First Quarter 2019 Key Takeaways

After posting their worst December since 1931, U.S. stocks surged to their best January since 1987, followed by further gains in February and March. Once again, the markets surprised the consensus and demonstrated the folly of trying to predict short-term performance. Investors who bailed out of stocks during the year-end selloff experienced severe whipsaw as the market rallied. Larger-cap U.S. stocks gained 13.6% for the quarter, placing it in the top decile of quarterly market returns since 1950. As a reminder, last year's fourth quarter 14% drop was a bottom-decile dweller.

Foreign stocks also rebounded sharply in the first quarter. Developed international markets gained 10.6% and European stocks were up 10.9%. Emerging-market (EM) stocks rose 11.8%, after holding up much better than U.S. stocks on the downside in the fourth quarter of 2018.

Fixed-income markets were also strong: High-yield bonds gained 7.4%, floating-rate loans were up 4%, and investment-grade bonds rose 2.9%. The 10-year Treasury yield fell to 2.39% during March, its lowest level since December 2017. Our PIMCO Income fund (PONAX and PIMIX) performed in line with the Barclays Aggregate Bond Index at 2.93% and 3.03% respectively for the quarter. Likewise, our Schwab US TIPS ETF (SCHP) performed in line with its benchmark earning 3.29% for the quarter.

Our "bond-alternative" fund, the Litman Gregory Alternative Strategies fund (MASNX and MASFX) did not disappoint for the quarter, besting the Barclays Aggregate Bond Index by roughly 1.00% at 3.94% for the quarter.

The market rebound was predominately due to a U-turn in Federal Reserve monetary policy. After hiking interest rates four times in 2018, Fed officials suddenly reversed course. They emphasized they would be "patient" and pause any further rate increases. Admittedly, there were other positives for the markets as well: The federal government shutdown ended in late January, signals from the U.S.-China trade talks turned more positive, and the likelihood of a "hard Brexit" seemed to wane.

It certainly feels better to see strongly positive portfolio performance this quarter compared to the losses in the fourth quarter of 2018. But just as I wouldn't extrapolate last year's losses when looking out over the coming years, it's equally important to temper expectations on the upside after this quarter's strong rebound.

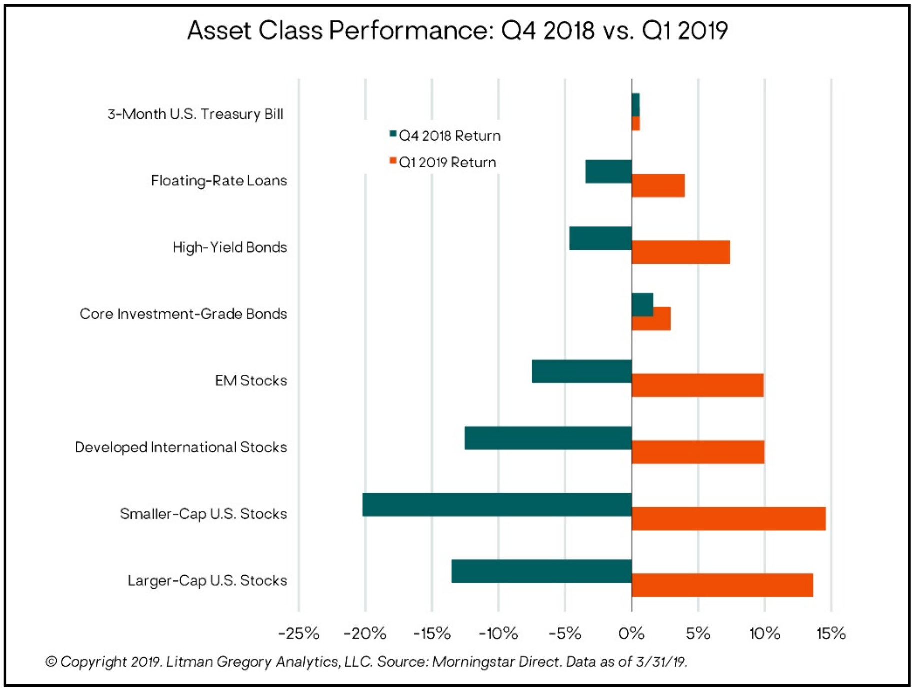
If monetary and fiscal stimulus around the globe extend the cycle for another few years, our portfolios have exposure to a wide range of investments that will particularly benefit. These include global equities, with an emphasis on developed international, European, and emerging-market stock, and Treasury inflation-protected securities.

On the other hand, if a recessionary bear market strikes, our bond/bond-alternative holdings, and our holdings in the Gateway fund (GATEX and GTEYX), which hedges against stock market declines through options, should provide shelter from the storm. And I would then be in position to tactically add back to riskier asset classes, such as U.S. stocks, at lower prices and higher prospective medium-term returns.

First Quarter 2019 Investment Letter

Market Recap: Financial Markets Sharply Rebound

The first quarter was an unusually strong period for equities. It also marked a striking reversal from the end of 2018. After posting their worst December since 1931, U.S. stocks surged to their best January since 1987, followed by further gains in February and March. Larger-cap U.S. stocks gained 13.6% for the quarter, placing it in the top decile of quarterly market returns since 1950. As a reminder, last year's fourth quarter 14% drop was a bottom-decile dweller. Once again, the markets surprised the consensus and demonstrated the folly of trying to predict short-term performance. Investors who bailed out of stocks during the year-end selloff experienced severe whipsaw as the market rallied.



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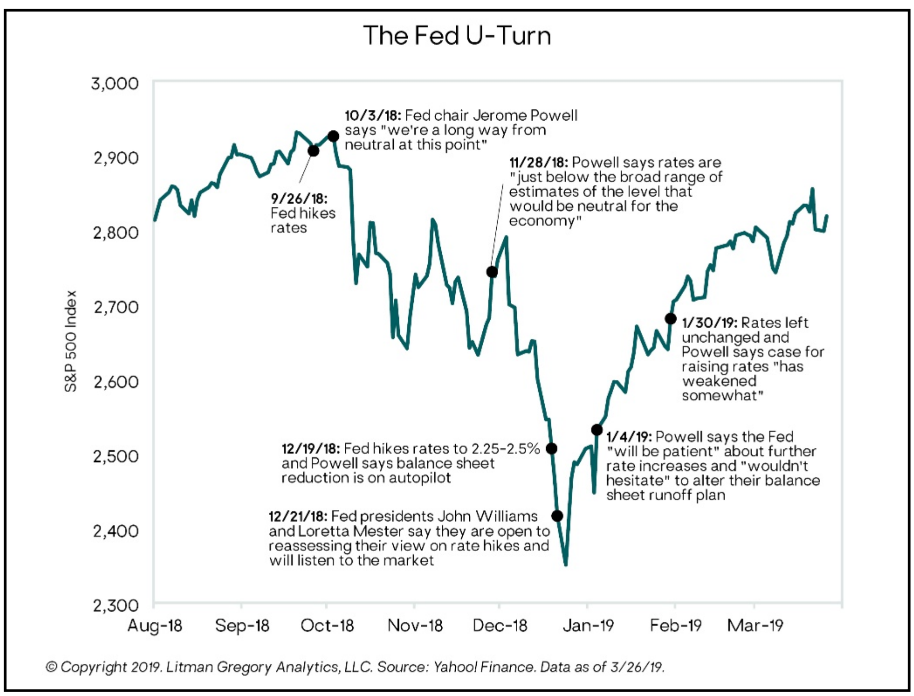
What Caused the Rebound: The Fed not the Fundamentals

The key catalyst for the rebound in equity markets was a significant shift in the Federal Reserve's stance on monetary policy. In late December and throughout January, the Fed became much more dovish. After hiking interest rates four times in 2018, including at their mid-December meeting, and indicating further tightening would occur in 2019, Fed officials suddenly reversed themselves. They emphasized they would be "patient" and pause any further rate



increases. In early January, Fed chair Jerome Powell said the Fed could also slow down or stop shrinking its balance sheet of bonds purchased during quantitative easing. This came just two weeks after saying the Fed's balance sheet reduction program (quantitative tightening) was "on autopilot." The U-turn in Fed policy was music to the ears of the financial markets, which had become concerned about ongoing policy tightening in the face of slowing economic growth in the United States and abroad.

There were other positives for the markets as well: The federal government shutdown, which had started to weigh on sentiment, ended in late January. Signals from the U.S.-China trade talks turned more positive, although far from anything definitive. The likelihood of a "hard Brexit" also seemed to wane, but again, far from anything definitive.

In sum, the market rebound was due more to improving investor sentiment and risk appetite—caused largely by the shift in Fed monetary policy—than any meaningful improvements in underlying economic or business fundamentals.

In fact, most economic indicators show a continued deceleration in global growth this year. For example, as reported by Ned Davis Research, the OECD's composite economic leading indicator fell for the 16th straight month in January to its lowest level in nearly a decade. Other broad global economic indicators, such as BCA's Global Leading Economic Indicator and Citigroup's Economic Surprise Index reflect similar headwinds.

The U.S. economy is in better shape than most, but even here growth expectations have been coming down. At its Federal Open Market Committee (FOMC) meeting on March 20, the Fed downgraded its median GDP growth estimate to just 2.1% for 2019 and 1.9% for 2020, citing the effects of economic slowdowns in China and Europe, fading stimulus from the 2017 Trump tax cuts, and ongoing uncertainty around Brexit and trade policy.

At its March meeting, the Fed also cemented the dovish stance it had signaled in prior months. It made clear the majority of FOMC members no longer expect to raise rates at all in 2019. (In contrast, in December it was expecting two more hikes this year.) It reiterated it will remain patient and "data dependent" regarding any future changes in the policy rate, raising the possibility that its next move could be a rate cut. Fed chair Powell cited persistently low inflation/disinflation across the globe as "one of the major challenges of our time" for central bankers. Regarding the U.S. economy, he said, "I don't feel that we have convincingly achieved our two percent [inflation] mandate in a symmetrical way. That gives us the ability to be patient, and not move until we see that our target goals are being achieved."

The Fed also announced it would stop the roll-off of Treasury bonds on its balance sheet (quantitative tightening) at the end of September, somewhat earlier than expected. That will leave the Fed holding $3.6 trillion in securities, around 17% of U.S. GDP. This compares to 6% of GDP before the financial crisis. If the March announcement does mark the end of this Fed tightening cycle—with the real (inflation-adjusted) federal funds rate barely above zero and a bloated Fed balance sheet—it will be another indicator of just how far our economic and financial system has veered from the old "normal," reflecting the ongoing impact of unprecedented monetary policies since the financial crisis.

It's also worth noting that two days after the Fed's announcement, the 10-year Treasury yield fell to 2.44%, causing an inversion in the yield curve between the 10-year Treasury and the 3-month T-bill, which yielded 2.46%. A *persistently* inverted 10-year/3-month yield curve has been a consistent leading indicator of recession in past U.S. economic cycles, although the lead time has been variable and lengthy—anywhere from four to 16 months prior to the onset of recession. Furthermore, since 1962 the yield curve has inverted on nine separate ocassions, seven of which were followed by recession, two of which were not. So the prognosis of an imminent recession is far from certain.

Besides the indicators of a slowing economy, U.S. corporate earnings growth expectations have also continued to decline, albeit from unrealistically lofty levels last year. The chart to the right from BCA shows 2019 consensus earnings-per-share growth estimates for the S&P 500 dropping from 12% (as of 12/31/18) to just 4.1% as of mid-March. Even with the Fed now on hold, earnings growth will need to improve for stocks to appreciate meaningfully from current levels, given their sharp rebound in the first quarter and now higher valuations.

First Quarter Portfolio Performance & Key Performance Drivers

Our portfolios generated good performance for the first quarter, benefiting from the rebound in financial markets. Returns were driven by our allocations to U.S., international, and EM stocks. Our modest overweight positions in European and EM stocks were positive absolute contributors but slightly trailed U.S. stock returns.

Moving on to bond markets, our position in actively managed multi-sector bond fund generated good absolute returns in line with the overall bond market averages.

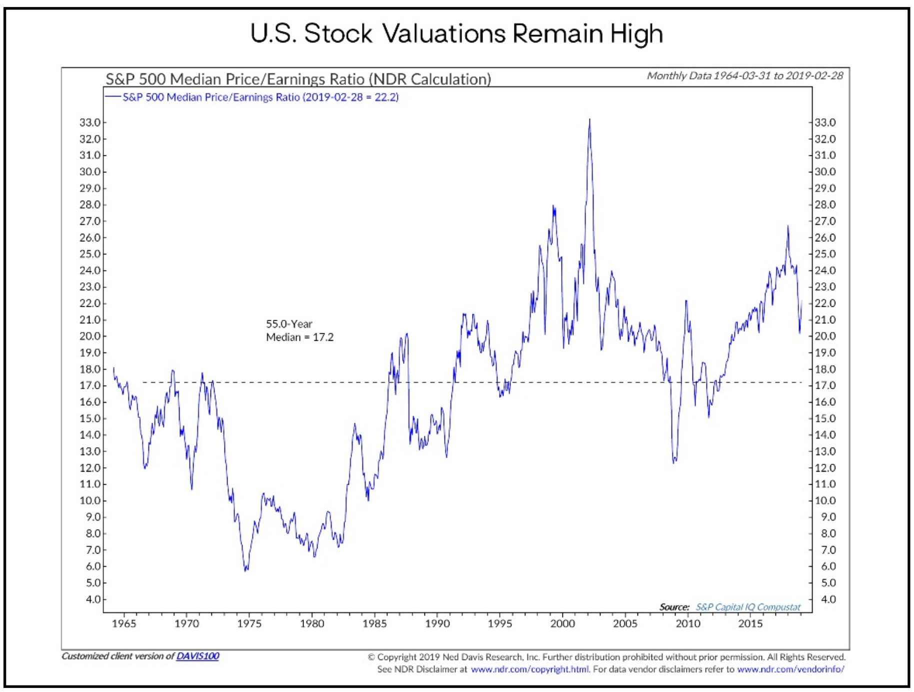
Finally, regarding alternative strategies, our allocation to lower-risk actively managed funds performed in line with expectations, earning positive returns that were better than core bonds but well below the soaring stock market. Given their lower-risk and more-defensive positioning, this was to be expected.

Market Outlook

The obvious question after experiencing such a rebound is, what's next? It's easy to be enamored with the U.S. equity market, especially when the Fed is playing its cards face up. However, the reality is the market rebound was due more to improving investor sentiment and risk appetite—caused largely by the shift in Fed monetary policy—than any meaningful improvements in underlying economic or business fundamentals.

From my vantage point, looking out over my longer-term investment horizon, seemingly little has changed after the roller coaster ride of the last six months. The first quarter of 2019 was certainly a nice respite from the losses of 2018, but I remain prepared for renewed market choppiness as the economic cycle gets later and later (and closer and closer to the inevitable downturn).

While the U.S. economy is still arguably the strongest market, growth expectations have been coming down. At its Federal Open Market Committee meeting on March 20, the Fed downgraded its median GDP growth estimate to just 2.1% for 2019 and 1.9% for 2020, citing the effects of economic slowdowns in China and Europe, fading stimulus from the 2017 Trump tax cuts, and ongoing uncertainty around Brexit and trade policy.



U.S. corporate earnings growth expectations also continue to decline. Consensus earnings-per-share growth estimates for the S&P 500 have dropped from 12% (as of 12/31/18) to just 4.1% as of mid-March. Even with the Fed now on hold, earnings growth will need to improve for stocks to appreciate meaningfully from current levels, given their sharp rebound in the first quarter and high valuations. My annualized return expectation for U.S. stocks as a whole is in the low-single-digit range over the next five years. However, my expectation for U.S. stocks with significant earnings from abroad is in the mid- to high single digit range, as I expect a resolution to trade tensions will disproportionately benefit companies doing business abroad.

On the other hand, there are a number of short-term scenarios that could see further equity gains, in particular in foreign markets. The Chinese government is once again trying to boost their economy via fiscal and monetary policy (including tax cuts, lower interest rates, and expanded bank lending). A revival in Chinese growth would have positive ripple effects across the global economy. It would benefit other emerging markets and Europe in particular, as China is a major importer of their goods. This foreign stimulus, combined with the Fed's policy U-turn, may enable equity markets to extend their positive run for another few years. This outcome would certainly benefit our portfolio positions in developed international and emerging markets.

While I'd prefer to see global growth rebound with continued strong performance, I believe it is wise to be prepared (mentally, emotionally, and financially) for shorter-term downside and negative market surprises. If and when a recessionary bear market strikes, I will look to our holdings in core bonds as well as our alternative strategies to provide ballast to our portfolios and limit the impact of equity declines.

Any prolonged downturn will also likely present me with opportunities to tactically increase exposure to riskier asset classes, such as U.S. stocks, at lower prices and higher prospective returns.

As always, I appreciate your trust and confidence in my investment discipline, and I promise to work hard every day to continue to earn it.

Best,

Kelly D. Kane, ChFC, CFP

Disclosure

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