# The Rubber Band Rally

## How does your equity portfolio look today versus the end of December?

Thanks to the Federal Reserve, you may have started the year with a case of whiplash. The Fed's monetary policy went from hawkish in December to dovish in January. This dovish turn bodes well for investors for the remainder of 2019.

In December, the Fed stated that two rate raises were on the table for 2019, and that its balance sheet reduction program was on "auto-pilot." Equity markets reacted poorly, turning in the worst December performance since 1931. The S&P 500 ended the year down more than 6%. 2018 was not only a year of declines, but of volatility as well. VIX spiked to levels unseen in more than five years. At the start of 2019, it looked like the record U.S. bull market was near an end.

What a difference a quarter makes! The Fed soon reversed course: no more rate raises and forget about balance sheet reduction for now. Markets were gleeful. Investors who stood pat in Q4 were rewarded for it in Q1 with low volatility and the best quarterly market performance since 2009. Like a stretched rubber band, the financial markets snapped back hard.

Below, we summarize Q1 financial market highlights and touch on what will move markets in Q2 and for the remainder of 2019.

## 2019 Q1 MARKET SUMMARY

Before we look at key market drivers for 2019, we briefly summarize 2018 market performance.

**The US economy is still a world-beater as growth rolls along.** Although job growth has slowed, employment activity remains strong; inflation is still below 2%; and full-year GDP growth is trending toward a favorable 2.5%. The US economy shows few signs of weakness. Recession risk remains low for 2019, however a yield-inversion hints at dark clouds on the horizon.

**The US equity markets had a superlative start to 2019.** The bull market continues. The S&P 500 bounced back with a vengeance, up 13% in Q1 after declining 15% in Q4 of 2018. The Fed driven rally bumped up every industry sector, with technology and industrials leading the way. A blessing of unicorns is stampeding to the public markets as 2019 shapes up to be a record year for public offerings. Lyft shot up during initial trading and has since declined; Uber, Airbnb, Pinterest, and others are hoping for big debuts when they list.

### US credit markets snapped back from Q4 declines, but a yield-curve inversion signals trouble ahead.

Q1 credit market performance was strong. Investment Grade (+5%), High Yield (+7%) and Leverage Loan (+4%) indices all started the year up after 2018 declines. Defaults remain low. Returns for index investors, however, may normalize going forward, as gains have already been front loaded.

Yield curve inversion—when short term rates are higher than long term rates—signals a future recession. The benchmark for inversion used to be the 2-10 year bond spread (which hasn't inverted); but better data has shifted the focus to the 3 mo-10 year spread (which has). In March, for the first time since 2007, an inversion occurred. The inversion signal is generally far in advance of a recession and markets took the signal in stride.

### The Federal Reserve gave investors whiplash and central banks turned back to dovish.

It was only in December that two rate hikes seemed certain for 2019. Now, Powell says, rates will remain steady and quantitative tightening (that is, a reduction of the Fed's balance sheet) will be put on hold. The ECB has also swerved from normalization. The bank has not only committed to maintaining rates through 2019, but has reversed its own balance sheet reduction plan. Central banks dare not normalize until the economy is strong enough to handle higher rates, but if a recession comes they may not have the ammo to fight it.

### Global equity markets have a stellar Q1, but the European economic outlook is bleak.

The EAFE index was down over 16% in 2018 and then rallied 10% in Q1 2019 (the index captures equity performance of developed markets, excluding the US and Canada). Throw a dart at a map and you'll hit double digit returns: Australia (+12%), China (+31%), France (+11%), Italy (+14%)… etc. Of course, coming off of 2018's declines, these increases are just enough to bring investors back to even. Slow growth in Europe, combined with uncertainty surrounding Brexit, may temper gains for the remainder of the year.

With the market's rubber band rally in Q1, investors may wonder how much more the market can run. More upside exists, we believe, and below we detail the drivers for further increases. Generally, most US asset classes have room to run in 2019. International investors will have to be pickier (due to slower economic growth in those economies), but can still find value, especially in emerging markets. Trade is the main driver of the Chinese equity market, which is, like the S&P, primed for a rally if a trade deal can be finalized.

## WHO LET THE DOVES OUT? CENTRAL BANKS TURN EXPANSIONARY

Central Banks in Q1 turned dovish. And not just in the US. The European Central Bank (ECB) committed to flat rates and to maintaining its balance sheet, to help the struggling European economy. Central bank policies continue to drive markets, with credit and equity investors being the main beneficiaries of those policies.

## CREDIT MARKET STABILITY LIKELY IN 2019

Credit investors should be in a good mood. Interest rate certainty from central banks may help enhance Q1's gains. With defaults still low, credit market volatility has rewarded investors with multi-sector expertise who can seek out relative value. In December, for example, High Yield (HY) bond-market declined enough to make the asset class favorably priced. When HY snapped back in January, investors who had reallocated to the asset class after December's declines were able to capture much of that gain. Ups and downs in the market create opportunities to find value for investors with multi-sector expertise. Low rates and a sturdy economy can sustain credit markets through 2019, but what about those dark clouds from the yield curve inversion?

## DOES A YIELD CURVE INVERSION STILL SIGNAL A RECESSION?

As noted above, a rate inversion occurred toward the end of Q1. Here is why you shouldn't worry about it… yet.

First, an inversion occurs far in advance of the recession it's signaling. The inversion occurs, on average, 17 months before a recession starts. From when the inversion occurred in Q1, a recession may not result until the middle of 2020. And that's if the signal even holds. Next, the signal may not be as reliable as in the past, for the reason that we are at the tail-end of a 40 year declining rate environment. The spread between short and long rates, therefore, is unusually narrow. As a result, it's uncertain whether the inversion signal is as reliable when spreads are so compressed. Finally, the strength of the signal is related to the depth of the inversion. The Q1 inversion was shallow, the equivalent of the 10-year barely dipping its toe in. Until it dives deep, the signal isn't very strong. As it is, the markets barely reacted to the signal. For now, the US economy, helmed by the Fed, is charging full speed ahead in 2019.

## THE RUNNING OF THE EQUITY BULLS

Equity investors are also benefitting from central bank dovishness. With rates low and Fed balance sheet reductions off the table, current monetary policy is supportive of equity markets. Investors have received Q1 returns with low volatility, as VIX has declined from its heightened Q4 2018 level. Further, Q4 corporate profits have been coming in above estimates, reflective of the underlying strength of the US economy. Still to come is a trade deal with China that could spring load gains for the equity market. Finally, the halo of positive IPOs performance could bring more attention (and capital) to the equity markets.

Q1's gains left investors in a good position to prudently reevaluate their portfolios. The US economy is strong. The risk of a recession is low and central banks are determined to manage the economy without any surprises. But a recession will eventually come. Reallocation to more resilient investments, better suited to a shift in market cycle, is easier to do before the market turns. Preparation for a decline should take place before the market cycle turns; the next time the rubber band stretches it might just snap instead of snap back.