DANN ASSET ADVISORS, LLC

First Quarter 2019 Update
April 11, 2019

1Q19 Highlights
- U.S. stocks rebound strongly from fourth quarter 2018 sell off
- Interest rates decline as Fed becomes substantially less aggressive
- Economic growth moderates in the fourth quarter and is expected to slow further near term
- Following a strong January, international stocks lag for the quarter

The table below summarizes the performance of some key indices during the first quarter:

Market Performance Index	% Ch. 1Q19
S&P 500	13.7
MSCI Developed Markets (excl US)	10.0
MSCI Emerging Markets	9.9
MSCI All Country World	12.2
US Aggregate Bond (1)	2.9
Liquid High Yield (1)	7.5
US Dollar Emerging Markets Bond (1)	7.4

(1) Barclays indices

Equities. The first quarter increase in stock prices was nearly a mirror image of the freefall that occurred in the fourth quarter of 2018. From the December 24 low to the close of the first quarter the S&P 500 rose approximately 20%. Into February, nearly all sectors of the market rallied. Later in the quarter divergences began developing, with growth stocks leading value (similar to most of 2018) and large cap companies doing better than small cap companies. We believe these divergences reflected investors becoming more concerned about future growth and earnings as the quarter progressed.

The S&P 500 ended the quarter at a not inexpensive 16.8x 2019 consensus earnings forecasts compared with 14.4x then consensus earnings estimates at the end of 2018 (estimates from Yardeni Research). Earnings growth expectations for 2019 have moderated in recent months from 7%-8% to 3%-4% currently (Yardeni research). The increase in stock prices in the first quarter despite slower near-term growth may imply that investors expect earnings growth to reaccelerate later in 2019 into 2020.

While up nicely, international stocks continued to trail the U.S., especially late in the quarter. European economic growth lagged that of the U.S. throughout 2018 and seems to have slowed even more into 2019 (a recent German manufacturing index fell to its lowest level since summer 2012 according to a March 22 Reuters article). With growth slowing and risks of contraction rising, European stocks – especially those in more cyclical/trade dependent industries – have had a tough time advancing. Resolution of trade issues and Brexit likely would improve international economic growth and stock market performance.

Fixed income. The 10 year Treasury yield rose to 2.79% in mid-January (from 2.67% at year end) and then fell quickly to 2.41% at quarter end as the Fed announced a more accommodative than expected stance following its mid-March meeting. Two year yields also declined, from 2.62% in January to 2.27% at quarter end. The 14 basis point (a basis point is 1/100 of a percent) difference between the two rates is close to the 17 basis point spread at December 31.

Late in the quarter, the 10 year yield moved below the yield on the three-month Treasury bill, leading to speculation that a recession might not be too far off. Short term rates below long-term rates usually have been a reliable indicator of an upcoming recession; however, there can be a considerable lag between the yield inversion and the recession's beginning. We'd note that German 10 year bonds joined Japanese bonds with a negative yield toward the end of the quarter – this could be stimulating demand for U.S. Treasury bonds (with their relatively higher yields), driving down their rates below what might normally be the case with the U.S. economy still growing. In other words, we're not sure how significant the recent yield inversion is.

<u>Market sectors</u>. A diverse group of sectors led the market during the first quarter, with technology, real estate investment trusts (REITs) and energy the top three performers. Technology and energy were among the worst performers in the fourth quarter sell off – both are considered more cyclical sectors and their rebound may have reflected expectations that the economy will improve later in 2019. After a terrible fourth quarter oil prices gained roughly 30% in the first quarter and this certainly helped energy stocks. REITs, with their above-market yields, often rise as interest rates fall, as occurred in the quarter.

The quarter's worst performing sectors were healthcare, financials and utilities, although we note that in a broadly strong quarter for stocks, each of these sectors rose at least 8%. The first quarter saw a couple of high-profile clinical trial failures and these may have served to hold back healthcare; continuing political chatter around restraining drug price increases also may have been a factor. Financials had been having a strong quarter until interest rates fell late in the quarter; this group often moves inversely to interest rates. We note that even though they were the third worst performing sector, utilities still rose nearly 11%.

<u>General comments</u>. We were surprised by the strength of the market's upturn in the first quarter, just as we were surprised by the speed and magnitude of the decline in the fourth quarter. However, when we look at the U.S. economy and corporate earnings (the key factors that we believe move markets over the long term) over the past six months, we don't see anything to explain the recent roller coaster in prices. To us, the near-term outlook for the economy is a bit weaker than expected six months ago, which makes the market's recent rebound even more perplexing.

The one item that has changed significantly over the past six months is Fed policy. In October 2018 the Fed was expecting to raise rates at least three times in 2019. At the end of its recent March meeting, the Fed indicated the likelihood of no rate increases in 2019, and that it would be less restrictive with other aspects of monetary policy. In reaction to the Fed's change in course, interest rates have come down significantly and, in our opinion, that's the primary reason the stock market was so strong in the first quarter.

Despite more accommodative Fed policy and lower rates, we expect managements to be cautious in their outlooks as they report earnings in upcoming weeks, and this could lead to a market pullback. However, we believe lower rates will provide some boost to the economy and earnings later in the year and that the U.S. market will end 2019 higher than where it began if not higher than the first quarter close. We expect that getting there from here will be a lot more volatile than the just ended first quarter.

Portfolio Positioning

The first quarter was quiet for most clients. We made no significant changes in fixed income allocations, continuing to be most heavily invested in short duration (which we define as three years or less) investment grade funds. For most clients, we added no new equity positions in the quarter and reinvested into existing funds some of the cash we'd raised in the fourth quarter.

Economy

U.S. GDP growth slowed to 2.2% in the fourth quarter of 2018, compared with 3.4% and 4.2% in the third and second quarters, respectively. Growth in the earlier quarters likely was helped by tax cuts and increased government spending. Fourth quarter consumer spending slowed to a 2.5% increase from 3.5% in the third quarter, the deceleration probably caused in part by a falling stock market and the beginning of the government shutdown that lasted into the first quarter of 2019.

First quarter GDP will be reported in the next couple of weeks and is expected to grow around 1.5% according to a recent Wall Street Journal survey of economists. The government shutdown will negatively impact first quarter numbers; however, recent decelerations in job growth and retail spending seem to indicate that the economy has slowed sustainably from the mid 2018 pace.

In response to slower growth and perceived risks to the economy, the Fed in its March meeting said it was likely to maintain the federal funds rate at current levels at least through the end of 2019. The Fed also outlined the timeframe in 2019 over which it would end other perceived restrictive policies, including shrinking its balance sheet. The Fed has become significantly more accommodative in recent months – as recently as December it had expected to raise rates at least twice in 2019.

We certainly have no better idea than the Fed what will happen with the economy. While the U.S is less dependent on trade than some of the world's other large economies, we believe slowdowns overseas and in China will restrain U.S. growth over the near term. Trade negotiations with China add to uncertainty that businesses face. On the other hand, from a peak of near 3.25% in October, ten-year yields have moved down materially in recent months and this has the potential to stimulate future growth. Our guess is that U.S. growth will be stronger later this year.

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