STRATEGIC INVESTMENT ADVISORS

The Ten Themes of 1Q 2019

Every quarter we write about ten themes which in our opinion had the greatest impact on global financial markets. While there are always more factors that move stock and bond prices, providing you with the ten most important factors is worthwhile. During 1Q 2019, there were just three words, let alone themes, that explained why global stocks posted one of their best quarterly gains in over ten years. Discussing anything else has the potential to minimize just how important these three words were in explaining how financial markets performed in the 1Q 2019 period.

What were those three words? **Better than feared.**

Rising share prices: Using the S&P 500 as a proxy for U.S. stocks, the index rose +13.07% from January 1, 2019 to March 29, 2019. This represented the best quarterly gain for the index in ten years. This is simply remarkable considering how negative sentiment was in the prior quarter that led to a -13.97% decline for the index during the last three months of 2018.

So why the turnaround in sentiment and stock prices in 2019? Better than feared! At the end of 2018, investors became fearful the U.S. economy was going to sink into a recession (i.e. two quarters in a row of negative GDP growth.) In our opinion, it would have been a self-inflicted recession caused by Jerome Powell, the Chairman of the Federal Reserve Bank. Powell tightened the screws on the economy four times in 2018 by raising interest rates. It was his last interest rate hike in December 2018, and then his statement of even more interest rate hikes this year, that caused rational stock investors to head for the exits.

In the Fall of 2018, our market indicators were clearly signaling slowing economic growth. Under those conditions, further interest rate hikes were no longer warranted. Yet, Jerome Powell continued to raise interest rates. Worse, he said he was not going to stop. It made no sense. In our 4Q 2018 quarterly letter, we said the Fed needed to adopt a more dovish stance on interest rates. Jerome Powell must have heard us because he completely changed his view on monetary policy that aligns with what we said.

Powell's new dovish stance on interest rates (i.e. no more interest rate hikes this year) appears to have eased investor's fears of a looming recession. Stabilization in China's economy, and rising hopes for some sort of resolution on trade with China, has also helped. **When stocks factor in the worst (i.e. recession), and the worst does not come, prices re-set higher.** This is exactly what happened in the 1Q of 2019 as economic data has turned out to be much better than originally feared.

Stay tuned as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.**

1. Friendly Fed
2. China stabilizing
3. Growth estimates are getting cut more
4. Stellar stock returns
5. Alligator Jaws
6. Flattening yield curve
7. Getting expensive again
8. Accelerating growth expectations
9. Rising commodity prices
10. Global stock returns

Friendly Fed

On December 19, 2018, the Fed hiked its benchmark federal funds rate by +0.25% to a range of 2.25% to 2.50%. It marked the fourth hike in 2018. The Fed's "hawkish" stance to continue to raise interest rates increased the risk that the central bank would make a policy error and trigger a U.S, recession. On January 4, 2019, Fed Chairman, Jerome Powell, flipped on his monetary stance and said the Fed would be "patient" on deciding to continue raising interest rates. This was code for the markets that the Fed was not going to hike interest rates again for the foreseeable future. Stock prices have been rising ever since as recession fears have subsided.
Source: The Earnings Scout/Fed Chairman Jerome Powell

China stabilizing

In 2018, Chinese stocks, as measured by the Shanghai Composite index, declined -24.69% as its economy cooled, and trade conflict tensions intensified. A slowing Chinese economy was beginning to impact sales and profits of U.S. based multinational companies such as Apple selling less iPhones or A.O. Smith selling less water heaters.
Source: New York Times, January 2, 2019 "Apple cuts Revenue Forecast Because of Slow iPhone Sales in China/Kevin Wheeler, CEO of AO Smith, October 30, 2018 earnings release.

To combat its slowing economy, Chinese policy makers have increased monetary and fiscal stimulus measures. While economic data out of the country could still be characterized as bad, Chinese stocks, as measured by the Shanghai Composite index, rose +23.93% during the 1Q 2019 period. This should be a reminder that stocks look forward to what is expected to happen as opposed to what is currently happening. If you are bullish on U.S. multinational corporate earnings, and the U.S. financial markets, you should be rooting for China's economy to continue to improve (i.e. become less bad.)

Chinese stock investors in 2018

Chinese stock investors in 2019

Growth estimates are getting cut more

S&P 500 EPS growth expectations are falling

Date	1Q19E EPS Growth	2Q19E EPS Growth	3Q19E EPS Growth	4Q19E EPS Growth
11/1/2018	7.94%	6.23%	6.12%	12.03%
12/1/2018	6.26%	5.46%	5.19%	11.77%
1/1/2019	5.54%	5.00%	4.91%	11.65%
2/1/2019	2.29%	2.77%	3.06%	11.05%
3/1/2019	0.10%	2.33%	3.23%	10.00%
4/1/2019	-0.66%	2.04%	3.44%	9.82%

Source: The Earnings Scout

Based on the EPS estimate revisions of the early 1Q 2019 reporters, we anticipate the 2019 earnings growth estimates for S&P 500 will continue to come down over the next several months. Don't panic about this though.

Stellar stock returns

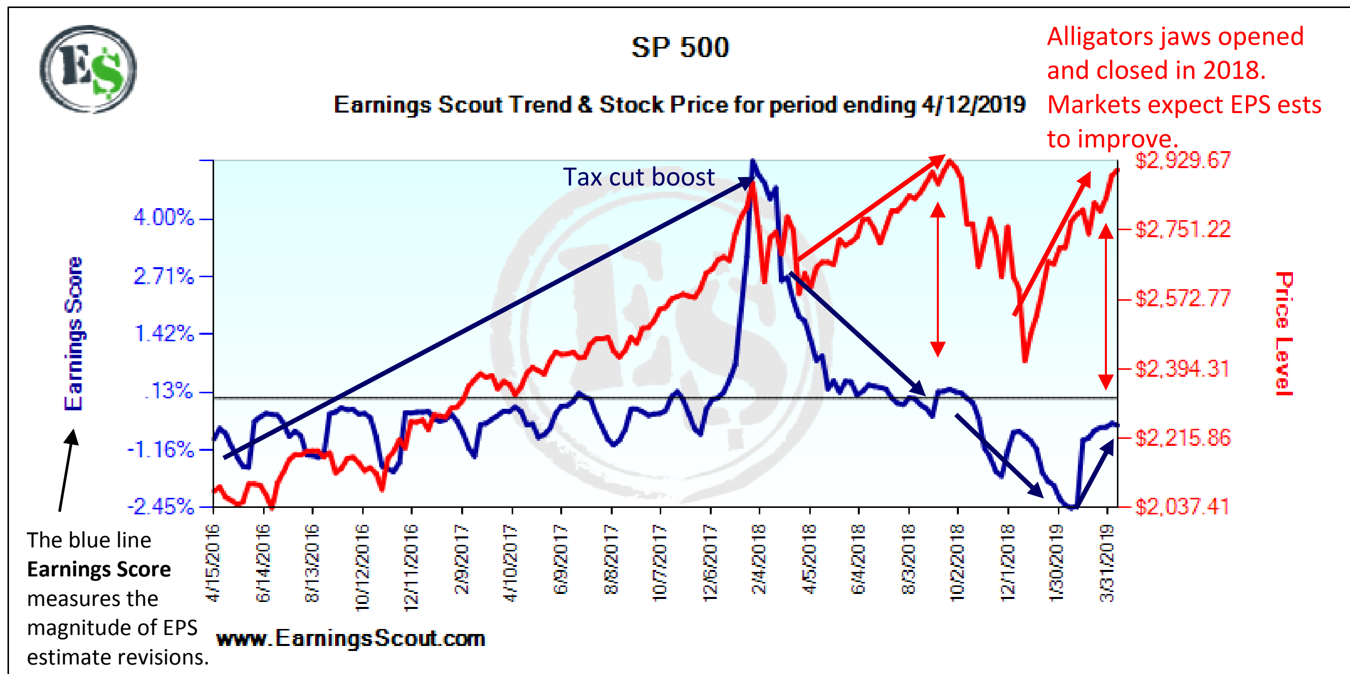
The last three months of 2018 would like to be forgotten by almost every stock investor because it was the worst performance we had seen for any quarter since the financial crisis of 2008. The strong start to 2019 is just what the doctor ordered as most investors seem to have forgotten already about their paper losses at the end of last year. Check out the returns of some select U.S. stock indices during the 1Q 2019 period. Simply stellar.

Stock index	1Q 2019 Return	4Q 2018 Return
NASDAQ Composite Index	16.49%	-17.54%
Russell 2000 Index	14.18%	-20.51%
Dow Jones Transportation Average	13.50%	-19.41%
S&P 500 Index	13.07%	-13.97%
Dow Jones Industrial Average	11.15%	-11.83%

Source: Bloomberg

Weakening earnings expectations and Alligator Jaws

Chart 1: The rate(s) of change to overall S&P 500 EPS expectations the past three years



In Chart 1 above, it shows the rate of change to overall S&P 500 EPS expectations over the past three years. Notice in the Fall of 2018 that EPS expectations moved south as stock prices moved north to all-time highs. We liken this to an alligator jaw opening. The diverging EPS estimate and price trends indicted that stocks became overvalued.

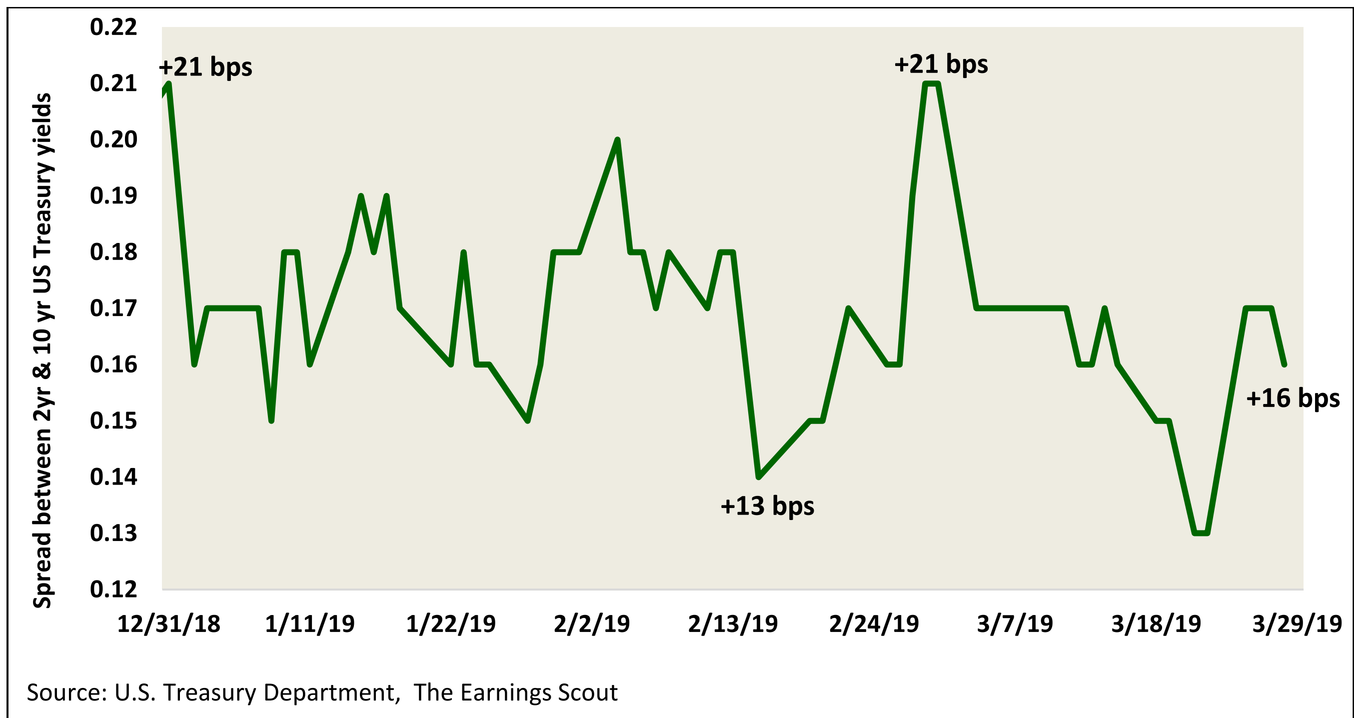
The sell-off during the 4Q 2018 period closed the alligator jaw and stocks became cheap. Keep in mind, alligator jaws always close. Right now, the jaw has opened back up with stock prices approaching all-time highs again as earnings estimate continue to fall. The jaws will close in one of two ways. Price will drop, or earnings expectations will improve. Currently, the market is anticipating earnings expectations to improve dramatically in the second half of 2019 and that is how the jaw will close this time.

Flattening yield curve

The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond. When the spread widens (i.e. steepening yield curve) between the rates on 2 and 10-year notes, it usually indicates an expanding economy. When the spread narrows (i.e. flattening yield curve) it typically means less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

The rate on a 2-year note closed 2017 at 1.89% and the 10-year bond ended the year at 2.40%. Thus, the yield curve was +51 basis points (bps.) At the end of 2018, the yield curve narrowed to just +21 bps. By the end of the 1Q 2019 on March 29, 2019, the spread between two-year and ten-year Treasury rates was just +16 bps. Ideally, we would like to see the yield curve steepen so it would reflect better economic growth ahead. However, the bond market remains cautious and market bears keep pointing to the flattening yield curve as a sign of a recession on the horizon.

The U.S. yield curve (2's & 10's) stands at +16 bps

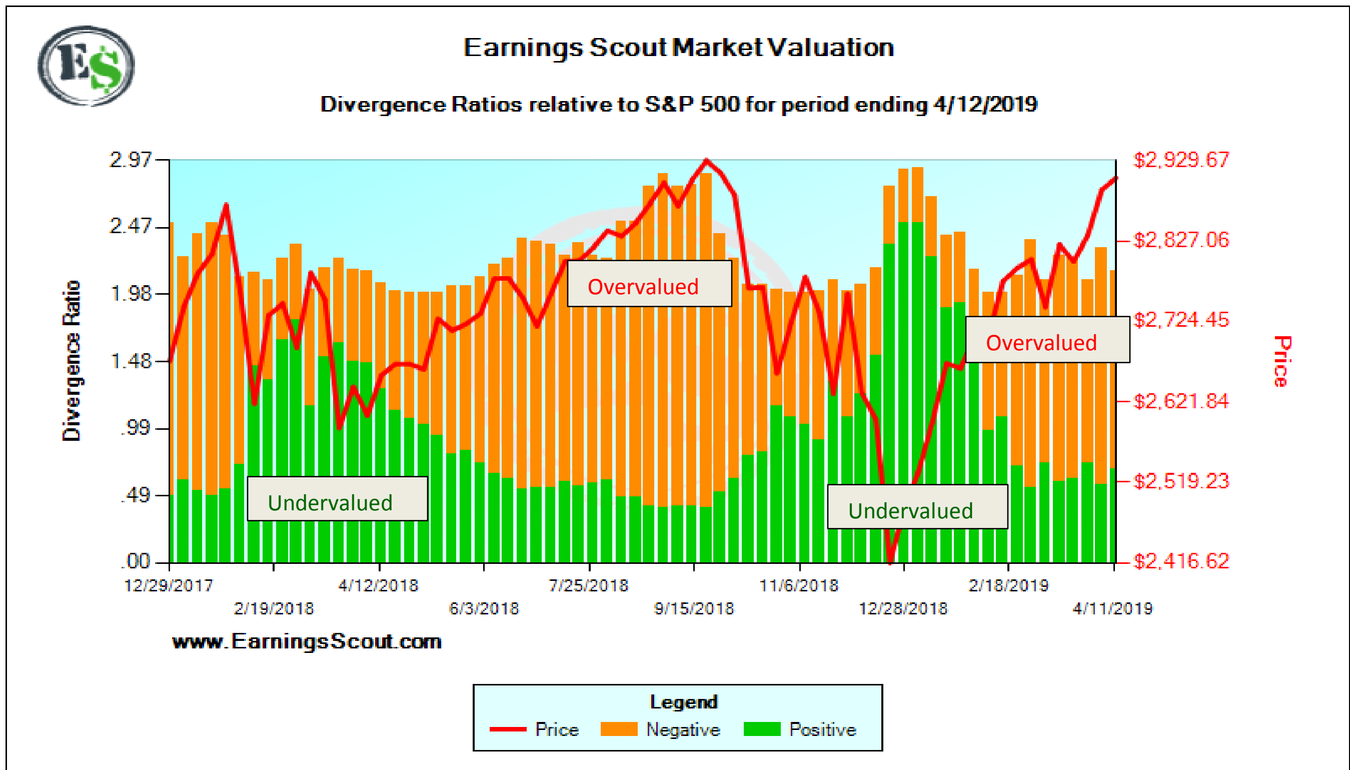


Getting expensive again

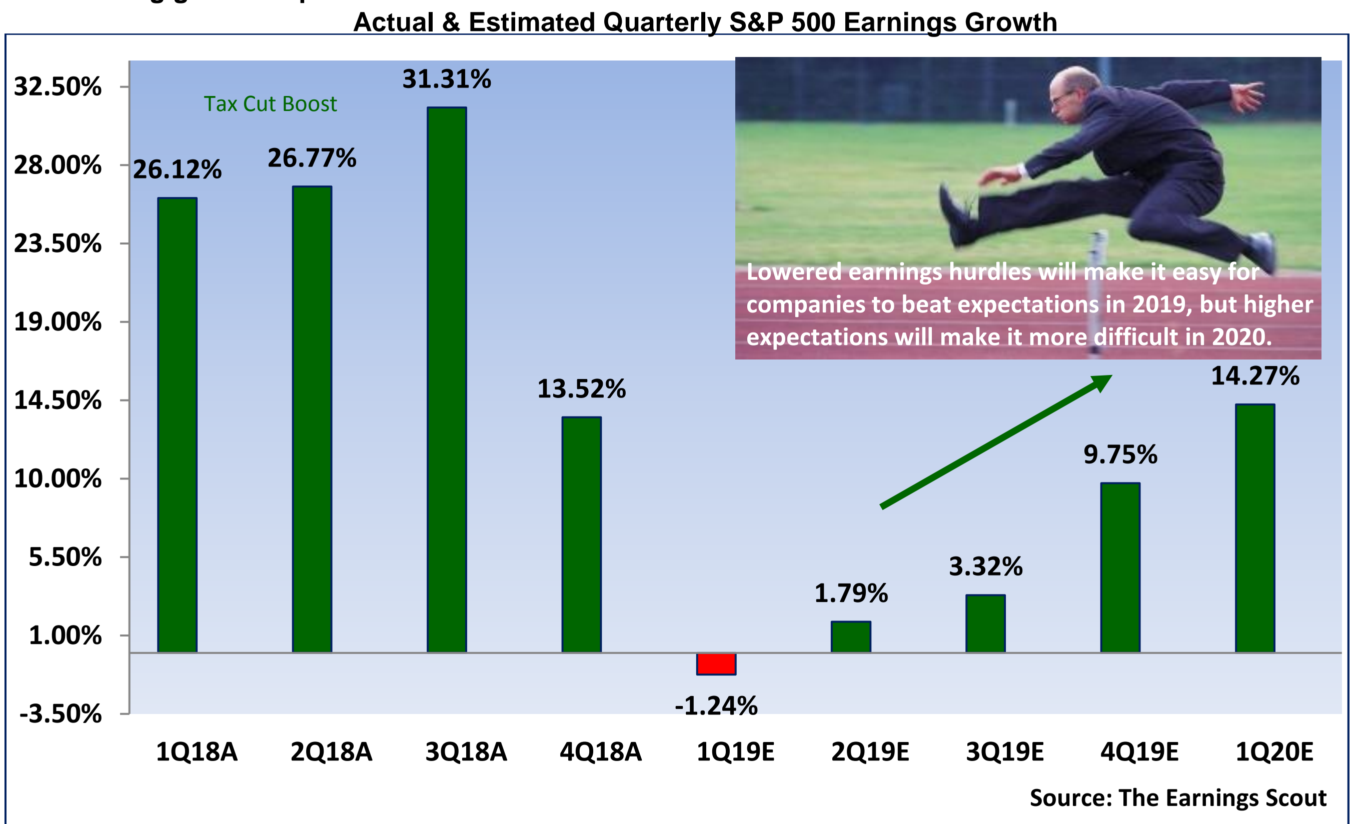
Based on our proprietary metrics, stocks became cheap after the sell-off at the end of last year. The forward 12-month PE multiple on the S&P 500 was just 13.92x on January 1, 2019. That meant stock investors were only willing to pay $13.92 for every dollar of expected earnings for the market. Currently, the forward 12-month PE multiple is 16.70x. This means investors are now paying $16.70 for every dollar of future earnings on the market.

In addition to the rising, i.e. more expensive, PE multiple on the S&P 500, we track the amount of positive and negative divergences that arise among 4,000 different companies. When we start to measure more companies with negative divergences (i.e. weakening earnings expectations and rising share price) than positive divergences, the market becomes more overvalued. At the beginning of 2019, there were 2.75 companies with a positive earnings divergence for every one with a negative divergence. Today, they are 1.95 companies with a negative divergence for every company with a positive divergence. This confirms stocks are getting expensive.

The ratio(s) of positive & negative earnings to price divergences



Accelerating growth expectations in 4Q 2019 and 1Q 2020



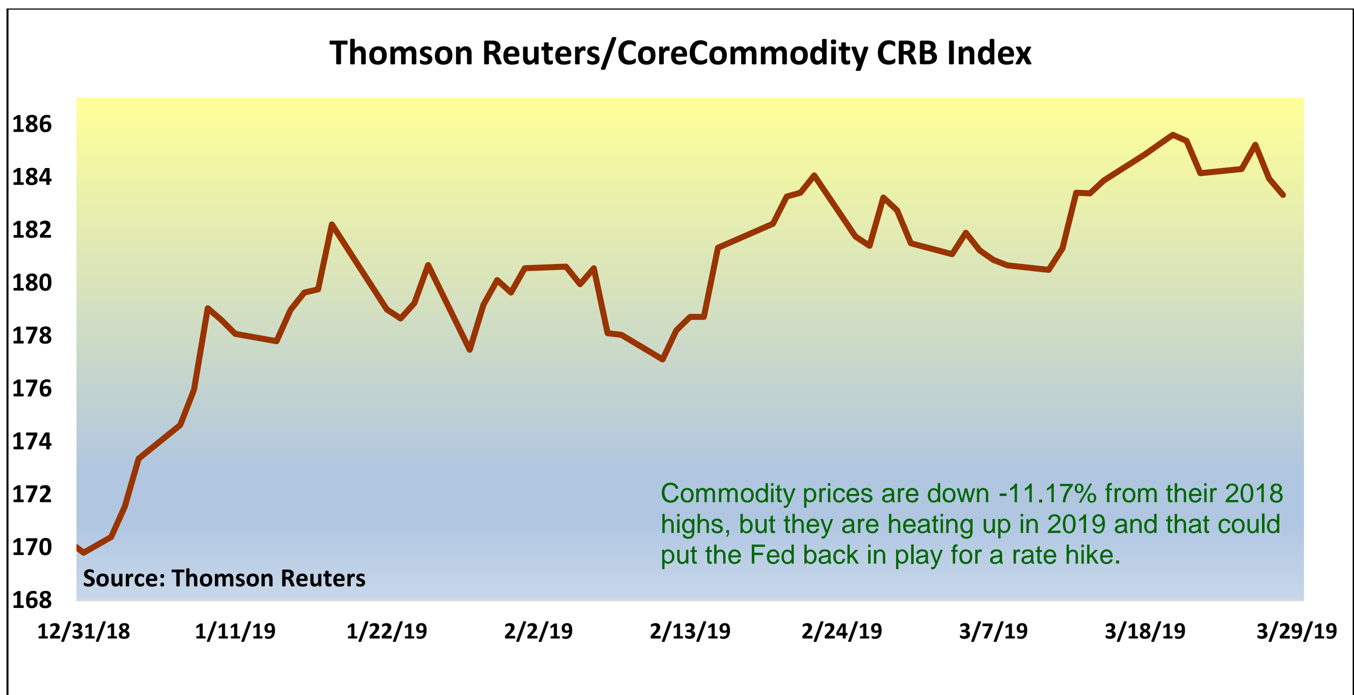
Rising commodity prices

In 2018, the U.S. bond and commodity markets were both signaling caution. That was not the case during the 1Q 2019 period. While bond markets are still cautious, commodity prices, are signaling better economic outcomes ahead. We like to use the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities from crude oil to orange juice, to gauge overall commodity prices. We use the CRB index as a predictor of future inflation expectations.

In our 4Q 2018 commentary we stated, “With the Fed and some investors worried about inflation rising too fast, we are highly unlikely to see it any time soon given commodity prices cratering in 2018.” Fast forward to today and investors and the Fed came around to our view on inflation not being a problem. Just as they start to see what we saw months ago; we are now concerned inflation could become a problem based on the +7.97% rise in commodity prices during the first three months of the year. We will continue to monitor commodity prices daily. If they create inflationary pressures, the Fed could come back into play for more interest rates. That is certainly not being discounted into stock prices today.

We want to also highlight that rising commodity prices are usually a sign of improving economic activity, particularly in Emerging Markets. Therefore, in 2019 we want to see commodity prices rise gradually to indicate a gradually improving economy. We do not want to see a rapid rise in price though. Slow and steady will be better.

Inflation Watch: Commodity prices rose +7.97% in the 1Q 2019 period



Global Stock Market Performance Returns

Country	Stock	1Q 2019 Return	2017 Return	2018 Return
China	Shanghai Composite	23.93%	6.56%	-24.69%
Greece	ASE	17.62%	24.66%	-23.56%
Italy	MIB	16.17%	13.61%	-16.15%
U.S. Small Cap	Russell 2000	14.18%	13.14%	-12.18%
France	CAC	13.10%	9.26%	-10.95%
U.S. Large Cap	S&P 500	13.07%	19.42%	-6.24%
Canada	TSX Composite	12.42%	6.03%	-11.64%
Hong Kong	Hang Seng	12.40%	35.99%	-13.61%
Ireland	ISE	12.02%	7.99%	-22.14%
Portugal	PSI	10.04%	15.15%	-12.19%
Australia	S&P/ASX 200	9.46%	7.12%	-6.96%
Taiwan	TSE	9.39%	15.01%	-8.60%
Germany	DAX	9.16%	12.51%	-18.26%
Brazil	Ibovespa	8.56%	26.86%	15.03%
Spain	IBEX	8.20%	7.40%	-14.97%
U.K.	FTSE	8.19%	7.63%	-12.48%
India	SENSEX	7.22%	27.91%	5.91%
Philippines	PSEi	6.09%	25.11%	-12.76%
Japan	Nikkei 225	5.95%	19.10%	-12.08%
Russia	MICEX	5.39%	26.76%	6.12%
South Korea	KOSPI	4.88%	21.76%	-17.28%
Thailand	SET	4.78%	13.66%	-10.82%
Indonesia	JSE Composite	4.43%	19.99%	-2.54%
Mexico	Bolsa IPC	3.94%	8.13%	-15.63%
Turkey	BIST 30	2.80%	48.81%	-19.54%

Source: Bloomberg

Conclusion

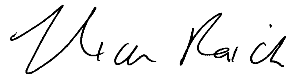
Last year's decline in U.S. stock prices, as measured by the -6.24% drop in the S&P 500 index, came from the combination of slowing global growth and self-inflicted wounds set by both monetary and fiscal policy makers. In 2019, policy makers have learned from their mistakes and are now taking steps to make sure that economic data will be much **better than feared.** In turn, the 1Q 2019 period was one of the best quarters for stock price returns in ten years.

Looking forward to the 2Q 2019 period, we are maintaining a normal allocation to Equities as risk and rewards have become balanced. We are keeping a real close eye on the flattening U.S. yield curve and rising commodity prices. While markets think the Fed is no longer going to hike interest rates, we believe the central bank will come back into play if commodity prices keep rising. Given high 4Q 2019 and 1Q 2020 earnings expectations, the potential for a more hawkish Fed could lead to prices re-setting lower later this year.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,



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