Review & Outlook

First Quarter 2019

April 8, 2019

Executive Summary

John Augustine, CFA, Chief Investment Officer

Looking for a Soft Landing

Year-to-Date market returns:

S&P 500 = +13.65%	Barclays Intermediate Bond Index = +2.33%
S&P 400 = +14.49%	Barclays High Yield Bond Index = +7.26%
S&P 600 = +11.61%	Barclays TIPS Bond Index = +3.19%
MSCI EAFE = +10.15%	Barclays Municipal Bond Index = +2.90%
MSCI EM = +9.90%	Gold = +1.34%

All markets lifted in the first quarter of 2019, reversing a difficult and unusual fourth quarter of 2018. For diversified investors, this was a very good start to the year, with the average moderate growth mutual fund gaining 9.01% according to our friends at Morningstar.

The quarter featured several new headlines and the continuation of others (Brexit, U.S./China trade talks). Here are some new headlines that will be discussed throughout these pages:

1. The Federal Reserve pivoted from thinking it would raise rates this year to putting itself on hold. Fed officials downgraded their assessment of the U.S. economy this year but are certainly not calling for a recession.
2. The federal government shutdown for much of January did impact the economy in areas such as retail sales, investment, and overall government spending. This will start the economic year off slower than many anticipated.
3. Economic numbers from Europe and China took a decidedly tepid turn in the first quarter, and markets will be watching how the global economy —including the U.S.—gets its footing during the second quarter.
4. 2019 earnings estimates for the S&P 500 have gone from +8.31% on 12/28/18 to +4.72% on 3/29/19, according to a weekly Bloomberg survey of sell-side analysts. This will also be an area of focus for stock markets during the second quarter.

Our investment strategy has moved to a more balanced approach between stocks and bonds in accounts. While we are maintaining only a 25% risk of recession over the next 6–12 months currently, we want to have a balanced approach to portfolios given that GDP and earnings estimates for this year are currently moving lower.

Our equity and fixed income teams are now even more focused on quality of balance sheets and stability of earnings in the companies in which they invest, given the downside estimates for this year. They will discuss their strategies in the following sections.

The Economic Forecast

George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Economic growth slowed in the first quarter from strong, broad-based real GDP growth of 2.9% in 2018. Subdued growth in consumer spending, business investment, and exports are contributing to a first quarter slowdown, which is expected to be temporary.

Challenges to financial markets have been significantly reduced recently through the commencement of a patient, flexible Federal Reserve monetary policy stance—and—the government shutdown was ended before significant long-term negative impacts to the economy occurred. Several areas supporting the economy include:

- Indicators from the Institute for Supply Management reflect economic activity continuing at a moderate pace of growth during the spring and summer, despite the first quarter spending slowdown.
- Labor markets have remained generally strong, with the unemployment rate ending the quarter at 3.8%.
- Housing markets have shown signs of a rebound from a slowdown in 2018.

Economic activity is expected to accelerate gradually in the second quarter, and real GDP is forecasted to ultimately achieve 2.1% growth for all of 2019.

Inflation, as measured by the Consumer Price Index, is forecasted to slow from 2.4% in 2018 to 1.9% in 2019, reducing overall cost pressures in the economy.

Growth in the international economy is expected to be below average for the current economic recovery, which should further assist in the containment of inflation, although it will likely detract from economic growth.

Interest rates are generally expected to reflect a more subdued economic growth and inflation environment than encountered in the last 2 years, with the Federal Reserve forecasted to hold the Fed Funds rate target in the 2.25%–2.50% range, and the 10-year Treasury yield forecasted to end the year at 2.75%, somewhat higher than where it started the year.

Fixed Income Markets

Kirk Mentzer, Senior Vice President, Director of Fixed Income

As world economic growth and inflation metrics stalled during the first quarter of 2019, the 10-year Treasury note yield held a narrow range of 2.6% to 2.8%. However, that all changed on March 20 when the Federal Reserve shocked markets with a broad policy shift.

The Fed essentially will leave the Federal Funds target rate in the 2.25% to 2.50% range all year, provided inflation remains well behaved. In addition, Fed officials said they were adjusting their balance sheet strategy to be less stringent on liquidity. Balance sheet runoff will begin tapering in May and balance sheet reduction will cease completely by October. The Fed's announcement sent U.S. bond markets on a massive rally to end the quarter. Highlights for the period included:

- U.S. 10-year Treasury fell to 2.37% during the quarter but ended March at 2.41%.
- The yield curve inverted briefly between Fed Funds and 10-year Treasury note at the end of the first quarter, but only for a short period of time and with little conviction.
- Investment grade credit outperformed similar maturity Treasury markets by +260 basis points.
- Government Agency securities ended the quarter +11 basis points better than Treasury markets.
- Municipal bonds likewise exceeded Treasury security performance by +100 basis points.
- Taken together, the Bloomberg Barclay's Intermediate Index produced a positive total return of +2.33% for the quarter.

Looking ahead, we anticipate the yield curve to normalize towards a flat level while shifting upwards overall. Why would this happen? Our outlook for 2.1% U.S. economic growth and restrained inflation pressure gives the Federal Reserve room to hold rates steady.

As recession fears dissipate, we believe investors are likely to reverse anticipated future rate cuts and allocate to higher yielding maturities out on the yield curve.

In terms of sector strategy, we continue to advocate boosting portfolio income to buffer portfolio values should volatility return. Remaining overweight corporate bonds are our preferred method to increase portfolio income. But given the strong rally in credit, there are fewer relative value plays and areas offering a compelling story. We find the best risk-reward in large banks, REIT, utility, and financial technology issuers.

Our focus is on A-rated over BBB-rated names in economically stable sectors with little to no M&A risk. In the government agency space, callable agency notes offer higher yields in exchange for potentially early redemption. In a slowly rising rate environment, this risk is low, and as a result, these securities provide a performance edge.

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Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

The positive returns in the first quarter were juxtaposed to a deteriorating earnings backdrop. As noted above, full year earnings estimates have come down from 8.31%–4.72%. At the same time, Q1 earnings per share are estimated to decline -3.58% as of 3/29/19. Bloomberg estimates have the first quarter earnings growth as the first year-over-year decline in earnings since the second quarter of 2016. As we progress through the calendar, the same Bloomberg survey of sell-side analysts forecasts earnings growth to increase to single-digit numbers year-over-year.

The first quarter did end with a few unresolved potential catalysts for the market:

- The biggest story is the potential for the U.S. and China to finalize a trade deal. This has long been rumored, but markets remain patient, hoping for a favorable resolution.
- The passage of the revised NAFTA by Congress appears to be decreasing in likelihood as we progress through the calendar and towards next year's election.
- Brexit looks to be delayed further into the year, with unknown impacts to the global economy at this point.

Looking ahead to the second quarter of 2019 and the remainder of the year, some of the factors we are keeping our focus on at Huntington include:

- U.S. economic growth, as noted above, has been revised downward to 2.1% for 2019. We forecast inflation to slow and the Fed Funds rate to remain stable.
- S&P 500 EPS estimates have been falling and we believe should stabilize as the year progresses.
- Headline risks to domestic equity markets have shifted from tax-cut incentives going away to the threat of tariffs being implemented and these tariffs lowering economic growth rates (and corporate profits) worldwide.
- Given the uncertainty around the timing of higher rates and faster growth, we believe this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist. We continue to focus on accelerating earnings growth where valuation presents attractive opportunities. Staying invested is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the headwinds and tailwinds, we ultimately see a continuation of double-digit earnings growth in 2020, which should be beneficial for stocks all else being equal. If these forward earnings estimates hold, this will call for U.S. equity investors to be patient in the near-term, yet maintain a positive longer-term stance.