Legacy Trust

Investment Perspectives

A Strong Start to the Year

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Key Takeaways

- As anticipated, the sharp market selloff in Q4 was short-lived and stocks bounced back in the first quarter
- The Fed backed off on additional interest rate hikes and the potential for a trade deal between the U.S. and China has improved
- Economic growth is showing signs of slowing, particularly in Europe; China appears to be stabilizing and the U.S. remains strong
- Fundamental conditions are still supportive for equities and we do not see a recession on the horizon

March brought a continuation of the market rally that began in the final trading days of 2018, and global equities closed out the first quarter of 2019 with double-digit gains from almost all market segments. In a reversal of the negative investor sentiment that drove risk assets sharply lower in Q4, signs of progress on a trade deal as well as a pivot by the Federal Reserve toward a more dovish posture helped give stocks a boost. Bonds and real assets also got a lift as interest rates fell.

A key driver of the fourth quarter market selloff was concern over the pace of the Federal Reserve's interest rate hikes. The Fed, which has been in a tightening posture for several years, implemented four rate increases in 2018 and as recently as December indicated that more hikes were expected this year given the broad health of the U.S. economy.

However, the U.S. has fallen short of the Fed's inflation target and the global economy is showing signs of a slowdown in growth. In response to shifting conditions, the Fed's posture changed meaningfully in the early weeks of 2019 as they voiced a more cautious outlook and emphasized that they would be "patient" in their approach to additional rate hikes. In response, markets today are pricing in a higher probability of a rate cut than a hike as the Fed's next move. This dynamic has been a key driver of market gains so far in 2019.

Market sentiment also shifted significantly on the outlook for a potential U.S.-China trade deal, which appeared to be a long-shot in the fourth quarter but has since gained momentum. It seems to be clear that both sides want to reach an agreement and reports on ongoing negotiations have been much more positive than they were last year. Equities have rallied on these developments and appear to already be pricing in the expectation that a deal will be reached. Emerging market equities in particular have benefitted from this optimism.

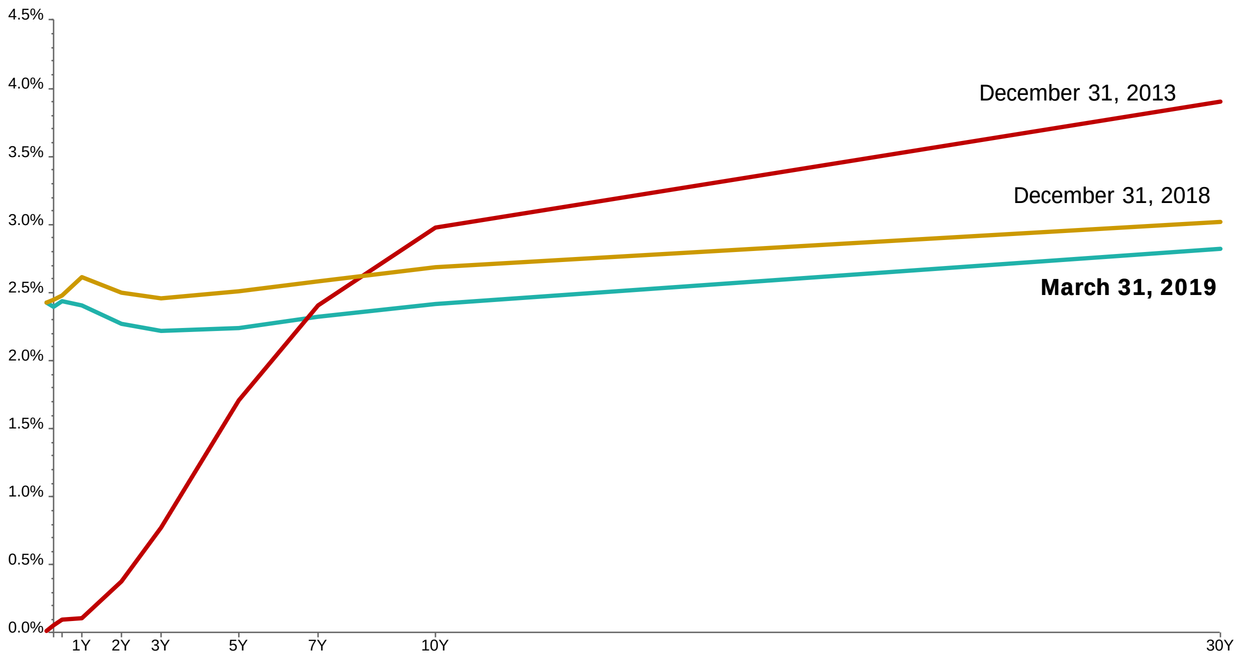
Global equities gained 12% in the first quarter, with U.S. small- and mid-cap stocks leading the pack. With the temporary effects of last year's tax reform package fading and the economy expected to slow (albeit remain in expansion), this year will likely be a more modest one for corporate earnings growth. We continue to see opportunities in sectors and companies that will benefit from a still-solid American economy and remain underweight to international developed market equities in exchange for a higher weight to the U.S.

Fixed income investments, which were largely flat to negative last year due to rising interest rates, have also benefitted from the changing market conditions. Core U.S. fixed income gained 3% in the first quarter as rates fell after the Fed's positioning shifted. The more opportunistic segments of the bond market, such as high yield and emerging market debt, also booked solid gains.

We continue to favor high quality core fixed income as a key stabilizer of a balanced portfolio. Opportunistic fixed income can be helpful to boost yield and diversify, but it should be employed carefully as it will behave more like an equity investment during a strong market sell-off as it did in Q4. Active managers can help to mitigate that risk through strategic portfolio positioning and responding to the changing market conditions.

Looking ahead, fundamentals are supportive and markets do not appear broadly overstretched. As we are in the late stages of the economic cycle after ten years of expansion, we will be vigilant for signs that the outlook is shifting but for now we remain cautiously optimistic looking forward.

United States Treasury Yield Curve



Source: FactSet Research Systems