



April 2019

Market and Economic Outlook

Global Stocks Rally as Fed Changes Course, Bond Market Warns of Recession



Create Opportunities

Following a tumultuous end to 2018, stocks were up sharply in the first three months of 2019, driven in large part by the Federal Reserve's about-face regarding future rate policy.

The rally in risk assets was broad based. The large-cap tracking S&P 500 had its strongest start to a year since 1998, rising 13.7 percent. Small caps (Russell 2000) did slightly better, gaining 14.6 percent. In the continuation of a familiar theme, growth-style stocks and the technology sector led the way, with the S&P 500 tech sector up nearly 20 percent for the quarter. The interest-rate-sensitive real estate sector also saw share prices jump as rates fell, with that sector index finishing up 17.5 percent for the quarter. The energy sector, which has lagged the broad market in the last two calendar years, was buoyed by a sharp increase in oil prices and posted a return of 16.5 percent. The worst-performing sectors still had positive returns for the quarter; financials and health care were up 8.6 percent and 6.6 percent, respectively. (Bloomberg, Standard & Poor's).

| Total Returns (%) as of March 31, 2019 | | | | |
|--|----------------------------|------------------|-------|------|
| Index Name | Capital Market Segment | 1st Quarter 2019 | 2018 | 2017 |
| Bloomberg Barclays U.S. Aggregate Bond | U.S. Broad Market Bonds | 2.9 | 0.0 | 3.5 |
| S&P 500 | U.S. Large Cap | 13.7 | -4.4 | 21.8 |
| Russell 2000 | U.S. Small Cap | 14.6 | -11.0 | 14.7 |
| MSCI EAFE | Non-U.S. Developed Markets | 10.0 | -13.8 | 25.0 |
| MSCI EM | Emerging Markets | 9.9 | -14.6 | 37.3 |
| Hypothetical 60/40 Portfolio* | Diversified Mix of Indexes | 8.7 | -5.1 | 15.3 |

* 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM

An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

Source: Morningstar

Global markets continue growth

In non-U.S. stocks, the major indices for developed (MSCI EAFE) and emerging economies (MSCI EM) were both up approximately 10 percent. Japan, which comprises nearly one quarter of the MSCI EAFE index, returned 7.95 percent in dollar terms (iShares ETF [symbol EWJ]). The second largest market in the developed market index, the United Kingdom, returned 12.47 percent in dollar terms (iShares ETF [symbol EWU]).

Bond returns up, yields down

Bonds posted positive returns in the first quarter, with yields falling rather dramatically. The bellwether 10-year Treasury was priced to yield 2.41 percent at the end of the quarter, 28 basis points (or 0.28 percent) lower than the beginning of the year, and more than 80 basis points lower than in October 2018. Meanwhile, investment-grade corporate bonds finished the quarter with a yield of 3.68 percent, or 58 basis points lower than the beginning of the year (ICE Bank of America Merrill Lynch Investment Grade Bond Index via Bloomberg).

The total return (which includes the price changes of the bonds plus interest) for the broad, taxable U.S. bond market was 2.94 percent for the quarter. Tax-exempt municipal bonds posted a return of 2.9 percent.

Global bonds yields also fell. The yield of the 10-year German *bund* closed the quarter with a yield of minus seven basis points (-0.07 percent). That's not a misprint. Germany joined the likes of Japan and Switzerland, whose 10-year government bonds now yield less than zero.

Basis points explained

Like any profession, finance has many terms and phrases that have specialized meanings. "Basis points" is one such term. We use it so reflexively that we sometimes forget that others may be a bit bewildered by it. Once you get the hang of it, you will see that it's a very easy and unambiguous way to talk about percentages.

1 basis point = 1/100th of one percent

| Basis Points | Percentage Terms |
|--------------|------------------|
| 1 | 0.01% |
| 10 | 0.10% |
| 33 | 0.33% |
| 50 | 0.50% |
| 100 | 1.00% |

Example: Say the yield of some bond went up from 1.42 percent to 1.69 percent. How much did the yield go up? The answer is 27 basis points, an easier and clearer way of saying 0.27 percent.

Another way to underscore how the first quarter of 2019 was a “risk on” period: high yield (a.k.a. “junk”) bonds returned 7.26 percent and emerging markets bonds 6.59 percent. (Indices via Morningstar: Bloomberg Barclays U.S. Aggregate, Bloomberg Barclays Municipal, Bloomberg Barclays U.S. Corporate High Yield, and JP Morgan Emerging Market Bond Index Global).

Fed halts rate increases ... for now

The Federal Reserve (known as the Fed, which is the U.S. central bank), has played a crucial part in the story of the capital markets so far this year. Prior to this quarter, the Fed implied it was on a steady course of rate increases and [balance sheet reduction](#) (via quantitative tapering).

Interest rate policy: hawkish vs. dovish

The financial media often uses the terms hawkish and dovish as short-hand for the Fed’s general outlook and interest-rate policy stance. Here is a simplified guide:

Hawkish — Inclined to raise interest rates. This is generally due to concerns over higher inflation and the economy “over-heating.” A hawkish central bank will implement rate hikes as a way to tame inflation.

Dovish — Inclined to lower interest rates. A dovish central bank will see lower rates as a way to stimulate an economy that is in danger of stalling or contracting due to deflation (the opposite problem of inflation).

But after its meeting in January, the Fed announced that “the case for raising rates has weakened,” signaling that rate hikes would be put on hold. Jerome Powell, the Fed chair, pointed to growing global risks, a potentially slowing U.S. economy, and subdued inflation.

The Fed’s switching to a more dovish stance is generally seen as a major positive for risk assets such as stocks, and the market responded accordingly in the first quarter. Some have viewed this move as yet another manifestation of the “Fed put,” a term invoked to describe how the central bank will “backstop” the stock market by lowering rates — which adds monetary liquidity to the

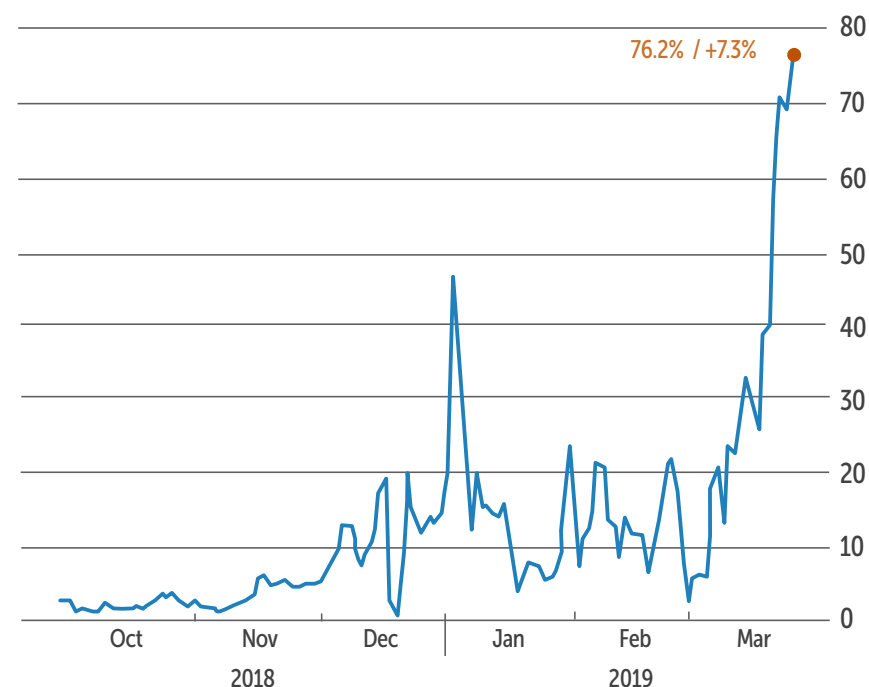
economy and increases investor appetite for risk-taking by lowering the relative appeal of “safe” assets like Treasuries and bank deposits.

Critics of the “Fed put” say that this approach distorts market prices and leads to asset bubbles (which eventually burst, as all bubbles must, e.g., internet stocks in late 1990s and housing in the early to mid-2000s).

Others say the Fed is simply reacting appropriately to changing market and economic conditions. Rick Rieder, chief investment officer of fixed income at BlackRock, the world’s largest asset manager, asserts that the Fed’s pivot to a “paradigm of patience” is right on the mark. His view is that tepid global growth, in addition to the deflationary forces of aging demographics and technological innovation, means that central banks need not be concerned with inflation.

Some market analysts agree that the Fed is doing a pretty good job navigating the difficult waters of a late-cycle economy. In addition, the corporate sector generally has confidence in the Fed’s leadership. A global survey of corporate CFOs showed an 80 percent approval rating for the Fed (November 2018, CNBC Global CFO Survey). Regardless of your opinion of the Fed, its current policy stance is favorable for the stock market.

Market-Based Probability of a Fed Rate Cut in 2019



Source: Bloomberg

Bond yield curve signals “recession”

The U.S. Treasury curve inverted (i.e., the yield of the Treasury bond maturing in 10 years fell below that of three-month T-bill) on March 22. This rightfully created a lot of buzz, as yield curve inversions have been predictive of recessions. The last nine recessions were all preceded by an inverted yield curve, with an average lead time of 14 months.

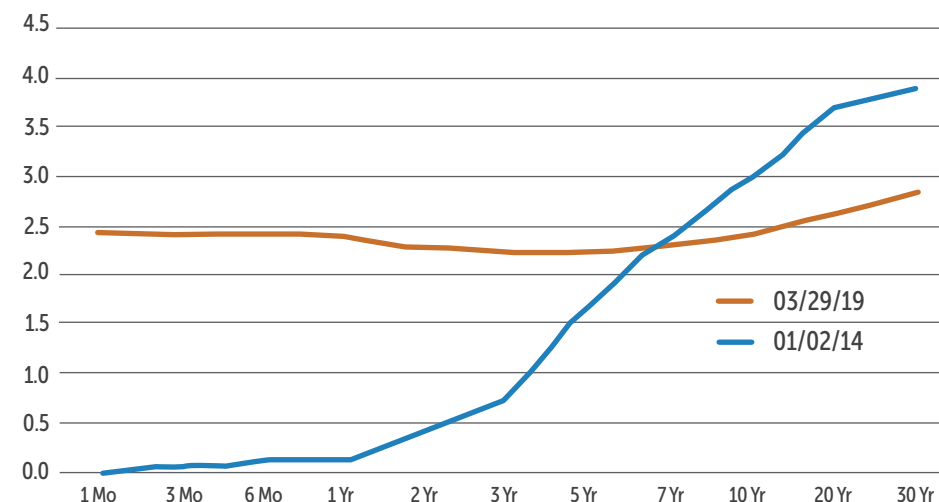
| Date of Yield Curve Inversion | Lead Time (Months) to Recession | Recession Dates |
|-------------------------------|---------------------------------|-------------------------------|
| January 2006 | 23 | December 2007 – June 2009 |
| April 2000 | 11 | March 2001 – November 2001 |
| February 1989 | 17 | July 1990 – March 1991 |
| September 1980 | 10 | July 1981 – November 1982 |
| September 1978 | 16 | January 1980 – July 1980 |
| March 1973 | 8 | November 1973 – March 1975 |
| December 1967 | 24 | December 1969 – November 1970 |
| September 1959 | 7 | April 1960 – February 1961 |
| December 1956 | 8 | August 1957 – April 1958 |
| Average | 14 | |

Sources: National Bureau of Economic Research, St. Louis Federal Reserve

Before we go any further on the inversion signal, let’s define the terms. The “yield curve” refers to a graph of the current yields for bonds of varying maturities. The U.S. Treasury issues bonds ranging in maturity from one month to 30 years. Most of the time, bonds of longer maturities will have higher yields. We refer to this difference in yield (a.k.a. spread) between longer and shorter maturities as the “term premium.” This is intuitive, as you would expect to receive a higher yield as compensation for the risk associated with having to wait longer for a bond to mature and pay you back the principal.

So what does it all mean?

Treasury Yield Curve



Source: U.S. Department of Treasury

Occasionally, the curve takes on a different shape. We currently find ourselves at one of these unusual moments. In the graph above, we have plotted two yield curves. The blue line is a snapshot of the U.S. Treasury curve at the beginning of 2014. This was a “normal” yield curve as it slopes up (i.e., the yields are higher as you go further out on the curve). Today’s curve (as of the end of the quarter), is depicted by the orange line. We currently have a “flat” curve, and it’s also inverted, with the 10-year yield below the three-month. This comparison also highlights how much rates on the short end of the curve have risen, while yields have fallen on the long end.

So what does it all mean?

The data show that recessions have been preceded by inversions, but with a substantive amount of lead time. In this way, inversions are of little use in terms of timing the market (which, as we've consistently written, is a fool's errand, anyway). Also, the signal is not perfect. For example, no recession followed the curve inversion of December 1965 to February 1967 (Pension Partners). Some analysts, including the Leuthold Group, note that the current inversion differs from previous ones in one important way: The economy is receiving fiscal stimulus through tax cuts. As this was not the case previously, it may be the case that the boost from tax cuts can override the recessionary forces.

Tracking manufacturing using PMI

Manufacturing is vital to the economy. The PMI® (formerly called Purchasing Managers' Index, but now used as a stand-alone acronym) is a gauge of business confidence and the relative health of the manufacturing sector. The PMI is compiled and released by the Institute for Supply Management, which surveys senior decision-makers at more than 400 companies. A firm called IHS Markit Group provides similar measures for various countries outside of the United States.

Why is the PMI important? Manufacturing is generally regarded by economists and market analysts as a leading indicator. As such, the monthly PMI reading — both its trend and level — is viewed as providing clues to where the U.S. economy is headed.

Below is a long-term chart of PMI, along with a smaller window in the upper right focusing on just the previous 12 months. To interpret this index, you need to know two generally accepted key PMI levels:

- **50** — A reading above this level is seen as indicating expansion of the manufacturing sector, while sub-50 indicates contraction.
- **43.2** — A reading above this specific level is deemed to show expansion of the broad U.S. economy, and sub-43.2 indicates contraction.

The last sub-43.2 reading occurred in June 2009. As of March 2019, this means the overall U.S. economy has expanded for 119 consecutive months, an extraordinarily long stretch.

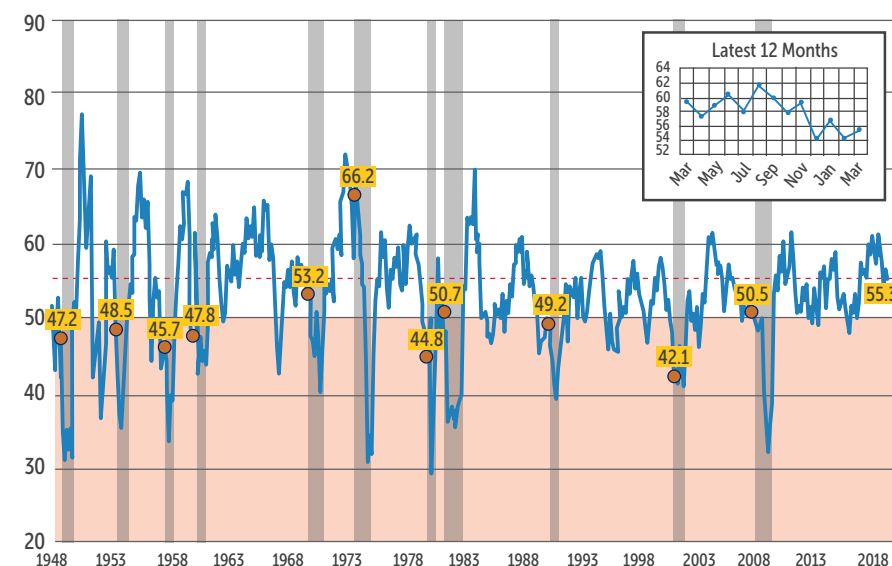
In regards to the chart below, we would make a few observations:

- Although the March reading (55.3) came in above consensus expectations and showed an increase over February (which was the lowest point in two years), the trend over the last year has been down.
- The index remains solidly above the manufacturing sector "growth level" of 50. In addition, the current reading, based on historical precedent, would indicate that a recession is not imminent. On the chart below, the PMI reading for the month preceding a recession is shown as a red dot. Of the 11 red dots on this long-term chart, nearly all of them — with just one exception — are at PMI levels lower than where we are currently.

PMI Composite Index

Monthly series with recessions highlighted

Data through March 2019



Dashed line shows the current level, dots highlight the month before a recession.

Source: Institute for Supply Management and Advisor Perspectives (dshort.com)

Manufacturing jobs have increased the last 10 years

U.S. manufacturing employment has grown steadily since the Great Financial Crisis. At its post-crisis nadir, the manufacturing sector employed 11.4 million Americans, while the latest reading is at 12.8 million. As a marker of how automation and a more globally-interconnected economy have caused changes, this latest head count is far below the late 1970s peak, when nearly 20 million held manufacturing jobs. (U.S. Bureau of Labor Statistics).

[Erik Skie](#), a principal in the [manufacturing and distribution](#) industry for CLA, said that while overall employment in manufacturing has fallen in recent decades, the United States has been a leader in productivity gains over the same period.

“Increases in productivity have reduced the base employment required to generate the same level of manufacturing output and helped the American companies maintain their competitiveness during the expansion of global manufacturing capabilities,” Skie said. He added that U.S. manufacturing is also facing one of its most stringent labor markets in history. Coupled with some of the highest job opening levels, this has led to strains on the industry and complicated the growth trajectory.

Survey shows growth and optimism in manufacturing

Contrasting with PMI and other indicators, a recent survey of CLA manufacturing and distribution clients found that the vast majority of respondents are optimistic about the future. Most say they are turning a profit, with many logging growth of 10 percent or more in 2018. The majority (78 percent) report that they also increased revenue in 2018. Nearly half of the companies surveyed said they will expand internationally in the next two years due to internal and external requirements.

“The optimism within our client base largely reflects what many industry observers believe — that trade uncertainty and the currently threatened tariffs are a temporary challenge and one that will resolve itself with time,” Skie said.

He said current trade policy and tariff negotiations have created some uncertainty in manufacturing that can be seen in some of the recent softness in the PMI data. In addition, there is a belief that some of the increased capital spending expected from tax reform has been dampened due to this uncertainty.

If some trade certainty can arise from the current negotiations, primarily with China, this could serve as a strong catalyst for growth in the back half of 2019, Skie said.

Until then, he said companies can be expected to remain conservative with spending due to increased cash flow requirements. This is due to increased pricing of materials and many companies making the decision to carry additional inventory due to uncertainty around availability of materials and increased lead times.

With the multiple levers available for U.S. manufacturers to pull, is it expected that innovation will continue to drive growth for U.S. manufacturers in 2019.

Global manufacturing shows signs of slowing

Some important non-U.S. economies have seen significantly lower industrial output. Germany’s manufacturing sector is in recession. Per the latest report from IHS Markit, Germany’s PMI is at an 80-month low and well below the important 50 level. The charts for other major eurozone markets, such as Spain, Italy, and France, are trending similarly to Germany.

An interesting exception here is the United Kingdom, where output has increased in recent months. Concerns over [Brexit](#) have caused a short-term spike in the U.K.’s PMI, as customers build stocks as a pre-emptive move against Brexit being fulfilled. As we’ve written in the past, Brexit — the ultimate fate of which remains uncertain as of this writing — has major implications for the U.K., and by extension, the global economy.

German Manufacturing PMI

Seasonally adjusted



Source: IHS Markit

Let's not lose sight of the U.S. economy's strong tailwinds

As the extremely long-lived bull market continues, it may be easy to focus on the headwinds that threatened to stall market and economic advances. It may, therefore, be appropriate to mention just some of the tailwinds that are helping to push things along.

A strong jobs market and continued historically low unemployment, combined with tax cuts, provide a boost to consumer spending, which is the primary engine of the U.S. economy. Corporate tax reforms should also support continued business investment. Lower interest rates have aided the [housing market](#), which had recently started to slow.

Extending the sailing analogy to its logical conclusion, we would say that the tailwinds and headwinds combine to create unpredictable cross current, along with occasional squalls and dangerous storms. Although no one can predict the future, we can and do apply our knowledge and experience to help investors safely reach their destination.

CliftonLarsonAllen Wealth Advisors, LLC
Investment Committee
connect@CLAconnect.com

Tax Information

Find these topics of interest at CLAconnect.com/tax:

- [Opportunity Zones Resource Center](#)
- [The R&D Credit Can Help You Save on Taxes \[Video\]](#)
- [Your Business and Individual Tax Rates for 2019](#)

CliftonLarsonAllen Wealth Advisors, LLC ("CLA Wealth Advisors")

The purpose of this publication is purely educational and informational. It is not intended to promote any product or service and should not be relied on for accounting, legal, tax, or investment advice. The views expressed are those of CLA Wealth Advisors. They are subject to change at any time. Past performance does not imply or guarantee future results. Investing entails risks, including possible loss of principal. Diversification cannot assure a profit or guarantee against a loss. Investing involves other forms of risk that are not described here. For that reason, you should contact an investment professional before acting on any information in this publication.

Financial information is from third party sources. Such information is believed to be reliable but is not verified or guaranteed. Performances from any indices in this report are presented without factoring fees or charges, and are provided for reference and competitive purposes only. Any fees, charges, or holdings different than the indices will effect individual results. Indexes are unmanaged; one cannot invest directly into an index. Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.

Prior approval is required for further distribution of this material.





CLAAconnect.com

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.

