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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

During the first quarter, even though stock market returns were generous, a recurring debate about when, and whether, a recession was imminent was reflected in market volatility. In the midst of much chatter, there was significant misinformation applied to the discussion. Since it has been ten years since the last recession, we thought this might be a good opportunity to use this edition of our Newsletter to correct some of these misunderstandings.

The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) is generally seen as the authority for dating US recessions. **The NBER defines an economic recession as "a significant decline in economic activity spread across the economy lasting more than a few months normally visible in real Gross Domestic Product (GDP), real income, employment, industrial production, and wholesale-retail sales."** It is often thought that the criterion for recession is two consecutive quarters of negative economic growth as measured by a country's GDP, although the NBER does not need to see this occur to call a recession. Indeed, given the nature of economic data, the proclamation of recession can sometimes be misaligned by several quarters.

Recession should be regarded as an unpleasant but inevitable part of an economic cycle. In order to understand where we are in the cycle, it is important to understand the leading and lagging indicators of recession. Misuse of these indicators continues to be a major source of confusion. Unemployment is a lagging indicator of recession—we should understand that unemployment doesn't cause a recession; recession causes unemployment. Similarly logical, consumer confidence peaks just ahead of the beginning of recession, just before consumers begin to hoard rather than spend. The Federal Reserve Bank has developed models to forecast the start of recession, but, these models have something of a spotty track record. **Currently they attach a 24% probability to recession in the coming year; such a small probability would indicate a recession is unlikely.** The index of leading economic indicators (LEI) has a much better track record, with an ability to forecast recession somewhere between 8 and 21 months into the future; the past five cycles have averaged 13 months. In past cycles, another commonly used indicator of a downturn in economic activity has been the bond yield spread or inverted yield curve. We will discuss this indicator in our fixed income commentary.

One problem with trying to forecast recession is that it is difficult to isolate the causes of recession in real time. The severity of the last recession was exceptional in that it was caused by excess speculation in the real estate market compounded by lack of controls in the financial system, which, combined, produced universal mayhem. As a consequence of the near collapse of the banking system, the 2008-2009 recession was much more severe than most. **We expect the next recession, whenever it occurs, will be brought about by the convergence of several, less fundamentally structural, factors and will lack the systemic severity of the last recession.**

Even if we could know with certainty the onset of the next recession, it would be difficult, if not impossible, to profit from this information. There have been five recessions going back to 1980. Maybe because the stock market is one of the more robust leading indicators, it has appreciated in three of the past five recessions. Furthermore, from the perspective of profiting from perfect knowledge of an imminent recession, the stock market has delivered positive returns four out of five times in the twelve months prior to the onset of a recession. Hence, we feel justified in remaining invested even if we anticipate a slowing economy.

While the debate continues, we do not expect an economic recession in the immediate future. The policy shift, on the part of the Federal Reserve Bank, to stop raising short term interest rates will allow the US economy to continue to grow at a slow but sustainable pace; at the same time, pressure from a global slowdown is likely to subside. As we have discussed, the prospect of a global trade war has not been a major factor in recent global slowing. **Rather, the current headwinds are likely temporary, the result of past tightening policies which are already in the process of being reversed.**

That is not to say we are without concerns. Investment has weakened globally. Residential investment has weakened everywhere in the developed countries, with the exception of Germany, as a function of tighter monetary conditions, i.e. higher interest rates. We expect this to reverse with lower interest rates. Simultaneously, non-residential investment has dropped in the U.K., France, and Italy due to political concerns. This creates headwinds amplified by feedback loops within and between countries; e.g. concerns about growth trigger a sell off which causes financial conditions to tighten and become a further drag on growth.

No discussion of recession would be complete without the mention of a corporate profits or earnings recession. We last experienced a decline in earnings during late 2015 into the first half of 2016. We are probably experiencing a similar slowdown this quarter. **With lower earnings guidance, and the impact of the $1.5 trillion tax cut rolling off from the comparable period last year, earnings are expected to shrink by .3 to .5% vs. the 26.5% growth in first quarter of 2018.** Even with an adjustment for positive surprise, earnings are expected to be flat when reported. Although this is widely expected, it will be interesting to see what guidance accompanies the reports.

Fixed Income

The Federal Reserve's decision to leave the target fed funds rate unchanged at 2.25-2.50% was widely expected for the March meeting. The surprise was the Fed's revised interest rate projections which were even more dovish than anticipated. **Long-term yields dropped as the Fed's "patience" stance with respect to future policy changes signaled no further rate hikes until the end of 2019.** The 10-year yield moved to 2.41%, 28bps lower than at the start of the year.

The Fed also announced that it will end its balance sheet normalization, known as quantitative tightening (QT), in September of this year. From a peak of $4.3 trillion, the Fed's balance sheet has lowered to $3.8 trillion and is expected to be close to $3.5 trillion by September under the revised plan. Market participants have widely expected for some time that the terminal balance sheet will be far bigger than it was pre-crisis. This partially explains why the term premium on longer-dated Treasury notes has not increased during QT and long-term rates have remained low. Further, the end of QT would presumably put additional downward pressure on long-term rates. In September, the Fed will start purchasing offsetting amounts of Treasury securities as maturing mortgage-backed securities roll off, normalizing the composition of its assets and holding only Treasuries as it did pre-2008. **The Fed's net buying of Treasury securities will put downward pressure on long-term rates; the 10-year Treasury yield moved sharply lower on the news.**

The move in long-term yields reduced the spread between the 2-year and 10-year Treasury yields to a low of 13bps during the quarter. The yield curve has moved closer to an inverted curve, where short-term rates are higher than long-term rates. Given the structural factors that continue to keep long-term rates low (i.e. the Fed's balance sheet will remain much larger than it was pre-2008), we continue to place less emphasis on an inversion of the yield curve as a recession indicator. **Prior recessions have occurred when short-term rates moved higher than long-term rates due to the Fed's tight monetary policy which controlled only the short end and not both ends of the curve.** In past cycles, the market anticipated that tight monetary policy would slow the economy and effectively lower future inflation. Whereas some segments of the yield curve have inverted, the more meaningful spread between 2-year and 10-year yields remains slightly positive and driven by structural factors which were not occurring in previous recessionary periods. Even if we assume an inversion of the yield curve does imply a future slow down, prior data indicates that a recession would be a long way off, since the time between the inversion of the spread to the start of the slow down was 9 to 23 months ahead of the past five recessions.

International Market

International markets continued to have an eventful first quarter of 2019. But, unlike the recent past where international developments were mostly viewed as a cloud hanging over the equity markets, news of progress helped to clear some of the gloom. **Encouraging developments, primarily from the trade treaty renegotiation between the US and China, or "trade war" as touted by media commentary, have not only helped to stabilize equity markets but also fueled one of the best starts to the equity markets in years.**

With the phrase "trade war" flooding the news headlines of major media networks and arguably causing unnecessary concern in the markets, we have repeatedly emphasized that aside from short-term psychological effects, **a trade conflict is unlikely to have a lasting fundamental impact on the global economy.** We continue to view the tension in trade negotiation as a means to accomplish a larger goal, not the goal itself.

Despite headlines proclaiming the world's two largest economies are fighting a trade war with global consequences, the reality is that bilateral trade between the US and China accounts for just over 3% of total global trade. Moreover, much of the trade lost within this bilateral relationship would be shifted to trading partners, as buyers would seek alternate sources for tariff targeted goods. **Therefore, it is difficult to imagine that a breakdown of bilateral trade between the US and China could severely hamper global growth enough to cause a recession.**

Studies conducted by governmental agencies such as the Organisation for Economic Co-operation and Development (OECD) and the World Bank, as well as academic analysis, including that of Nobel laureate Paul Krugman, share a similar conclusion: Even in a worst-case scenario where all governments impose blanket tariffs of 25% on all imported goods, the immediate potential negative impact to GDP would be just over 2%. **An impact of this magnitude would potentially lower the global GDP growth outlook for the next 5 years from an annual rate of 3.5% down to 3.3%, a growth rate far above the negative growth necessary to define a global recession.**

Our earlier observation that "the prospect of a global trade war has not been a major factor in recent global slowing" is also true when applied to China. The Chinese economy has experienced a noticeable slowdown in growth, but trade tensions have only been a small contributor to that slowing. In reality, it is the Chinese government's years-long campaign to restrict riskier lending practices through tightened fiscal and monetary policies which has produced the current slowing of economic activity. The government has now reversed its course. **With a goal to stimulate the economy, Chinese policy makers have commenced a series of aggressive policy maneuvers.**

On the fiscal policy side, Beijing has allowed local governments to issue increased amounts of special purpose bonds to finance local infrastructure projects. Approximately 2.15 trillion RMB (roughly $310 billion USD) of bonds will be issued. Further, a wide range of tax cuts has been announced and/or implemented for personal income, corporate earnings, and the value-added tax to imports and exports. This reduction in taxes and fees will amount to another 2 trillion RMB ($290 billion USD), as announced by Premier Li Keqiang at the annual National People's Congress.

On the monetary policy side, the People's Bank of China has reduced financial institutions' reserve requirement ratios multiple times, with the most recent cut at a full percentage point, just before the Lunar New Year. The recent 1% reduction alone is estimated to generate up to 800 billion RMB ($117 billion USD) of capital that will be injected into the economy in the form of new loans. In addition, the central bank has also taken various measures to support small- and mid-sized firms. These actions have helped to stabilize the markets and the impact is already apparent. **Recovering from a low at the start of the year to recent highs, the Shanghai stock market has generated returns of more than 20%, and is now technically in a bull market.**

Besides China, investors are keeping a watchful eye on the Brexit negotiations. As expected, Prime Minister Theresa May has requested an extension on Article 50 from the EU following the two failed passage attempts of her transition plan by Parliament. A number of likely scenarios could happen as Brexit continues to unfold. Parliament could reach and pass an enhanced deal, allowing for the UK's smooth exit from the EU. Alternatively, a new referendum could be held, and current polls suggest UK voters would likely cancel Brexit. The required petition for the government to revoke the letter sent under Article 50 of the EU's Lisbon Treaty has surpassed a record-breaking 5.5 billion signatures, a wide margin above the 4.1 million signatures logged by the previous Brexit petition in 2016. **Lastly, a no-deal Brexit is also a possibility; however we view this scenario as the least likely to occur. Prime Minister May has made it clear that a no-deal Brexit will not happen unless Parliament agrees to it.**

Regardless of the Brexit outcome, investors should remain objective and focused on their long-term goals. While the prolonged uncertainty is not beneficial to business or financial market sentiment, we continue to expect the impact of a no-deal Brexit to be modest for the global economy. With exports to the UK accounting for only 4% of world goods traded, less than 3% of GDP for most European countries, and less than 1% for other countries including the US and Japan, the expected impact would be fairly limited. **In sum, we remain relatively sanguine with regard to the global economic consequences of Brexit, and despite possible short-term disruptions alongside the ample flow of negative headlines, surprises could be on the upside.**

Our vision is to provide sound financial management for each client, always placing the best interests of the clients first. We aim to preserve and enhance every client's wealth while providing peace of mind and financial security, now and for future generations.