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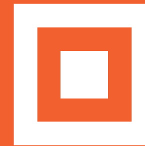

Wealth Management

Market Outlook

Domestic Growth Still On Track Despite Global Economic Divergence

Like a bouncing ball, highs and lows are to be expected in many aspects of life. This fluctuation applies to financial markets as well and has been evident during the last six months. Following the near bear market correction we saw in the 4th quarter of 2018, a strong bounce back in the equity markets occurred during the 1st quarter of 2019. What led to this? Has the economic and market landscape really changed from the lows of December to today?

While there were several reasons for the correction during the 4th quarter, one of the driving forces was the commentary by the Federal Reserve (Fed). The fear of the Fed being too aggressive and causing an inverted yield curve and a recession sparked the equity sell off. In turn, an apparent reversal of Fed policy occurred in January when the Fed stated that short-term rates may be near neutral and a pause in further tightening may be prudent due to a slowing global economy. This commentary resulted in a risk on market with higher equity prices and tighter bond spreads.

At the beginning of 2018, global economies were on a simultaneous growth pattern, but today the scenario is different. The Chinese economy is facing growth struggles in both the manufacturing and services sectors. The Manufacturing ISM stands at a level slightly below 50, which is a key level between expansion and contraction. The Services ISM remains above 50 but stands at 51 after declining by more than 2 points from the previous report. The decline in economic activity is partially attributable to the ongoing trade discussions with the United States, but it is also due to structural issues within the country. The current level of economic activity is almost recessionary for China after its strong, double-digit growth trajectory since the mid 1990s.

The slowing growth in China has compressed the Eurozone growth rate due to its dependence on exports to the Chinese market. Germany has seen a dramatic decline in its Manufacturing ISM to recessionary levels (44.7) as a result of the decline in autos and auto parts exports. France, Spain and Italy are all experiencing slowing growth as well, resulting in a fear of recession in the Eurozone.

Trade negotiations and tariffs continue to be the main headwinds facing the global economy. However, another issue that is still outstanding is Brexit. The inability of the United Kingdom Parliament to approve an exit plan from the European Union and the continued delay of the deadline remain an overhang on its economy as well as other European countries. The leadership is being questioned, which is never a positive and leads to greater uncertainty. Currently, the UK continues to be in an expansionary economic environment but the longer this goes on, the higher the probability of a negative impact on economic growth.

Despite the slowing economic trends globally, the United States continues to be one of the strongest wheels in the cog exhibiting growth, albeit slower than 2018. The U.S. Manufacturing ISM remains well above 50 despite a decline from the most recent highs, with the Services ISM also continuing to show strength. The continued headwind from trade negotiations is still evident as demonstrated by the most recent Business Roundtable CEO Economic Outlook Index declining due to global growth concerns, although it remains at an expansionary level nonetheless. First quarter GDP expectations stand at around 1.5% despite the government shutdown, the polar vortex, snowstorms and flooding across the nation. Current expectations are for a pickup in growth over the remainder of the year with no recession on the horizon in the next 12 months.

In June, this will become the longest expansionary period post World War II,

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surpassing the economic expansion of the 1990s. This expansion could continue for an extended period of time, but there are risks lurking in the shadows. One of these risks is the political dysfunction and uncertainty heading into the 2020 election. Following the government shutdown, there was a budget resolution for this year, but this will all be replayed heading into the fall with a new fiscal year budget. The partisan divide is so evident that the probability of a reasonable solution is low, and the risk of another shutdown may be looming. Will it be a replay of this year?

Another risk the market may fear is the potential inversion of the yield curve. While the Fed is on hold for the near term, the most recent decline in intermediate to long term interest rates leaves the probability of an inversion from the 3 month to the 10 year a strong possibility. Historically, this has been a precursor to a recession in the next 12 to 18 months. Is it different this time? You could make the argument that the United States' interest rates have declined due to global economic weakness and historically low or negative interest rates and not because of the Fed's tightening to slow down an overheating economy. In any event, this is a potential risk that could change the outlook for continued growth.

While we do not believe the U.S. economy is going to enter a recession in the next 12 months, we do believe there is caution warranted in our portfolios as a result of the strong recovery in the equity markets as well as the continued headwinds from slowing global economies, trade negotiations and the political dysfunction. We started the year targeting a neutral allocation to all asset classes in our portfolios and at this time, we believe it is prudent to maintain our position. We will resume a tilt towards growth over value in the equity portfolios and neutral duration in the bond portfolios. We will continue to monitor the market and economic environment, making adjustments as needed.

Ten-Year Bull Market Rolls On

If you have ever been whitewater rafting you can probably relate to the choppy waters of the recent stock market returns. After last year's rapid 4th quarter decline led to the first negative year for the S&P 500 since 2008, many investors may have wanted to hide in cash until things settled down. Fortunately, long term investors were rewarded as investor sentiment quickly changed, and stock markets across the globe proceeded to rally. In fact, many of the losses suffered in 2018 have been greatly minimized or even eliminated as the 1st quarter draws to a close.

Equity sectors that typically outperform when investors embrace risk are once again leading the market higher. Technology, one of the worst performing sectors during the market sell off in 2018, has been the best performing sector so far in 2019, pushing the S&P 500 index to a four month high. Thanks to a rebound in capital expenditures, technology stocks have been reporting stronger than expected earnings in a challenging global environment. As of this writing, the NASDAQ is up 15.40%, and the S&P 500 index is up 12% for the year and on pace for its best quarter since 1998. Needless to say, this strong performance follows the worst December since the Great Depression.

So what has changed since the rapid double digit correction in 2018? On the surface, it doesn't seem like much has changed. Investors are still worried about China trade tariffs, slowing global growth, and Brexit. However, one key instrumental voice changed everything for investors in January. The Fed has once again become "investor friendly" after communicating its intention to hold interest rates at current levels while opting to monitor the global economy and let the data dictate the next Fed policy move, whether an increase or a cut.

In addition to a more dovish Fed, equity prices have been pushed higher as investors are increasingly pricing in a positive resolution to the U.S. and China trade war. A trade deal would certainly provide clarity, as well as a catalyst for businesses, investors and economies around the world. One of the economies that would benefit the most from a U.S. and China trade deal is Europe. However, Brexit continues to be an uncertainty as political leaders are trying to extend the decision past the March 29th deadline. The European Central Bank (ECB) has recently downgraded its 2019 growth expectations for Europe from 1.7% to 1.1%. In an effort to spur growth and spending, the ECB is delaying any further interest rate increases and will again provide cheap funding for banks until 2023.

First quarter 2019 earnings expectations for S&P 500 companies are anticipated to see a year-over-year decline of 3.6%. However, top line revenue growth is expected to grow by 4.9%. If earnings do actually decline for the quarter, it will mark the first year-over-year decline in earnings for the index since the 2nd quarter of 2016. Looking further out at subsequent quarters, analysts currently see low single-digit earnings growth for the 2nd and 3rd quarters of 2019, followed by high single-digit earnings growth in the 4th quarter. Stock investors could be rewarded if companies are able to exceed these low expectations. However, China trade, tariffs, Brexit and a weak European economy will continue to be near-term headwinds.

The good news is many indexes are up double digits since the start of 2019. The bad news is stock markets do not go straight up, so it would be normal to see some retracement of the upward move we have seen since the Christmas Eve low. Based on current earnings estimates, stocks continue to appear fairly valued given the current forward price to

earnings multiple of the S&P 500 is around 16.3x. Since the bear-market bottom in March 2009, equities have experienced an average annual rate of return of 15.25%. Going forward, we continue to expect mid to high single digit stock returns, albeit with increased volatility as the current secular bull market enters its 11th year. The end of a bull market is always tricky to identify as the stock market has experienced very strong returns in the final year of previous bull markets, even as the macro economy was deteriorating. Therefore, it is best for investors to focus on risk vs. reward instead of trying to time the exact tops and bottoms.

Portfolios have certainly benefited from the stock market rally in the 1st quarter. The investment team has decided to re-position portfolios back to our neutral allocation target in equities to capture some of these gains. Portfolios will continue to have an increased overweight to growth companies as they offer more durable growth in a lower-growth environment. Given the uncertainties and slower global growth, we remain neutral in international stocks with a slight overweight to emerging market equities.

U.S. Stock Indexes

Index	% Change YTD (as of 3/25/19)
Dow Jones Industrial Average	10.04
S&P 500	12.18%
NASDAQ Composite	15.40%
S&P Midcap 400	12.13%
Russell 2000	12.51%

Source: Morningstar

Federal Reserve Reassesses Economic Risks

Through the end of the 4th quarter 2018, the fixed income markets heard a persistent story from the Fed. Its assessment was that U.S. economic growth would continue and could accelerate inflation even with the headwinds of the government shutdown, China trade war, and global slowing. More importantly, the Fed conveyed its intention to gradually raise short-term U.S. interest rates through 2019 and into 2020, while reducing the size of its balance sheet. Its outlook inspired a risk-off investor psychology that resulted in double digit global stock market losses, falling interest rates, and a flattening of the U.S. treasury curve.

We give credit to the Fed for not continuing its monetary policy plans. During a speech in early January, Fed Chairman Powell acknowledged global growth problems. At that time he stated the Fed would be more data dependent. This acknowledgement and change in strategy helped the global equity market recovery during the 1st quarter. The bond market believed the change in Fed actions was too little too late in the face of a continued global economic slowdown. As a result, global yields continued to fall and the U.S. treasury curve flattened further.

The final Fed capitulation came at the March 20th Federal Open Market Committee (FOMC) meeting. At this meeting, the Fed announced a pause in its rate hike policy throughout 2019 and a September 30th end date for reducing the size of its balance sheet. The Fed cited the weakening U.S. and global financial conditions and reduced inflation concerns.

The Fed did leave open the possibility for another interest rate increase in 2020 or 2021 after its last FOMC meeting. And yes, the Fed policy makers could raise rates later this year if the economic outlook brightens. Considering the seasonal weakness associated with 1st quarter economic growth, being data dependent is a wise move for the Fed. However, Chairman Powell emphasized that monetary policy is "in a good place," and the next move in rates could be in either direction. History suggests it's going to be a cut, regardless of the chairman's statement.

Diving deeper into the FOMC policy change, the Fed believes the current Federal Funds rate is close to, if not right at, its desired neutral rate. This rate is where interest rate policy is normal and neither accommodative nor restrictive to economic growth. The Fed also saw the flattening yield curve as a signal that its cumulative rate hikes had reduced both inflation and economic expectations. Finally, with intermediate and longer term rates falling during the 1st quarter, the Fed has no desire to invert the treasury yield curve. Whether investors follow the yield spread difference between the 2 year to 10 year treasury or the 3 month t-bill to 10 year treasury, they recognize the predictive accuracy of a future recession when the yield curve inverts.

With interest rates falling during the 1st quarter, fixed income investors continued their hunt for yield. Credit spreads expanded with eroding global conditions during the 4th quarter of 2018 and ultimately hurt fixed income returns. However, they represented a bargain when global equity markets recovered in the 1st quarter.

The recent fall in interest rates did result in yield curve inversions in the intermediate (5 year) portion of the yield curve. A flight to safety and rush to buy fixed income securities took both yield and credit spreads lower. Trillions of global sovereign debt still have negative yields. While U.S. short term securities may offer a yield incentive and lower duration risk if rates reverse course, the prudent strategy is to hold various laddered maturities. Whether this strategy utilizes individual securities or mutual funds, our fixed income portfolios remain neutral to this duration objective. Our typical fixed income portfolio is diversified

but with a domestic bias over international debt exposure. The most recent decline in yields after the March FOMC meeting may prove to be hasty if the U.S. economy bounces back in the second half of the year, and the Fed puts a rate hike back in play. Right now, the market is only guessing what is going to happen next. We feel interest rates are lower for longer. We are also monitoring the risk that the economy takes a turn for the worse and that yields fall even lower as a result. Our portfolios are positioned for this possibility, but our current outlook is that the economy will continue in its moderate growth trajectory of the last ten years.

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Trust, Investments, and Expertise

Tuesday, April 16th at 3:30 PM (CST)

Save the date to join an exclusive group for a stimulating discussion about the economy and market conditions around the world.

Call in details will follow.

Your Financial Strategy

Midland Wealth Management

Like a chess grandmaster, it's worth thinking a few moves ahead.

Provided by Steve Hofmann, J.D., CPA, CFP®
& Stephanie Jacobs, AFIM, MBA

Thinking about retirement might seem far-fetched. As you budget your monthly bills, you might feel as if you simply don't have enough to handle both your day-to-day obligations and still save for the future. It is a fairly daunting task. With some careful thought and a little imagination, you can probably think of ways to make what once felt impossible, more possible.

The strategic approach is known to grandmasters, generals, and sports coaches the world over. Simply put, it's a matter of looking over your resources and options, then taking steps to use them to your greatest advantage. Strategy doesn't guarantee any particular outcome, but it can help you make arrangements for all manner of financial situations, both positive and negative.

You probably have some questions. That's good; asking questions and seeking answers is a healthy beginning to a strategy.

Isn't financial strategy only for wealthy people? Not necessarily. Building a strategy could potentially give you a boost toward a better future for you and those you love. Whether it's just you as a single person or you and your family, giving some thought to your finances could be all that is standing between your current reality and realizing a dream. It could also potentially be what prevents a negative financial situation from becoming even worse. All of this can be avoided by just thinking a few moves ahead.[1]

Am I ready for this? Absolutely. Financial strategy is just a way of thinking ahead. If you're reading this, you're already thinking ahead. This means you are ready to be thinking about putting money aside for retirement, contemplating insurance choices, setting up beneficiaries, creating or updating a will, and even designating a financial power of attorney and health care proxy as well as drawing up a living will.[2]

These topics might seem "far away" or even fill you with a little anxiety or dread. That anxiety is rooted in the uncertainties in life; you never know what's coming next. At least with a strategy in action, you have some things in place for your family. If it still seems like too much, it's good to know that you can reach out to professionals for help.

Do I have to do it all by myself? You have many choices when it comes to building a financial strategy. You could educate yourself and go it alone. It's certainly cheaper, but you're probably thinking more about all the things you need to learn and less about all the things you might miss by going the do-it-yourself route. There are also computer-based options, which can be affordable, but lack the advantages of human help.[2]

Finally, there is the financial professional. You might think of a financial professional as a man wearing a green visor, crunching numbers for some cartoon billionaire. The truth is that there are all sorts of financial professionals who specialize in working with people at every income level and from all walks of life. Some financial professionals charge flat rates or by the hour, and if you find a fee-only financial professional such as Midland Wealth Management, you can rest assured that they aren't working on commission.[2,3]

You have many options when it comes to choosing a financial professional. A skilled financial professional will be able to talk you through investments and financial issues in the news, while working toward your own goals. Ultimately, a financial professional can help you think a few moves ahead.

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2 - investors.com/etfs-and-funds/personal-finance/steps-in-financial-planning-2019/ [12/31/18]
3 - thestreet.com/personal-finance/when-is-it-worth-it-to-work-with-a-financial-advisor-14631145 [6/23/18]

We believe a disciplined approach through prudent investing and diversification minimizes risk and enhances return to achieve clients' goals both financial and aspirational.

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