

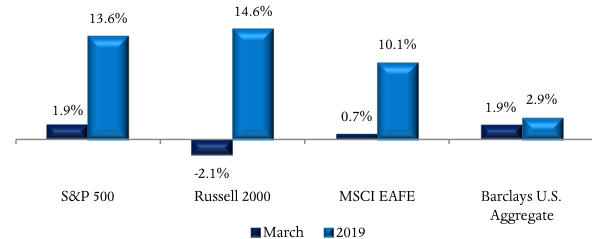


MARKETS

The first quarter of 2019 ushered in a new wave of optimism for financial markets globally. Investors cheered the potential for a resolution of the trade war between the US and China, and a dovish Federal Reserve pivot, which led to lower interest rates thanks to the prospect of continued loose monetary policy. With this backdrop, the S&P 500 index advanced +1.9% in March (+13.7% in Q1). The smaller capitalization Russell 2000 benchmark also started the year off well (+14.6% ytd), though retracing some of its gains in March (-1.9%). Overseas, the MSCI EAFE index marched higher during the first quarter, rising +10.2%. The Euro Stoxx 600 index performed strongly, adding +2.2% in March (+13.3% in Q1). In Asia, Japanese stocks were behind the curve, rising +6.9% for the quarter, while Shanghai listed Chinese equities led the pack higher, +24.0% in Q1. Lastly, the MSCI Emerging Markets index advanced by a respectable +9.9% during the quarter.

2019 has witnessed a sharp decline in global bond yields following an accommodative shift in Federal Reserve monetary policy. This trend has been exacerbated by slowing economic data, including a contraction in manufacturing orders in Germany and China. The US Treasury 10-year yield plunged -28 basis points in Q1 (to 2.41%), while the equivalent German and Japanese government bond yields turned negative for the first time in years. US credit spreads also compressed the most since the first quarter of 2012. Perhaps most importantly, the difference between the 3-month and 10-year US Treasury yields turned negative for the first time since August 2007. All but one of the previous “inversions” have been followed by a US recession.

Crude oil prices reached five month highs at the end of March, with the Brent benchmark closing the quarter at \$68.39 per barrel. A steady drop in OPEC output, which



hit a four-year low in March, has served to underpin prices. US sanctions against Iran also appear to be taking hold.

GEOPOLITICS

Britons voted to leave the European Union by 52% to 48% in 2016. In turn, British Prime Minister Theresa May gave notice of the intent to leave the bloc on March 29, 2019 under Article 50 of the EU's Lisbon Treaty. Fast forwarding to the present, PM May has failed on three occasions to pass her EU Withdrawal Agreement, forcing a delay of Brexit until at least April 12 and leading many to call for a cancellation of Article 50. An online revoke petition has garnered a record 6 million signatories (compared to 17.4 million people that voted for Brexit). Looking ahead, whether the government lurches toward a no-deal departure, calls a snap general election, works out a softer Brexit, or chooses to remain in the European Union, are all given similar credibility.

UNITED STATES

The US Federal Open Market Committee (FOMC), led by Chairman Jerome Powell, signaled that there would be no more Fed Funds interest rate increases for the foreseeable future, as well as its intention to cease quantitative tightening. Looking ahead, it seems that the Federal Reserve is poised to pre-emptively support economic activity over the coming quarters. Given the Washington policy debate concerning how to fund

higher government spending (the U.S. budget deficit is estimated to be \$1.1 trillion in FY 2020, even as revenues are expected to be the highest in US history), the topic of Modern Monetary Theory (MMT) has gained traction. MMT is a sibling to Quantitative Easing (QE) which would allow the printing of money to fund the government. In reality, the combination of QE and accelerating fiscal deficits have added more than \$10 trillion to the Federal Reserve and the Treasury's balance sheet over the past decade. While inflation has remained low, the case for fighting it does not exist, allowing for the exploration of the Treasury funding deficit spending to tackle rising wealth inequality, America's lack of universal health care, and ageing infrastructure. In the meantime, the US economy appears to be in good condition. March employment growth accelerated from a 17-month low, with the economy adding 196,000 jobs, leaving the jobless rate at 3.8%. Milder weather boosted construction and manufacturing activity, leading average wages higher by 3.2% from a year earlier. Retail sales have decelerated, but remain 2.2% higher than the year ago period. Overall, it is likely that first quarter GDP growth will approximate an annualized rate of 2.1%, indicating a stabilization following the earlier deterioration.

EUROPE

The European Central Bank (ECB) cut its 2019 Eurozone economic growth forecast to 1.1% from 1.7% last month. The slowing trend was corroborated by the manufacturing PMI declining to 47.5 and the new export orders component dropping to 44.8, both in contractionary mode. Yet, despite a weaker growth and profit outlook for the region, labor markets have held up well, with unemployment continuing to decline, to 7.8%. As expected, the ECB kept the deposit rate steady at -0.4% and said it would postpone an increase until at least next year. The central bank also announced a new round of low cost financing for the banking sector and discussed measures to reduce the drag that negative rates have had on bank profits.

The UK economy is similarly being supported by a

March 2019 Economic Statistics

	Mar-19	Dec-17	Dec-16
Federal Funds Target Rate	2.25 - 2.50%	1.25-1.50%	0.50 - 0.75%
Consumer Confidence Index	124.1	122.1	113.7
Manufacturing PMI Index	55.3%	59.7%	54.7%
Unemployment Rate	3.8%	4.1%	4.7%
JPY/USD	110.84	112.67	116.87
USD/EUR	1.1217	1.1996	1.0513
Gold/oz.	\$1,291.90	\$1,302.45	\$1,151.46
Oil (WTI)/bbl	\$60.14	\$60.42	\$53.72

strong labor market, with unemployment at 3.9% and wages rising by 3.4% over the prior year. Inventories have contributed positively to growth over the last few quarters. Presumably linked to Brexit, this trend has served to keep the economy growing despite weak consumer confidence and a contraction in business investment. Due to both Brexit uncertainty and the mixed economic data, the Bank of England remains on hold, despite rising wage pressures.

ASIA

Chinese authorities continue to stimulate domestic demand via reduced taxation (the VAT has been cut to 13% from 16%, while taxes on small enterprises have been cut up to 10%), and a 30% increase in lending to small and medium sized businesses by state owned banks. These measures should lead to a stabilization in Chinese growth, which is starting to manifest itself. China's non-manufacturing purchasing managers' index (PMI) increased to 54.8 in March, while its manufacturing PMI rebounded to slightly over 50, indicating a return to expansionary conditions. On the other hand, China's imports declined 5.2% year-over-year, in US dollar terms. From a macro-economic perspective, President Xi's government has set a GDP growth band for 2019 between 6.0% and 6.5%, with recent trends pointing to expansion of 6.2%. While growth in the world's second largest economy continues to decelerate, the absolute amount is impressive when considering its nominal GDP of \$14 trillion. It is also important to note that Chinese household consumption has been growing at an 8% annualized rate and that domestic

goods and services now account for 76% of economic growth. From a trade perspective, and the ongoing negotiations with the US, the takeaway is that China is becoming ever-less dependent on its global partners. Further, Asia now constitutes 50% of global GDP and trades more with itself than with Europe and North America.

OUTLOOK

The financial market weakness of the fourth quarter of 2018 appears to be in the process of self-correcting. Current monetary policy expectations are that the Fed won't raise interest rates again for the foreseeable future, with the next move likely to be a rate cut, implied by an inversion of the yield curve. In addition, the central bank has telegraphed that its balance sheet sales will soon come to an end. Importantly, Fed Chairman Powell has stated that he would heed signals coming from the bond markets. The Trump Administration has also taken corrective action by more constructively negotiating with China and deferring any additional increases in tariffs. Investors have applauded these market friendly actions. Ironically, the aforementioned issues were the ones that had caused stocks to correct in the first place. Looking ahead, will the Fed follow-through on its dovishness, and will the US administration continue to follow a subdued trade policy? Further, if the Fed does eventually cut interest rates, as the market now expects, will it be supported by a slowdown in growth and inflation? Or, will the central bank simply allow inflation to run above its 2% target in order to be more accommodative to financial markets?

Global economies have hit a soft patch, with the weakness most stark in the manufacturing and export sectors. Eurozone industrial production is down 2.5% since its peak in December 2017, while Korean and Taiwanese exports both declined about 8% year-over-year last month. While it is tempting to blame this global manufacturing and export slowdown on the trade war, softer Chinese domestic demand has also been a contributor. On trade, while some progress seems to have been made this quarter between the US and China, there is still uncertainty as to how the negotiations will evolve. Some of the underlying tension is unlikely to be resolved easily given that the US and Chi-

na are ultimately competing with each other in several key industries, especially technology. In addition, even if an ongoing truce can be agreed between the US and China, there is no guarantee that the US administration won't next turn towards a more confrontational trade policy with Europe and Japan.

The current environment for US equities appears to have normalized, with the S&P 500 index trading at a reasonable 16x 2019 expected earnings. For the recovery in stocks to continue, the weakness in global growth will likely have to recede, extending what is a long economic expansion by historical standards. There is also the added complication that profit margins for US corporations may be peaking. Taking the above into account, along with the near record S&P 500 index bullish sentiment (currently at 83%) it would be prudent for investors to temper expectations for outsized equity benchmark returns in the intermediate term. While indexes may not offer obvious opportunity, value oriented stock picking seems safer, with the potential for a reversion to the mean after many years of underperformance. Overseas equity markets may also offer investors above average return potential given the weakness of local currencies (versus the US Dollar) combined with lower than average valuations. Notably, the emerging market stock index trades at levels initially seen in 2010.

Given the pullback in global rates, with the 10-year US Treasury back down to 2.5%, and the German and Japanese equivalents in negative territory, we continue to lack enthusiasm for the potential returns of fixed income. Further, our analysis indicates that the narrow spreads of riskier credits are insufficient to compensate investors, especially in light of the dramatic increase in bonds outstanding and the degradation in quality over the past decade.

Given the current stage of the economic cycle, which typically ushers in periods of heightened volatility, we continue to recommend that risk-averse investors consider allocations to select alternative assets. Such alpha-seeking strategies can serve to increase a portfolio's overall diversification and resiliency, while striving for absolute positive returns.

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal