Independence Asset Advisors

MarketMatters

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First Quarter at a Glance

Global equity and credit markets rebounded in the first quarter following two significant market risk-repricings that occurred in the final quarter of 2018.

U.S. equities gained 13.7%, which fully offset the unrealized loss from the fourth quarter. Midstream MLPs and U.S. REIT investments also performed well, gaining 16.8% and 15.7%.

Foreign equity investments managed a decent return of 10.0%, but both international developed and emerging markets equities are facing mounting headwinds.

Bond markets could not match the strong equity rebound, but overall we saw good returns across investment grade, below investment grade credit and loans, as well as foreign debt.

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> **"We will be prepared to adjust policy quickly and flexibly, and to use all of our tools to support the economy should that be appropriate to keep the expansion on track, to keep the labor market strong, and to keep inflation near 2%."**
>
> U.S. Federal Reserve Chairman Jerome Powell – January 2019

First Quarter Market Overview & Key Themes

Global equity and fixed income markets were almost unanimously positive in the first quarter, with many asset classes fully offsetting their late-2018 unrealized losses.

The favorable results were precipitated by the U.S. Federal Reserve, which abandoned its two 0.25% interest rate hike projections and pivoted its stance from hawkish to dovish, proposing zero rate increases in 2019. Markets reacted with optimism to the more accommodative tone, rallying in January and then subsiding in February and March. This accommodative stance had a particularly positive impact on risk assets.

It also likely extended this current economic cycle by a few quarters, but more than likely the announcement merely desensitized investors to the multitude of macroeconomic challenges that fueled the late-2018 sell-off.

Importantly, it also seems to have overshadowed a few other key Fed announcements, including:

1) U.S. GDP growth will slow to 2.1% in 2019 from 3% in 2018, and it will slow further to 1.9% in 2020 and 1.8% in 2021.

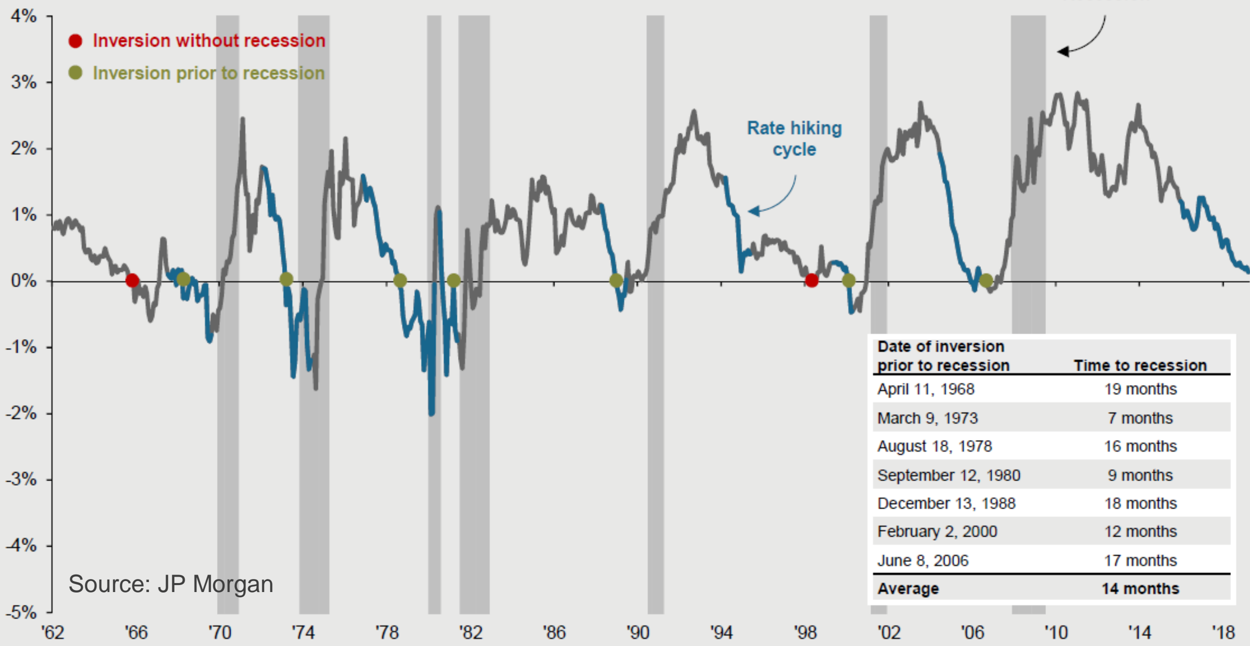
2) The unemployment rate will be 3.7% in 2019, then it will increase slightly to 3.8% in 2020 and 3.9% in 2021. That is well below the Fed's 6.7% target.

3) The core inflation rate, which removes volatile gas and food prices, will be 2% in 2019 and through 2021. This rate is aligned with the Fed's 2% target inflation rate, which gives the FOMC some leeway to raise interest rates to more normal levels.

In our view, the rebound in the first quarter has inflated market optimism on how dovish the Fed will be on rates. Therefore, we believe there may still be an opportunity for the Fed to tighten policy by another 0.25% before the end of the year. We also expect the Fed is more than likely to end the balance sheet runoff as early as the third quarter of 2019.

In terms of currencies and commodities, which can also have an important influence on the global economy, we saw the U.S. dollar strengthen by 1.2%, while crude oil prices rose 32.4%, from $45 to $60 per barrel. Copper prices, another leading indicator of economic trajectory, rose 11.8% in the first quarter.

U.S. Yield Curve Inversions and Recession History



Date of inversion prior to recession	Time to recession
April 11, 1968	19 months
March 9, 1973	7 months
August 18, 1978	16 months
September 12, 1980	9 months
December 13, 1988	18 months
February 2, 2000	12 months
June 8, 2006	17 months
Average	**14 months**

The chart identifies each instance of yield curve inversion over the past 56 years, as measured by the difference between 10-year and 2-year U.S. Treasury yields.

In all but two instances, every curve inversion has resulted in a hard landing and recession.

We have experienced two yield curve inversions over the past 4-months, but neither occurred between the 2-year and 10-year U.S. Treasuries.

Despite these yield curve inversions, we do not see evidence to support a recession in 2019. This opinion is supported in the comments below.

In terms of economic growth, the economy is growing more slowly. GDP results for the fourth quarter showed the economy expanded at a 2.2% annual pace, well below the 2.6% estimate and the 3.4% growth rate in the previous period. While we do not have enough data to accurately predict first quarter growth, from the information we do have, it appears to have slowed even more. Note that we do expect growth to rebound back to about a 2.0% annualized pace in the second quarter, but that remains far lower than the bounce back during the first half of 2018, when second quarter GDP measured 4.2%.

When we look at the current economic expansion, it has been methodical – akin to a tortoise rather than a hare – with an average of 2.3% growth. The growth in the fourth quarter of 2018 was directly attributable to the stimulus effects of the tax cut on investment and consumer spending. However, these tailwinds are fading and the natural growth rate of the U.S. economy, from a demand and supply perspective, is reverting back closer to 2.0%. We expected this growth downshift to occur in 2019 or 2020, but it appears to be happening right now, and our estimation is that by the end of the third quarter, the year-over-year GDP growth rate will be 2.0%, or slightly less.

Given this outlook, it is possible that we move into a recession as we enter the 11th year of the economic expansion. However, we believe there is evidence to support a soft landing. First, the cyclical sectors of the economy, considered to be the most sensitive, including auto sales, housing capital spending, and inventories, are not considered near their peaks. Prior recessions occurred as a result of specific cyclical crashes, such as housing in 2007 or tech spending in 1999. We do not see a specific risk to any of the primary economic catalysts at this time. The second reason we believe a recession may be avoided in 2019 or 2020 is because the Federal Reserve is being much more patient and conservative in their approach in this expansion compared to previous expansions. Usually at this point in an economic expansion there is an inflation problem, with the Fed regularly responding by pushing interest rates higher. However, as evidenced by their actions at the March meeting, it appears the Fed is not planning to raise rates, meaning this could be the peak of the tightening cycle.

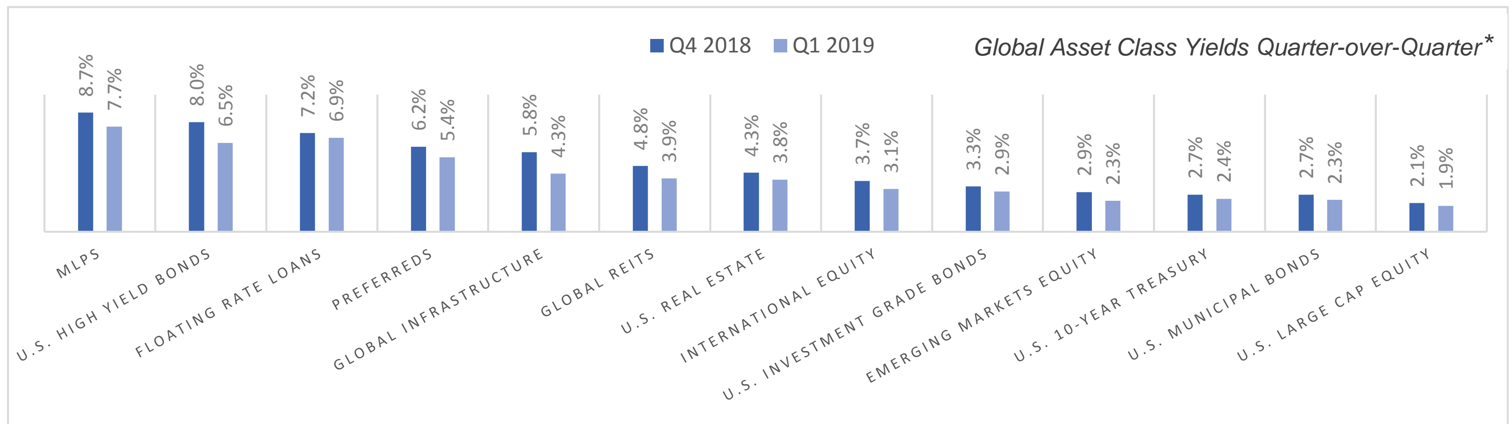
The typical reason for the end of an economic expansion is when the Fed overtightens. In this case the Fed seems determined not to do that, which could encourage a continuation of growth, albeit at a slower pace. Considering the growth outlook and the Fed's dovish positioning, we believe there is good evidence to support a soft landing.

What do we mean by a "soft landing?"

A soft landing, by definition, is a cyclical downturn which avoids recession. It typically describes attempts by central banks to raise interest rates just enough to stop an economy from overheating and experiencing high inflation, without causing a significant increase in unemployment, or a hard landing. After slashing interest rates from 5% to 0.25% in 2008, to accommodate business growth, the Federal Reserve began raising rates incrementally in 2016 to moderate growth after eight years of expansion. At the March meeting, Fed policymakers shifted to a dovish stance, forecasting rates to remain at current levels this year, which is contrary to guidance it suggested at the December meeting of two 0.25% hikes in 2019. The Federal Open Market Committee also pledged to start slowing the shrinking of its balance sheet in May and stop the drawdown altogether at the end of September. The economic growth projections were also lowered for this year by a full percentage point to 2.1%. Interest rates in the United States have averaged 5.7% from 1971 until 2019, reaching an all-time high of 20% in 1980 and a record low of 0.25% in 2008. Current rates reflect continuing low inflation expectations.

*Source: eVestment Analytics, JP Morgan, federalreserve.gov

2019 First Quarter Global Yield & Asset Class Review



- **U.S. Equities**

Domestic equities fully recovered from the fourth quarter loss by gaining 13.7% in the first quarter. January was particularly strong with the S&P 500 Index up 8.0% following the Fed's confirmation that it would adjust planned interest rate hikes to compensate for deteriorating economic momentum (also the U.S. government shutdown ended.) Momentum slowed during the quarter, however, with February and March returning 3.2% and 1.9%, respectively. The moderation of gains occurred as investors balanced the Fed's accommodative tone with the broader implications for economic growth.

- **Midstream MLPs**

Energy infrastructure investments performed very well during the first quarter, gaining 16.8%. This return was nearly adequate to fully offset the unrealized loss for the fourth quarter, and improved the 1-year Alerian MLP Index return to positive 15.1%. For perspective, the MLP 1-year result outperformed the S&P 500 index by 5.6%. Looking back, we see the Alerian has gained 5.6% since January 2008 compared to 8.3% for the S&P 500 Index. This is a lower relative return, but patient investors were rewarded with a significantly higher rate of income during that period.

- **U.S. REITs**

The Dow Jones U.S. Select REIT Index gained an impressive 15.7% in the first quarter. The unrealized gain was predominately attributable to REIT common equity, which returned 12.4%, supported by a boost of healthy economic indicators and easing long-term interest rates. REIT preferreds also rebounded, gaining 9.3%. Despite the strong first quarter return, the traditional "core" segments of the REIT market appeared under structural pressure, with institutional investors reassessing their exposures, as asset pricing appeared fragile to the downside.

- **Foreign Equities**

Foreign equities managed a decent return in the first quarter, gaining 10.0%, but both international developed and emerging markets equities are facing mounting headwinds. The unresolved Brexit negotiations continue to pressure European markets, geopolitical issues remain, trade remains a serious concern, and economic growth is showing signs of a slowdown amid weak industrial production and exports.

- **Preferred Securities**

After declining 4.3% in 2018, the S&P U.S. Preferred Stock Index gained 8.0% during the first quarter. Preferreds provide high relative dividend income compared to common U.S. equities, 5.4% at quarter end, but have demonstrated a meaningfully higher rate of volatility during negative periods in the market. Note that 72% of the Index is comprised of Financials.

- **U.S. Investment Grade Bonds**

The Barclays U.S. Aggregate Bond Index gained 2.9% in the first quarter. The index finished the period yielding 2.9%, which is down from 3.3% at year-end. This is also 2.1% below the 30-year average. Duration, which measures the sensitivity of the price of a bond to a change in interest rates (the higher the duration, the greater the sensitivity), moved lower to 5.8 years. This is 1-year higher than the 30-year historical average. Taxable bonds are priced at a $2.30 premium.

- **U.S. Municipal Bonds**

U.S. tax-exempt bonds were in line with their taxable peers, gaining 2.9%. Municipals are expensive at a $9.20 premium, but the tax-equivalent yield of 3.9% makes them attractive for coupon-clippers. In addition, the default rate remains near the historical low, and issuance and demand are balanced.

- **U.S. High Yield Bonds**

High yield bonds rebounded in the first quarter alongside U.S. equities. The spread-to-worst at quarter-end was 4.5%, roughly 1.3% below the 30-year average. Defaults were again lower, despite the fourth quarter risk-repricing, ending the quarter at 0.9%, a full 3.0% below the 30-year average rate. While default rates were at about the same place preceding the 2008 recession, there does not seem to be a direct correlation between the two. For comparison, default rates were roughly 10% and 6% before the 1990 and 2001 recession, respectively.

- **U.S. Leveraged Loans**

Bank loans performed well in 2018 before repricing in December. The asset class has yet to fully recover, but it managed to gain 4.0% in the first quarter. We are less optimistic about this asset class though, as loans typically reward investors when interest rates are set to rise.

*Sources: JP Morgan Guide to the Markets & Eaton Vance Monthly Market Monitor

2019 Global Market Outlook

In our view U.S. recession risk is muted, but we do expect sub-trend growth in 2019.

The economy currently resembles a rocket ship shedding its boosters, and after a decade of expansion, we see signs of a growth moderation to 2.0%.

Capital expenditure is broadly expected to recover from its first quarter lows, which should support a brief rebound in the second quarter, but we do not anticipate it will be adequate to sustain longer-term growth when we consider the offsetting impact of a broad reduction in business investment, the fading impact of tax cuts, global headwinds that include unresolved trade and Brexit negotiations, and broadly slowing global economic growth.

Domestically, we see the best value in midstream energy infrastructure. MLP and midstream businesses offer investors a compelling opportunity, and positive developments support the potential for midstream stocks to deliver attractive total returns over the next five years. In addition, we see that energy midstream fundamentals and company balance sheets have improved, though share prices have not, leading to improved valuations on higher quality companies. This asset class offers high relative income and an opportunity for growth, but is best suited for long-term investors that are willing to dig in and stay the course.

We feel that U.S. businesses are strong, with adequate capital and improved balance sheets. A plateauing of interest rates, or even a cut, will benefit domestic companies and support future earnings. We are maintaining a neutral allocation to U.S. large cap equity in most client portfolios.

International developed and emerging markets equities continue to provide a good opportunity for investors seeking higher long-term total returns, as these asset classes are attractively priced relative to history, and offer higher dividend yields relative to U.S. large cap equities. However, over the short-to-intermediate-term, we expect these asset classes will continue to contend with more of the same monetary policy and geopolitical issues that resulted in double-digit losses in 2018. We are actively underweight non-U.S. equity across our client portfolios.

For U.S. bond markets, we expect managers to generate some excess return from a combination of security selection and sector rotation. However, it is important to point out that a flat yield curve has historically preceded periods of economic stress, which can lead to a drop in rates. In this environment, holding a portfolio with some duration should result in outperformance of money market funds. In terms of below-investment grade credit, we greatly favor high quality high yield bonds over leveraged loans, as the latter will lose a key competitive advantage during a neutral or negative rate environment.

FINAL THOUGHTS

We remain cautiously optimistic about U.S. equity and bond markets in 2019, but acknowledge that support for a continuation of U.S. and global economic growth is becoming scarce. In addition, we do not see excellent opportunities to buy at good value, with global equities trading at or above median levels and most bonds trading at or above par. At this point in the economic cycle, we are looking for opportunities to rebalance back to long-term targets when markets undulate and seek investments that offer good consistency of income.

MLPs at a Glance

A master limited partnership (MLP) is a type of business that exists in the form of a publicly traded limited partnership. It combines the tax benefits of a partnership, where profits are taxed only when investors actually receive a distribution, with the liquidity of a public company.

The emergence of midstream c-corps is worth mention. The benefits of being a c-corp versus a traditional MLP vary and depend on the individual circumstances of the company. The c-corp structure broadens the investor universe for midstream businesses by eliminating the K1 and allows for broader index eligibility.

While MLP price performance has lagged the broader stock market until recently, fundamentals for MLPs continue to improve due to a growing economy, abundant and growing U.S. supply of crude oil and natural gas, and ever-growing global demand for energy. The U.S. has become a net exporter and is poised to become the largest exporter of LNG (liquified natural gas) worldwide. Rising oil and natural gas prices combined with increasing domestic production and growing global demand for energy products create a favorable backdrop for this asset class.

In our view, higher earnings per share, growing dividends, improving balance sheets, and better capital efficiency have largely been ignored and should ultimately lead to improved share price performance. The midstream space is better positioned today than it has ever been to pursue an abundance of organic growth opportunities.

The inherent economic risk for midstream businesses is a significant economic slowdown or a dramatic drop in commodity prices. The latter risk has decreased with significant reductions in breakeven production costs and lower leverage metrics among producers.

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