1st Quarter 2019: Quarterly Recap and Near-term Outlook

When wrapping up last quarter's *Near-term Outlook*, I talked about my unwillingness to abandon the continued global growth thesis. Although signs of slowing rates of growth surround us, aside from a few markets, there remain no signs that long-run up-trends will imminently reverse. A slower rate of growth is still growth, after all, so we remain positioned to capture as much up-side potential as is efficiently possible.

Time In

The Market

Beats

Timing

The Market

Attempting to time a turn in the economic cycle, as with markets, is folly. Our commitment to the growth thesis, despite recent growth-scares, benefited client accounts, as the U.S. stock market snapped back from 2018's losses to post strong gains during Q1. By the end of Q1, we were within striking distance of retaking the market levels lost during Q4 2018.

As measured by the Russell 3000 Index, after falling by 14.30% in Q4 2018, the Russell 3000 Index climbed 14.04% during Q1 2019. Striking distance, indeed. The Russell 3000 Index is a market-cap weighted measure of the largest 3,000 U.S. companies, and a proxy for the complete U.S. stock universe.

Nearly all investment styles, industry sectors, and company sizes within the U.S. market increased. In general, growth-oriented strategies beat value-oriented strategies, cyclical sectors outpaced defensive sectors, and small-company stocks beat large-company stocks.

International equity markets performed similarly, posting strong gains during Q1, following a year in which the divergence in returns between foreign markets and the U.S. market reached nearly historical levels. Both foreign developed and foreign emerging markets had strong positive returns, but both did lag slightly total U.S. returns.

Despite strong equity returns, it was bond markets that received most media attention during Q1. Following the Federal Reserve's December 2018 increase in short-term interest rates, longer-term rates fell across the globe in response to continued investor worries about slowing global growth. Long-term interest rates fell below zero in major international economies such as Germany and Japan, to the lowest levels since 2016. In the U.S., the yield on the 10-year Treasury bond fell below the yield on the 3-month Treasury bill, resulting in a yield curve inversion, often taken as an indicator of coming recession.

While yield curve inversion has often preceded downturns in an economy, it does not alone mean a recession is imminent. An inversion, however, does signal that bond investors anticipate a reversal in the Fed's recent path, and does forecast rising rates in the future. But for now, the resulting lower interest rates have supported rising stock prices. As bond prices are inversely related to bond yields, falling interest rates served to increase the price returns on bond investments during Q1.

Lake Jericho client portfolios are, most typically, balanced, globally diversified strategies that incorporate varying combinations of multiple asset types. Each asset type has a meaningful impact upon returns. Reviewing asset types below, you see where, and how, Lake Jericho managed portfolios were impacted. Below, we present the Morningstar, Inc. *Target Risk Portfolio* Series of benchmarks for a comprehensive, and relative performance comparison against independent, objective, balanced, globally diversified strategies.

- The Dow Jones Industrial Average, a measure of 30 "blue-chip" U.S. companies, finished Q1 with a total gain of 11.81%.
- The S&P 500® Index, a broad market index of the 500 largest U.S. companies, finished Q1 with a total gain of 13.65%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index finished Q1 with a total gain of 16.81%.
- Small- and mid-sized companies once again took a leadership role during Q1 2019, besting other broad measures of U.S. equity performance. One measure of performance of small- and mid-sized companies, the Russell 2500™ Index, finished Q1 with a total gain of 15.82%.
- International developed markets, as measured by the MSCI World (ex-U.S.) Investable Market Index, finished Q1 with a total gain of 10.52%. International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, finished Q1 with a gain of 9.67%.
- Bond, with the tailwind of falling interest rates, provided gains for investors during Q1. The Bloomberg Barclays U.S. Aggregate Bond Index, a broad measure of the performance of the U.S. investment grade bond market, finished Q1 with a total return of 2.94%.

You might also recall from our Q4 2018 *Near-term Outlook* that during December and early January we executed a number of significant changes to client portfolios. Each, as expected, contributed positively to returns during Q1, and has helped to close 2018 performance gaps. I highlight a few of the most significant changes here:

- Given a number of near-term challenges in larger international developed markets, we reduced our overall exposure to foreign markets, but increased exposure to emerging markets within the remaining allocation. As foreign markets have continued to lag, even though slightly during Q1, this move has served clients well.

Morningstar, Inc. Target Risk* Portfolio Series

Benchmark Comparisons For All Periods Ending March 31, 2019

Target Risk Portfolio	Q1 2019	YTD 2019	1 Year	3 Year Total Return	5 Year Total Return
Conservative	4.67%	4.67%	4.30%	12.65%	16.60%
Moderately Conservative	6.72%	6.72%	4.62%	19.64%	24.20%
Moderate	8.68%	8.68%	4.42%	26.15%	30.08%
Moderately Aggressive	10.71%	10.71%	4.06%	33.17%	35.92%
Aggressive	12.23%	12.23%	3.76%	38.14%	40.45%

* The Morningstar Target Risk Index family is designed to meet the needs of investors who would like to maintain a target level of equity exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds and inflation-hedged instruments. The Morningstar Conservative Target Risk Index seeks approximately 20% exposure to global equity markets. The Moderately Conservative Index seeks approximately 40% exposure to global equity markets.. The Moderate Index seeks approximately 60% exposure to global equity markets. The Moderately Aggressive Index seeks approximately 80% exposure to global equity markets. The Aggressive Index seeks approximately 95% exposure to global equity markets. Benchmarks are constructed with no management fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

- We reduced exposure to value-oriented strategies, largely because domestic and foreign bank stocks grew to uncomfortably large allocations in most value strategies. Further, we eliminated what had been additional allocations to the U.S. regional bank sector. Believing that continued growth concerns, and impacts upon the level and shape of the yield curve, would weigh heavily on the banking sector, we wanted to reduce these exposure to the extent possible. As a significant part of the overall financial sector, bank underperformance caused the total financial sector to be among the biggest laggards during Q1, recovering only about 8%.
- As the once high-flying technology sector was among the hardest hit during Q4 2018, prices returned to more attractive levels in the downturn. Largely coming from proceeds from value-oriented strategies, and banking sector sales, we moved quickly to capture those lower prices and increased our positions in the the technology sector. We are now overweight versus a market-neutral portfolio. Leading the way higher for U.S. stocks during Q1 was the technology sector, which skyrocketed nearly 20% in the period.

Near-term Outlook

Despite continued optimism for stocks, both domestic and foreign, our Near-term Outlook has moderated.

Economic signals remain positive, though signs of slowed growth are apparent. Consensus estimates for U.S. Q1 Real GDP now stands at 2.2%. This is a meaningful drop from the Q3 and Q4 2018 actual real GDP growth of 3.5% and 2.6%, respectively. The National Association of Business Economists has cut its forecast for U.S. GDP growth this year to 2.4% from 2.7%. However, the 55 economists surveyed see only a 20% chance of a recession this year.

U.S. corporate earnings estimates have also come down. The expectation is that earnings will decline from Q4's 13.4% growth, the first earnings decline since the second quarter of 2016. Last year saw a tailwind provided by tax cut legislation, but those benefits proved to be short-lived. Q1 earnings for S&P 500® Index companies are projected to be 3.9% lower than Q1 2018 on 4% higher revenues. Analysts are now looking for S&P 500® Index companies earnings growth of 4.2% during 2019, versus the 10.2% expected six months ago.

On inflation watch, despite average wages increasing 3.5% in the last twelve months, and commodity prices rebounding 7.1% in Q1 on the back of a 27% increase in oil prices, inflation fears seem to have moderated. This is a bit of good news as Q4's near-bear market was largely the result of market fears of an overheating economy and continued Federal Reserve tightening. With inflation remaining stubbornly low, and the Fed seemingly on hold as a result, we might have threaded a needle to keep the longest economic expansion on record alive and fighting.

Bull or a bear, the key is avoiding binary bets about whether the market will be up or down. What is important is having a strategy that works over time, and sticking with it. Even the best investment strategy is not fully immune to the ups and downs of markets or business cycles. But we have crafted ours so you can withstand fluctuations in the market, and trend changes in economic environments, and still be aligned with your long-term goals.

As always, I am available at any time, any day of the week, to discuss specific portfolio performance questions. Until then, be well, enjoy your week, and thank you!

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