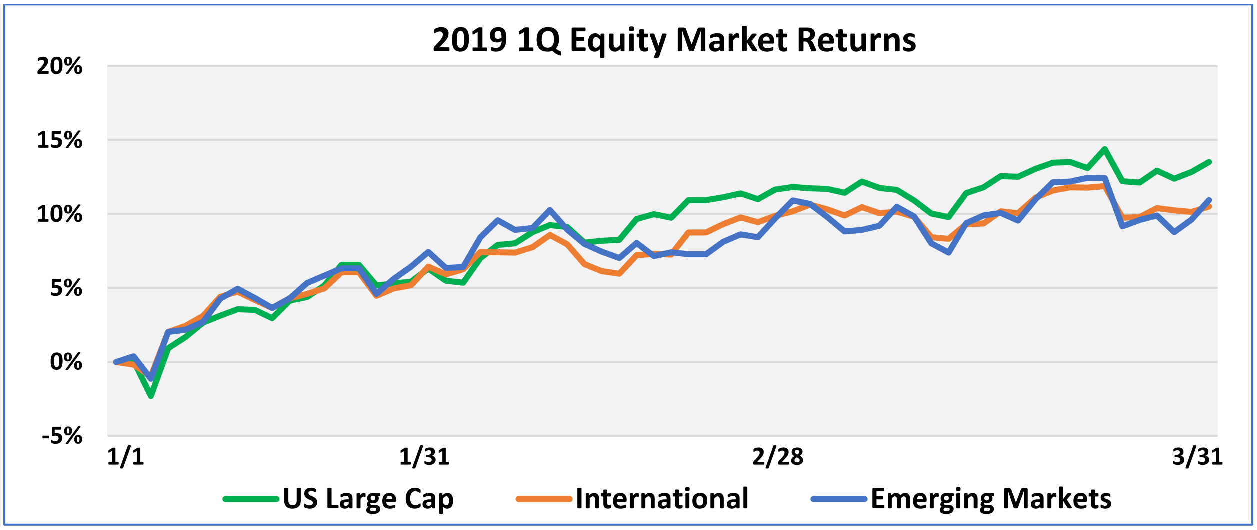
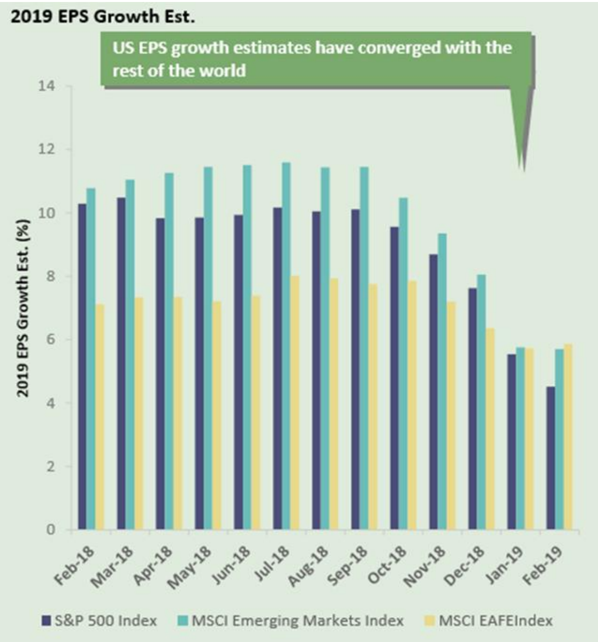
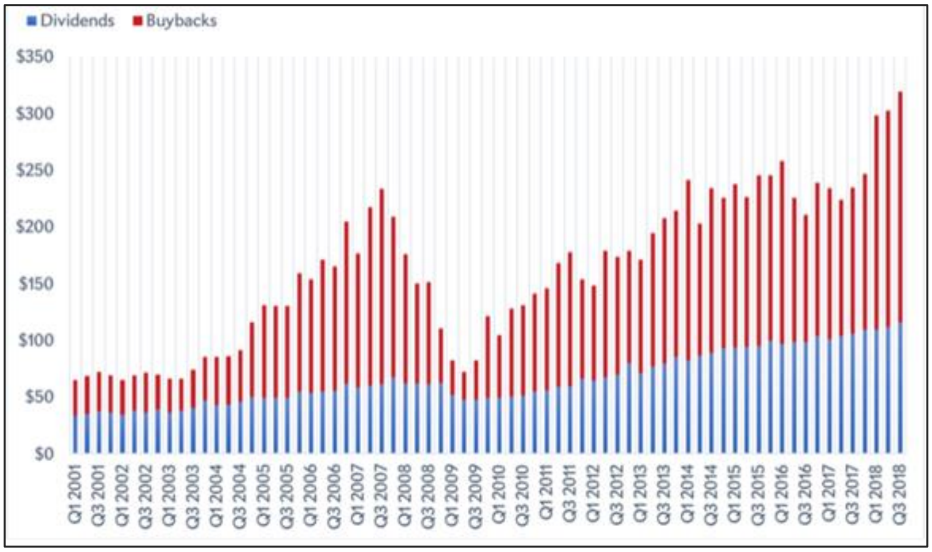
First Quarter 2019 – Paradox!



The First Quarter of 2019 delivered very high equity markets returns around the world while, paradoxically, global worries about economic growth and earnings vulnerabilities mounted. What gives? During the First Quarter the government shutdown ended, strong earnings were reported and the Fed stated that their tightening would end for the rest of the year. The Fed statements seem to have fueled growth and earnings worries but the market keyed on rates staying stable as an excuse to rally. Equities markets delivered a full year of returns in three months! Both earnings and dividends seem stable and expectations for growth, while moderating, are positive. The chart below shows that earnings expectations have moderated (left chart) but sentiment is improving (right chart). This rarely happens.

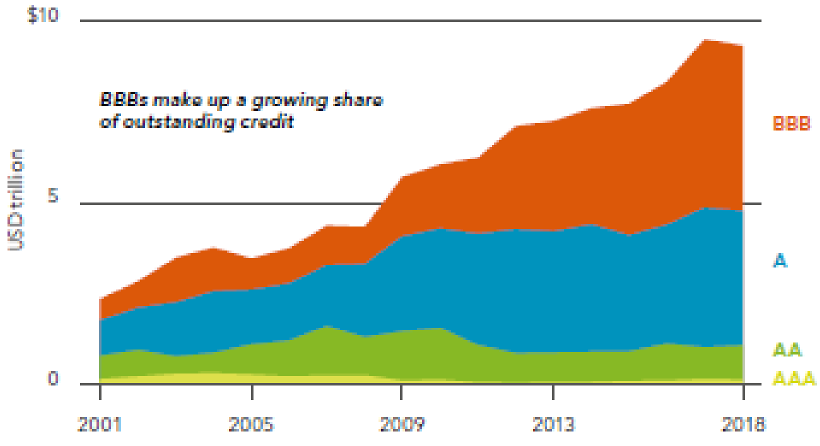


Meanwhile, dividends and buybacks have been rising. The below chart reflects the actual quarterly buybacks and dividend payments for the S&P 500 since 2001 (Red = Quarterly Stock Buybacks, Blue = Quarterly Dividends). We have said in the past that economic growth does not die of old age but as the cycle ages it becomes more vulnerable to external shocks and/or policy errors. Meanwhile, profit margins hit all-time highs in 2018 and will be under pressure in 2019, so it is far more likely that, in the near term, we will experience an Earnings Recession than an Economic Recession. Howard Silverblatt, of Standard & Poors, is the leading expert on earnings and tracks actual results and trends on forecasts. His work is very helpful in identifying how forecasts evolve over time and how inaccurate Wall Street analysts can be in their forecasting. Last year, estimates were too low at the beginning of 2018 and rose during the year. Conversely, estimates for 2019 were too high and are now in the process of being lowered. Right now Silverblatt's tracking of US S&P 500 earnings estimates calls for an 8.5% increase for 2019 vs 2018. Earnings reports for the first quarter of 2019 will be a key test, as it is the toughest comparable forecast for the year. We do not make forecasts but we watch those who do for information on market expectations. Right now the pundits are skeptical on 2019 earnings being positive at all.



A significant part of our clients' portfolios are in fixed income allocations. Our fixed income strategies have been quite conservative. We have a very high quality orientation for a number of reasons but the below chart drives home one key variable that worries us about fixed income indices.

Global investment grade corporate bond issuance by rating bands, 2001–2018



Sources: BlackRock Investment Institute, with data from Bloomberg, November 2018. Notes: The chart shows a breakdown of the Bloomberg Barclays Global Corporate Index based on market value by rating bands. The 2018 numbers are as of Oct. 31.

There has been a dramatic build up in low quality BBB bonds in the indices. This is due to very large issuance of BBB bonds by companies doing acquisitions and borrowing to fund share buybacks and payouts to private equity owners. This BBB component also has a "Covenant Light" feature. Issuers have eliminated many of the covenant protections in their BBB bonds being sold and the market is so yield hungry that they buy them anyway. The next recession (whenever that occurs) will put pressure on the BBB segment and downgrades and defaults will rise. Bond rating agencies will downgrade the BBB segment, the indexes will kick them out into the junk bucket, and selling pressure will mount.

It makes no sense to blindly buy a traditional bond index when the fundamentals within the components have deteriorated. Broad based bond index funds and ETF's will suffer when the liquidity dries up in the BBB sector and losses will mount. Our solution has been to dial down risk factors in our bond holdings. Bonds are meant to be there for you when you need them.

Thank you for your confidence in us.

Sincerely,

Donald E. Callaghan
Co-Managing Partner and Chief Investment Strategist