Review & Outlook

FIRST QUARTER 2019

WAYCROSS INVESTMENT MANAGEMENT COMPANY

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Review and Outlook

During the first quarter of 2019, the markets gained back most of their losses from last December. However, by quarter-end, most indices, including the CRSP and S&P 500, were still below their highs from September 2018. At the end of that year, we remained defensively positioned and held a significant amount of cash in our clients' accounts, but in early January 2019, we became more bullish as it became clear that the Fed had likely stopped raising interest rates and there were increasingly strong incentives for the US and China to come to a trade war truce. By mid-January, we'd shifted our clients to a more fully invested position, moving from largely cash in the global and alternatives asset classes to being fully invested relative to portfolio targets. The alternative REITs and MLP funds that we held in our clients' portfolios performed particularly well during the first quarter.

Index Performance Data: Total Return as of 3/31/2019

Indices[1]	Q1 2019	Trailing 12 Months
CRSP U.S. Total Stock Market Index (Total Return)	14.06%	8.82%
MSCI Global ex-U.S. Total Stock Market Index	9.55%	-6.83%
Bloomberg Barclays U.S. Aggregate Bond Index Composite	2.94%	4.48%

Quarter to date, both our domestic equity funds and individual stocks largely performed in line with our target benchmark, the CRSP index, but returns for the past twelve months trailed due to the market downturn at the end of the year and our tilt towards small cap and value funds, which significantly underperformed the CRSP index for most of 2018. We are currently evaluating whether or not the long-standing value premium should be expected going forward, but continue to maintain a slight tilt towards small cap and value stocks for the time being.

Throughout 2018, we were significantly underinvested in global funds relative to our clients' portfolio targets, ending the year with no global positions at all. Our benchmark for global funds, the MSCI ACWI ex-US index, returned -16.45% for the year, but the one small position focused on global small cap companies performed worse. However, since that security was only a small part of the target allocation to global funds which remained largely in cash, the overall performance for the global asset class was relatively good.

Looking forward, we see reasonable strength in the US economy, but also see potential trouble, much of it policy-driven. While we are hopeful that the trade disputes can be resolved, the underlying uncertainty requires us to remain cautious. If trade talks with China break down and there is a policy response of escalating rounds of tariffs, both domestic and global markets would likely be significantly and negatively impacted. Barring trade war escalations, we don't see compelling evidence for a recession any time soon, despite the recent, and brief, yield curve inversion in March.

In Focus

We have written in the past about the possibility of an inverted yield curve, and discussed how this event is often seen as a predictor of an upcoming recession. On March 22nd, there was a formal inversion of the yield curve when the yield for 3-month Treasuries rose above the yield for 10-year Treasury bonds, sparking fears of a looming recession. Concern is reasonable, since the past seven recessions have been preceded by an inversion of the yield curve. But should you be worried? Our answer is "not yet."

The recent inversion of the 10-year and 3-month rates was shallow and very brief, lasting only five days, and the mechanics of this inversion were unlike those of past inversions. This time, 3-month rates remained fairly steady while longer-term rates dropped significantly, but in past inversions, short-term rates have risen higher than the longer-term rates that remained relatively constant. There are a lot of good reasons to think that significant capital is flowing into U.S. bonds, driving longer-term rates down and causing the inversion, but that flow of money is not a sign of weakness in the U.S. economy.

Consider the existence of high-quality government treasury debt with negative yields. Over $7 trillion in government debt, much of it found in Japan and Germany, has been paying a negative yield, so savers in those countries are effectively paying to receive a fixed amount of money when their bonds mature. With bond yields so low in other countries, investors are moving their money to the U.S., driving down longer-term rates and helping cause the inversion. But are negative interest rates abroad suggestive of a terrible global economy that is destined to push recessionary forces in the U.S.? Is the inverted yield curve simply forecasting a recession driven by global economic downturn?

For all the angst about the health of foreign economic performance, many people overlook the fact that the U.S. economy is mostly driven by domestic consumption, not trade. The United States has a massive internal economy that does not rely directly on international trade, so as long as the U.S. consumer is employed, confident, and spending, a recession is unlikely.

The economy seems to be holding steady at about 2% growth, having slowed a bit from the high of close to 3% in 2018. Past drivers of inflation like higher wages, commodity prices, and rising retail prices have yet to start pushing measured inflation meaningfully higher, so even with remarkably low unemployment rates, the Federal Reserve can keep interest rates low.

While we are arguing that global economic activity and trade may not be as important as the headlines suggest, we agree that they are still relevant. Our biggest concern by far is that the U.S. and China might fail to come up with some kind of trade agreement. As sentiment has shifted to believing some kind of trade deal with China will be implemented, even if it is only temporary, the stock market has continued to rise. Investors seem to believe that if a deal is reached, sidelined business investment will reaccelerate in the coming months. Additionally, the removal of tariffs will help keep inflation lower, allowing the Fed to keep short-term interest rates lower for longer. One of the reasons the stock market started to decline last fall was the fear that the Fed was going to keep raising short-term interest rates.

For now, we continue to watch and weigh yield curve behavior. A return to a full and sustained inversion would require us to review our analysis and possibly revise our opinion about an impending recession. But if the Federal Reserve continues with their neutral stance and the trade war with China is resolved, even temporarily, we see no reason to think that a recession will occur in the next twelve months.

Even since the end-of-March inversion, the markets have moved such that we can discount that brief inversion as a warning of impending market turmoil. There was an initial sell-off on the day of the inversion, with the CRSP U.S. Total Stock Market Index dropping 2.1% and the small cap Russell 2000 Index falling 3.6%. However, the selling was short-lived, and by the end of March the market had nearly returned to its pre-inversion levels. So, while we respect the yield curve, we don't think that its recent inversion is a strong enough signal for us to shift our clients' investments. We continue to pay attention to a variety of economic and financial indicators that underlie the movements of the yield curve rather than the slope of the yield curve itself. So far this year, the markets have risen steadily, which is an indication to us that a recession is not imminent.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.