

INVESTMENT OUTLOOK

A QUADRANT CAPITAL MANAGEMENT PUBLICATION

FIRST QUARTER 2019: MARKETS SPARK JOY

And the day came when the risk to remain tight in a bud was more painful than the risk it took to blossom.
-Anais Nin

In March, we observed Women's History Month, commemorating and encouraging the study, observance and celebration of the vital role of women in American history. 2019 represents the 99th anniversary of women's suffrage in the US. In recognition thereof, we'd like to introduce you to some prominent women in the investment world, including Tina and Goldilocks.



But first, Marie. The whole world, it seems, has embraced Marie Kondo. All around the globe, people are emptying their closets, discarding the unloved and unused, and retaining only those items that spark joy.

During the fourth quarter 2018 market rout, investors decluttered their investment closets. But investors were perhaps not as thoughtful as people tidying up their homes. In a flurry of tax loss selling, algorithmically driven trading, hedge fund liquidations, and passive investment divestments, investors sold securities indiscriminately, including those that previously had sparked joy—the Netflixes and Teslas and Amazons in their investment wardrobes.

And yet, what a difference a quarter makes. Excess worry gave way to excess relief. In the new year, investors found joy blossoming in all assets, all around the globe.

Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	13.7%
US Small Cap Stocks	Russell 2000	14.6%
International Developed Markets	MSCI EAFE	10.0%
Emerging Markets	MSCI EM	9.9%
Real Estate	MSCI US Real Estate	16.3%
Commodities	Bloomberg Commodity	5.7%
Bonds	Bloomberg Barclays Aggregate	2.9%
Cash	FTSE 3-month UST Bill	0.6%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, MARKETWATCH.COM

Domestic stocks—both large and small cap—generated double digit returns. But so did international stocks—both developed and emerging markets rose about 10%. Real estate did even better, levitating 16%. Bonds turned in a very respectable quarter as well, up about 3% for the first three months of the year. Last year's best performing asset class, cash, took up the rear in the first quarter.

Pretty neat. Marie must be smiling and giving thanks as she folds her statement and tucks it neatly into its first quarter box.

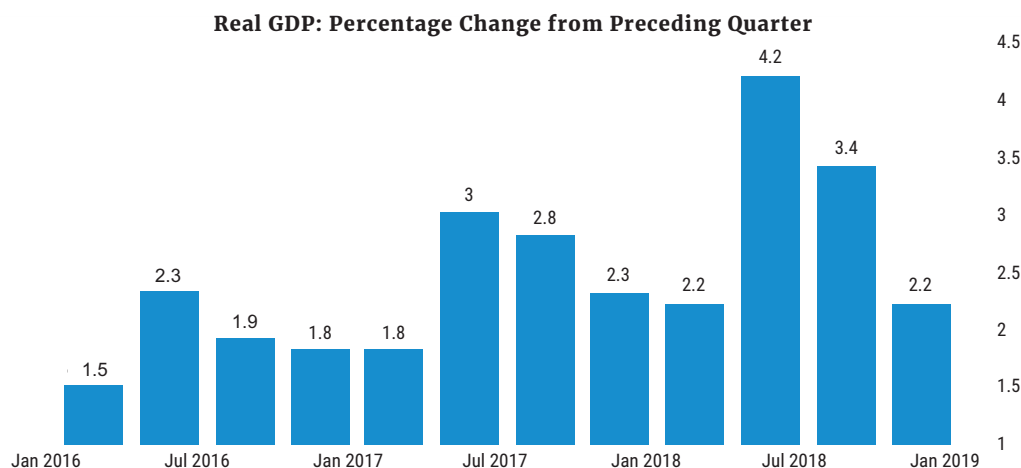
NOT TOO HOT AND NOT TOO COLD: THE RETURN OF THE GOLDILOCKS ECONOMY?

*I want people to walk around delusional about how great they can be—
and then to fight so hard for it every day that the lie becomes the truth.*

-Lady Gaga

Self-actualization through belief may be possible in human development, but it doesn't provide much of a road map for steering the economy. Wishing for economic robustness does not make it happen.

The US economy experienced growth acceleration in 2018, as the Tax Cut and Jobs Act provided fiscal stimulus from lower tax rates and immediate expensing of capital investments. Higher government spending also provided stimulus, and ongoing private sector labor strength contributed as well to robust growth of 3% for the year.



SOURCE: TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

GDP growth peaked at 4.2% in the second quarter, but the subsequent trend is somewhat concerning, as annualized growth fell by half from the second to the fourth quarter. Further, the Atlanta Fed estimates that the just-ended first quarter of 2019 saw GDP growth of 1.7%. (Seasonal adjustment issues, weather, and the government shutdown may have contributed to this weakness.) While the Administration maintains that 3% annual GDP is sustainable for years to come, most private economists forecast the economy returning to 2% trend growth in 2019.

Today, data are somewhat mixed for the economy. The brightest numbers come out of the labor market, where new job creation continues at an average pace of 200,000 new jobs each month, and wage growth climbed 3.1% over the past year.

Consumer spending appears adequate though hardly buoyant, rising 2.1% year over year. Manufacturing activity growth has cooled, as slower global growth and trade disputes have muted foreign demand for US goods. Business sentiment is somewhat cautious, as companies defer capital investment in the face of trade and economic uncertainty. Inflation is well contained, with the Fed's preferred measure—Personal Consumption Expenditures—rising only 1.8% at an annual rate.

Taken all together, the picture that emerges is one that suggests that the economy, like Baby Bear's porridge, is just right—not too hot to generate inflation, and not too cool to cause job losses. Goldilocks, spoon raised in anticipation, can dig in with gusto.

INTEREST RATES AND A MAN'S RIGHT TO CHANGE HIS MIND

If you're not making mistakes, then you're not making decisions.
-Catherine Cook

The Fed raised interest rates four times last year, and communicated its intent to continue to lift—indeed, to “normalize”—rates. In addition, it continued its policy of allowing bonds on its balance sheet to mature without reinvesting the proceeds. These actions, along with hawkish jawboning, spooked markets as investors grew concerned that tighter financial conditions could slow the economy and choke off the extended expansionary business cycle. Slower growth internationally added to investors' concerns.

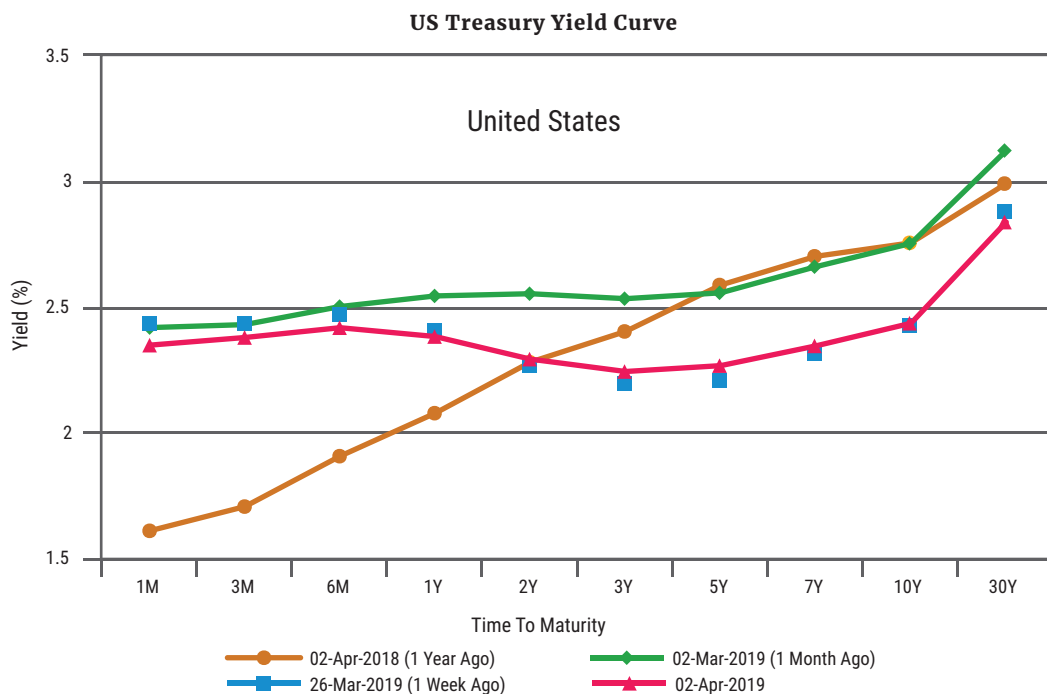
Bond investors followed the Fed in pushing up rates, with the 10-year US Treasury note reaching a yield of 3.23%. President Trump publicly excoriated Fed chair Jay Powell for the Fed's interest rate policy. Softer international economic data emerged. Markets rebelled. The lagged effects of multiple rate increases made themselves felt in higher mortgage rates and falling real estate sales.

Some combination of these factors—we leave it to you, dear reader, to determine which were the most influential—induced the Fed to reverse course. Hawks metamorphosed into doves, as the Fed embraced the virtue of patience in contemplating future rate increases and provided a timetable for ending the shrinkage of its balance sheet. Perhaps that's what passes for the Fed admitting to a mistake.

The bond market got the message. The Fed is now on hold. The European Central Bank deferred its own policy tightening moves. Rates fell sharply, with the 10-year US Treasury yield dropping to 2.40%. Shorter term rates fell as well.

The yield curve for US government securities is charted below. The yield curve represents interest rates for maturities from one month to 30 years. We highlight two issues. The yellow-orange line is the yield curve from one year ago. Note that it slopes upward from the lower left to the upper right. This is as we would expect—the longer you lend money to the US government, the higher the interest rate you receive.

Now look at the red line, which represents the US government yield curve as of the end of the first quarter 2019. Observe that interest rates for one, two, three, five and seven years are lower than for one, three, and six months. This phenomenon, known as an inverted yield curve, is closely followed by financial market participants because it is often viewed as a signal that a recession is coming.



While most economic data do not support a recession forecast, markets sometimes prove prescient. So the question arises: is the bond market preparing us for a downturn?

We are loath to dismiss the message of the market, and the lessons of history. That said, it must be acknowledged that in the post-global financial crisis world, central banks have intervened in fixed income markets to an unprecedented extent. In doing so, they create noise that overwhelms signal. Techniques such as quantitative easing (central banks' purchases of bonds) and Operation Twist (the sale of short term Treasury bills to buy long term Treasury notes) have created distortions that diminish the clarity and credibility of this market indicator. With the Conference Board's index of Leading Economic Indicators up 0.2% in its most recent reading, we—Fed-like—patiently await further economic data points before making an actionable recession call.

RISK ON: INVESTORS DO THE HOKEY POKEY AND TURN THEMSELVES ABOUT

You can't be that kid standing at the top of the waterslide, overthinking it. You have to go down the chute.

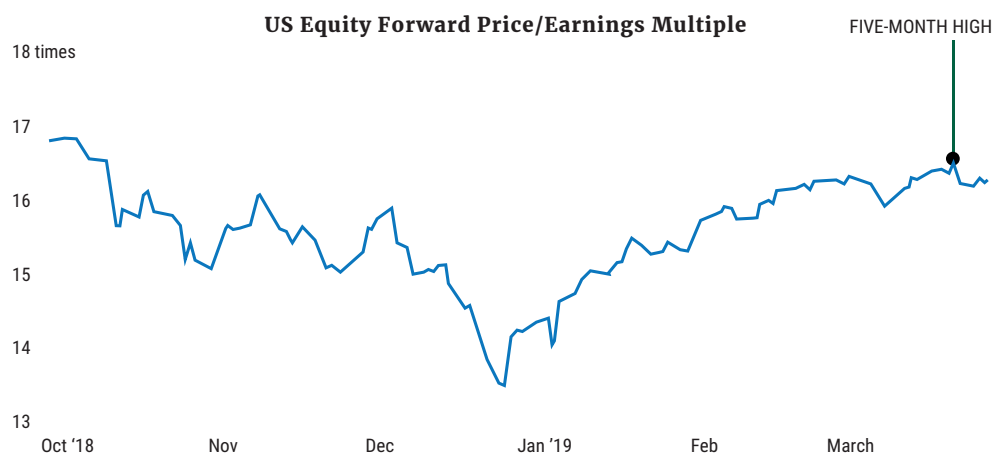
-Tina Fey

The bond market offered another message as well. And that message is that investors who lost their nerve in last year's fourth quarter found it again in the first quarter. Credit spreads—the extra yield above US Treasury rates investors demand for lending to companies—fell sharply in the first quarter. Investment grade spreads fell 34 basis points, and riskier high yield spreads fell by an impressive 124 basis points. Despite the elevated recession watch stemming from the inverted yield curve, bond market investors decided that defaults were unlikely and sought the higher interest available on corporate debt instruments.

If bond investors shouted, "Game on!" in the first quarter, equity investors out-shouted them. This new-found risk appetite manifested itself in the Initial Public Offering market, which saw successful offerings from the venerable jeans maker Levi's and the new economy ride-sharing company Lyft. Investors were willing to lift the value of an app-based company to \$25 billion, notwithstanding a loss of \$921 million last year on revenues of \$2.2 billion. (In other words, Lyft loses money on every ride but is trying to make it up on volume.)

Equity investors exited 2018 worried about the outlook for corporate earnings. Analysts steadily ratcheted down earnings expectations. Other things being equal—and they rarely are—we would expect stock prices to follow earnings expectations. And that's what happened in market correction of late last year.

Earnings expectations have not risen this year, yet—counter-intuitively—stock prices rocketed up. To explain the disconnect, we need to re-introduce Tina. We first met Tina when the Fed dropped interest rates to zero. With *de minimis* interest income from high quality bonds, returns-seeking investors had no choice but to shift to equities—thus we came to know There Is No Alternative (TINA) to stocks. In a world in which safer investments offer paltry returns, investors are willing to—indeed, must—pay up for those assets that offer more upside potential.



There are, basically, two drivers for higher stock prices: higher earnings, and a higher multiple paid for those earnings. When TINA shows up, higher multiples are paid. As the year began, stocks were trading for about 14 times estimated 2019 earnings. Exiting the first quarter, stocks are trading at about 16.5 times earnings. TINA is back, and maybe bigger than ever; she's alive and well and living at the New York Stock Exchange.

CASSANDRA IN THE HOUSE: CAUTION IS THE WATCHWORD

Though it is right to be prepared for the worst, there is no occasion to look on it as certain.

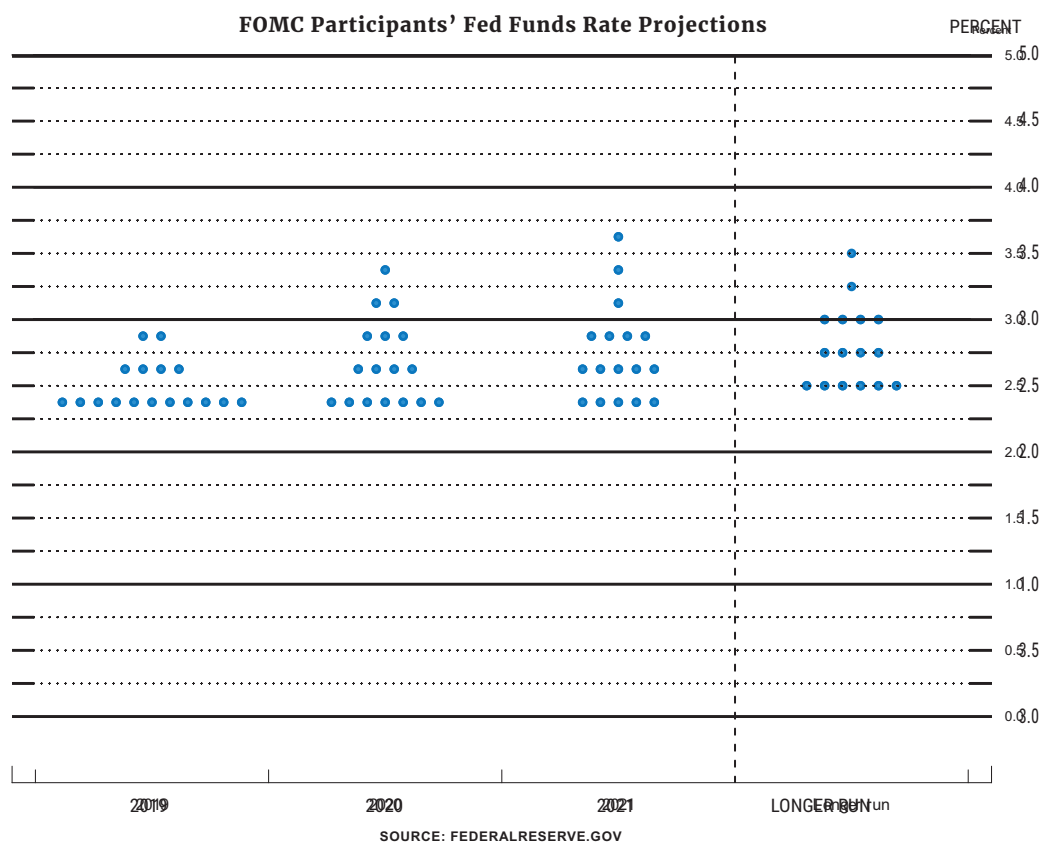
-Jane Austen

According to Homer, Cassandra was granted the gift of prophecy by Apollo but, refusing his advances, was doomed to having her prophecies not be believed. (Greek mythology is rife with #MeToo moments.)



While we lack Cassie's ability to see into the future, we risk being believed—at least insofar as structuring portfolios is concerned—and that inspires a duty of extra care in setting investment strategy.

The Fed continues to be the elephant in the room, and it seems uncontroversial to suggest that the interest rate outlook is stable. The chart below is known to Federal Open Market Committee ("FOMC") observers as the "dot plot"—it displays FOMC members' estimates of future Fed funds rate levels. What is readily apparent is that projections of interest rates show very little expected change for the next couple of years. It will take persuasive evidence that the economy is either slowing or accelerating materially to deter the FOMC from this steady interest rate policy. Any such data are unlikely to materialize before the second half of the year, at the earliest.



Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

A quiescent Fed may give a veneer of stability to financial markets, but risks abound, nonetheless. Internationally, Brexit remains devilishly difficult to accomplish, the Chinese economy is seeing slower growth, global trade disputes remain unresolved, Venezuela is imploding, and terrorist attacks are a constant threat. Domestically, important policy issues such as health care, immigration, infrastructure and other budget priorities go unaddressed in a climate of heightened political division.

Investment strategists are congenitally prone to be cautiously optimistic. At this juncture, with markets having raced ahead in the first quarter on slender economic footing, we are inclined to be simply cautious. Not cowering in the bunker, but a touch circumspect.

For equities, this means two things. One is not to get too far over one's skis: it remains prudent to rebalance portfolios, not to exceed one's risk tolerance and targeted equity exposure levels, to capture and keep profits. The second is to reiterate our belief that an all-weather portfolio should focus on high quality companies. High quality is both quantitative and qualitative. Quantitatively, high quality companies earn high and sustained returns on capital, generate free cash flow, maintain strong balance sheets, and focus on margin improvement. Qualitatively, high quality companies exhibit durable competitive advantages and strong shareholder-oriented managements.

For bonds, this also means a focus on high quality issuers. It is late in the business cycle, and investors are in our estimation inadequately compensated for taking higher risks in fixed income markets. At the same time, a Fed on hold has provided cover for investors to modestly extend duration.

This is how we stay prepared for the worst without acting—and investing—as if that's our base case. Markets will wax and wane, and we construct portfolios with a view to withstanding such vicissitudes. Lest that sound gloomier than we would intend, we pass along additional words of wisdom from another witty woman. Dolly Parton tells us, "The way I see it, if you want the rainbow, you gotta put up with the rain." As portfolio managers, we see it that way, too. After all, it is the rainbow that sparks joy.



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