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FIRST QUARTER 2019 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a severe stock market decline in the fourth quarter last year, stocks rallied during the first quarter of 2019 as fears that caused the year-end plunge abated. Late last year, investors and traders became concerned that the Federal Reserve Board was raising interest rates too rapidly and that President Trump might terminate the Federal Reserve Board chairman because he was upset about the pace of interest rate increases. Raising interest rates too fast can cause a recession, which harms corporate earnings and stock prices. Investors were concerned that these interest rate increases were occurring during a time when global economic growth was already slowing, partially due to the trade war between the U.S. and China. The U.S. economy had been growing while many foreign economies were struggling, and investors began to worry that economic problems in foreign countries could begin to negatively impact the U.S. economy and U.S. corporate earnings. Rising interest rates were also leading to a stronger U.S. dollar, which was creating a headwind for U.S. corporate profits.

However, at the beginning of this year, the Fed began to realize that perhaps they were raising interest rates too frequently and indicated that they were going to slow the pace of interest rate increases. Then in late March, the Fed announced that it will not be raising interest rates at all this year, demonstrating that they are sensitive to the negative impact that rising interest rates has on the economy and the stock market. Also, investors began to anticipate a trade agreement between the U.S. and China that could ease global economic pressures. With interest rate and trade issues mostly resolved, last year's stock market decline reversed, and the S&P 500 Index ended the first quarter of 2019 up 13.07%, while the Dow Jones Industrial Average ended the first quarter up 11.15%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index increased by 2.32% during the first quarter of 2019.

Although the first quarter market recovery was welcome, there are still many uncertainties that can create further volatility this year. First, it would be very unusual for the stock market to decline as rapidly as it did late last year without some type of secondary decline at a later date. When the stock market plunges, it often becomes very oversold as investors become overly pessimistic, so stocks may experience a snapback rally as we saw in the first quarter this year. However, these rallies can be fragile and any further concerns about the rate of growth of the U.S. economy or corporate earnings this year could result in another market drawdown. For example, if it turns out that economic figures begin to disappoint investors, they may become concerned that the reason the Fed decided to discontinue raising interest rates this year was that they knew the economy was already weakening and succumbing to economic problems overseas. Also, while there seems to be a truce in the trade war with China, investors could become concerned that the agreement will not be enforced properly or that another trade war could begin elsewhere. Trade wars are concerning for investors because they can potentially result in damage to supply chains, factory output, foreign sales, and other problems that can ultimately lead to a recession in the United States. That said, as long as the U.S. economy does not go into recession, a more significant stock market decline than a retest of last year's low should be avoided.

We believe that the U.S. economy will ultimately avoid a serious recession this year despite concerns over economic growth and global trade issues. However, a recession can be expected in the future

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under more strenuous economic and financial conditions. For example, if global investors determine that the U.S. has too much debt (currently over $22 trillion) without the political or economic will to reduce it, they may not be willing to buy as many U.S. Treasury bonds at current interest rates. This would lead to higher long-term bond interest rates in the U.S. Rising long-term interest rates would be negative for the U.S. economy because many loans in the U.S. are based on interest rates determined in the bond market. A recession will become more likely if interest rates that consumers, students, and corporations need to pay to borrow money increase. Also, if interest rates in the bond market rise, their yields may provide competition for stocks, resulting in money transferring out of stocks and into fixed-income investments. Finally, if the U.S. dollar strengthens too much due to rising interest rates, it can lead to a corporate earnings recession because companies that sell goods and services overseas will lose money due to negative currency exchange rates.

After avoiding some of the more volatile asset classes such as small company stocks and emerging market stocks during last year's decline, we have recently become interested in potentially investing in these asset classes for risk-tolerant investors. We also continue to like gold as a hedge against future inflation and because it typically performs well during times of economic and geopolitical uncertainty. Finally, we continue to invest mainly in short-term bonds rather than long-term bonds because long-term bonds offer little additional interest and more risk than short-term bonds.

In the meantime, please contact us if you have any questions or concerns regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on March 30, 2019.*

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