively weeded out the underperformers and are repositioning for the new

environment of a more “dovish” (accommodative) Federal Reserve as well as the possibility of a slower economy. We have taken advantage of the recently-increased interest rates by buying short-term bonds in some of the larger portfolios, and we continue to manage short-term cash investments with mutual funds yielding just under 2.5%. As was mentioned in last quarter’s letter, these funds need to be sold manually in order to free up cash for distribution, so just give me a call when you would like to move some of your cash out of your account. We will manually sell the money market fund immediately and make sure enough cash is available.

It is possible that any apparent resolution of the trade dispute with China would lead to a sharp “relief rally” in equities. That possibility is probably part of the reason equities have advanced and held their gains while some of the economic data have weakened. If that comes about, we may be faced with a “sell the news” situation where a sharp rally fails to hold and brings losses to those who buy during the excitement. It is a difficult combination of factors to navigate, especially with the number of risks to the economy that currently exist, but we plan to act incrementally with a focus on long term preservation of capital and investment returns.

If the economy slows, it is possible that investors will still be willing to “pay up for growth” and maintain the high price level of some of the more statistically expensive stocks. Statistically cheap stocks may continue to lag if a sharp “relief rally” occurs. However, we believe they will better preserve capital if and when we get another downturn in equity markets.

A slew of highly anticipated Initial Public Offerings are scheduled to come to market in the near future. You may have heard of some these as “unicorns,” high-profile private companies that are losing tons of money but that are offering their stock to the public at huge valuations. The first of these “unicorns” out of the gate was the high-profile ride-sharing company Lyft. It may not be as easy to make money on these exciting IPOs as the uninitiated believe. Lyft stock came to market at \$72 and, after a brief spike up in price, promptly fell to \$67 a share. Interest in pending offerings from Uber, Slack, and others has been high as well. For those who want to play this game, we can certainly help you invest a little if you so desire, but more than a modicum of caution is advised!

Enclosed you will find your statements and reports for the first quarter. Please review them at your convenience and call me if you’d like to discuss any aspect of your portfolio. You should have received all of your tax information by now, but if you need an extra copy of any tax-related reports, just let me know and we’ll get them to you or your tax preparer quickly.

Good luck with tax-time and let me know if I can be of any further help.

Sincerely,

Claude R. Carmichael CFA