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Investment Review & Outlook
2019 First Quarter Market Report

The long, painful market decline in the last month of 2018 seemed to promise more of the same for the new year of 2019, but at the end of the first quarter, the results couldn't have been more different. The U.S. market, measured by a variety of indices, posted its biggest one-quarter gain since the third quarter of 2009. This proves once again (as has been proven many, many times over) that you cannot extrapolate market returns from one month to the next, or expect that down or up trends will lead to more of the same.

Just about every investment asset rebounded in the early months of 2019. Looking at large cap stocks, the widely-quoted S&P 500 Index of large company stocks is up 13.07% so far this year. The Russell 2000 Small-Cap Index gained 14.58% the year's first three months. The technology-heavy Nasdaq Composite Index appears to have regained some of its mojo, gaining 16.49% in the first three months of the year.

International investors are experiencing somewhat smaller gains. The broad-based EAFE Index of companies in developed foreign economies gained 9.04% in the first quarter. In aggregate, European stocks are up 9.42% so far this year, while EAFE's Far East Index has gained 6.89%. Emerging market stocks of less developed countries, as represented by the EAFE EM Index, gained 9.56% in dollar terms in the first quarter.

In the bond markets, we are experiencing a very slight inversion in the yield curve. Coupon rates on 10-year Treasury bonds have dropped to 2.41%, while 6-month bonds are now yielding a higher 2.42%, and 3-month bonds are yielding 2.38%. Five-year municipal bonds are yielding, on average, 1.89% a year, while 30-year munis are yielding 2.72% on average.

These are, by any measure, extraordinary returns for a short three-month investment horizon, and nobody should expect that returns will continue at this pace for the full year. But the remarkable upsurge in stock prices does offer a lesson. Investors who took the December opportunity to buy stocks when they suddenly (and rather unexpectedly) went on sale are doubtless cheering their good fortune, but the larger number of investors who held on through December to reap the gains of 2019's first quarter should be similarly cheerful. Selling into the downturn, hoping to avoid more losses, was a losing strategy.

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It is also possible that the U.S. market is starting to get over its skis. Overall, American investors came out ahead of just about every developed or developing economy. The U.S. market performance finished only behind Ireland (up 30.5%), Greece (17.5%) and Italy (15.1%), well ahead of the U.K. (up 8.2%), Japan (5.3%) and India (5.3%).

Why are stock prices rising despite concerns about the yield curve inversion and persistent predictions of an upcoming recession? The answer could lie in some pleasant surprises that were contrary to what many investors were expecting. The Federal Reserve Board startled long-term market observers, in a good way, when it abandoned plans to continue hiking interest rates. Higher rates are considered impediments to higher market valuations for two reasons: they create more competition in the form of bond yields, and they raise borrowing costs for companies looking to expand.

Will the party continue? Who knows? The next few months will see many companies post their first quarter earnings per share, and negative growth (which is expected for many companies) could chill the surprisingly hot market. Nevertheless, slower profit growth is still growth, which suggests that a recession is not on the immediate horizon. Economists are still reluctant to predict an economic downturn when unemployment is at record lows, but it may be worrisome that the World Trade Organization's leading indicator of global merchandise trade dropped to its lowest level in nine years. Many are watching the new round of U.S.-China trade negotiations, hoping for a breakthrough that would re-integrate disrupted corporate supply chains around the world.

It is worth remembering that some of the steepest rises in market indices come right before a bear market, when investors become over-enthusiastic despite declining fundamentals and high valuations. We do not seem to be in that territory yet, but nobody knows for sure. It's always best to be cautious when the markets are rising fast, and optimistic when stocks go on sale. Actually doing these things is counterintuitive and very difficult emotionally, but for the intrepid, it has historically been a winning investment strategy.

The FAM Team