First Quarter Market Review and Comment
April 2019

Updated Market Performance

Returns	1st Quarter 2019	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**13.65%**	**9.50%**	**13.51%**	**10.91%**	**15.92%**
DJIA	**11.81%**	**10.08%**	**16.37%**	**12.21%**	**15.97%**

Performance: In the 1st quarter the S&P 500 surged leading to a strong start to the year leading to the best quarter since 2009 and best 1st quarter since 1998. This is in great contrast compared to the 4th quarter of 2018, which was the worst quarter since 2011 and not to mention the worst December on record since The Great Depression.

After posting the worst returns since 2011 in the 4rd quarter of 2018, the S&P 500 (SP500) posted a 13.65% return in the 1st quarter that just ended on March 31, 2019. The Dow Jones Industrial Average (DJIA) trailed the SP500, posting 11.81% over the same period. For the previous twelve months the SP500 has returned 9.50%, underperforming the DJIA which returned 10.08% over the same period. The annualized three-year returns are better than near term returns, with the SP500 posting 13.51%, while the DJIA is running at 16.37%. Over the last five years the annualized returns are running above historical norms (around 10%), with the SP500 returning 10.91% and the DJIA posting 12.21%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 15.92% vs the DJIA which turned in 15.97%.

Breaking down the returns for the Q1 2019, we note that there were six outperforming sectors and five underperformers. **The best sectors were Information Technology (19.37%), Real Estate (16.64%) and Industrials (16.64%)**. **The losers during the quarter were Healthcare (6.12%), Financials (7.90%) and Materials (9.68%).** Over the past year the growth sectors have continued to dominate their value counterparts. The clear winners the last twelve months were Real Estate (16.82%), Utilities (15.23%) and Information Technology (13.80%). Bringing up the rear were Financials (-6.63%), Energy (-2.55%) and Energy (-1.77%).

The DJIA posted double digits in the 1st quarter as the Fed took a dovish turn and took a pause on raising interest rates. Trade tensions continue to be visible, but there has been renewed hope of a trade deal that is evident of the recent returns in the equity market. Trade tensions and slowing economic growth are still top of mind as talks of a recession have diminished to whispers. Global trade and global economic growth are important since more than half of the 30 Dow components get 50% or more of their revenue from outside the U.S., according to FactSet. The SP500 by comparison derives 38% of revenue from outside the U.S.

Veritas Investment & Wealth Advisory, LLC
13850 Ballantyne Corporate Place, Suite 500, Charlotte, NC 28277
(p) 704-887-4942 (w) www.veritasinvestmentwealth.com

Economy: Economic growth is expected to slow down in 2019.

The third estimate of 4th quarter Gross Domestic Product (GDP) is 2.2% according to the report released at the end of March by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 4th quarter decelerated by ~1.2% compared to the 3rd quarter 2018 when GDP was running at a rate of 3.4%. Overall, the economic recovery has continued albeit slower so far in 2019 following growth of 2.9% in 2018 and 2.2% in 2017. The long slow recovery which has been in place since mid-2009 should continue for the foreseeable future although we continue to see pockets of deceleration. By comparison, China says their GDP grew at 6.4% in the 4th quarter of 2018. China's 2018 GDP was 6.6% compared to 6.8% in 2017. The weakest annual growth rate in 28 years, due to the continued trade pressure from the US as well as slowing demand at home and abroad. Declines were not as bad as feared by economists due to an increase in policy driven stimulus. Growth rates for the European Union (EU) and the Euro Area were 1.8% and 1.6% respectively in the 4th quarter 2018. For 2018, GDP rose 1.9% for the EU and 1.8% for the Euro Area. This is down from the 2.4% growth both achieved in 2017 giving further evidence to the slowing of global growth.

Unemployment continues to stay historically low. According to the Bureau of Labor Statistics, March unemployment held steady at 3.8%. Unemployment for 2018 came in at 3.9%, the last time the unemployment rate maintained an average of 4.0% or lower was in the late 1960s. Job growth occurred from healthcare, professional and technical services. The labor force participation rate was 63.0% for March and has shown little movement over the last 12 months.

Inflation is still below historical averages. After averaging ~2.0% in the 4th quarter, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 1.67% in the 1st quarter. The average rate of inflation for 2018 was 2.45% and continues to be subdued by historical standards (2.60% over last 30 years). March came in at 1.9%, a sharp increase from February's reading of 1.5%. Most of the increase is attributable to an increase in energy prices.

Consumption is an important driver of the economy as it represented 68% of 4th quarter nominal GDP. The U.S. Census Bureau announced in April that retail sales for February 2019 were down 0.2% compared to January but were up 2.2% above February of 2018. Non-store Retailers were up 10.0% from February 2018, while health and personal care stores were up 5.9% from last year.

Manufacturing economy had growth in manufacturing for the 31st consecutive month. Economic activity in the **manufacturing sector** grew for the thirty first consecutive month in March, with the Purchasing Managers Index (PMI®) registering 55.3, an increase from February's reading of 54.2. This was led by a continued expansion in new orders, production, employment, backlog of orders, net export orders, and imports. Customer inventories continue to struggle to maintain expansion levels as a result of supplier deliveries slowing and increasing prices. The **overall economy** grew for the 119th consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*.

Home prices continue to rise, but price increase have continued to slow since the peak in 2017. According to the S&P Case-Shiller Home Price Indices home prices rose in January with the S&P CoreLogic Case-Shiller National Home Price Index rising 4.3% over the last 12 months. Las Vegas, Phoenix and Minneapolis had the largest year over year increases of 10.5%, 7.5% and 5.1% respectively. The favorable economy has continued to support recent gains in housing. However, increases in mortgage rates in 2018 and reduced affordability have led to slowing sales in both new and existing homes. There continues to be a low supply of homes on the market.

Markets: After experiencing our first, second and third 1 day 1,000 point moves in the DJIA in 2018, who knew what to expect in 2019. So far in 2019 the bears have been sent back to hibernation (for now) and the whispers of a recession this year have all but gone silent.

- **Earnings growth for the SP500 is expected to decline -4.2% for the 1st quarter 2019. If actual growth comes in as estimated, it will be the first year over year declines for the index since Q2 2016.** According to FACTSET, of the SP500 companies that have reported earnings as of 4 April (Approximately 23), 83% reported earnings above the mean estimate and 57% have reported sales above the mean estimate. **Earnings guidance has been skewed to the downside with 79 companies issuing negative EPS (Earnings per Share) guidance and 28 issuing positive EPS guidance**. Estimated earnings for the first quarter fell by -7.3% from the end of 2018 through the end of Q1 2019. This percentage decline was above the 5-year average -3.2%, the 10-year average -3.7%, and the 15-year average -4.0% for a quarter. Looking at future quarters, analysts see no earnings growth in the 2nd quarter 2019, low single-digit earnings growth in the 3rd quarter, and high single-digit earnings growth in the 4th quarter.

- **Stocks are rich after the stellar 1st quarter and weak forward-looking earnings growth. There is not much room for P/E expansion, so we need earnings growth to increase to relieve the current extended valuations.** The current 12-month forward Price Earnings (PE) multiple on stocks is 15.6. The long term (20 Year Average) PE for stocks is 14.0, so we don't see a lot of room for valuations to move higher without growth. There is no room for PE expansion now, so to get continued appreciation we will need an increase in earnings and widening profit margins.
- **Global trade tensions continue to persist.** Trade tensions are still present. This continues to leave a cloud of uncertainty on the market. With trade concerns in the news often and continually being put off, the likelihood of real measurable impacts on U.S. businesses from domestic trade tariffs and retaliatory measures continue to be present.

- **Rising interest rates.** The Federal Reserve decided to pause and maintain the target range for the federal funds rate of between 2.25% and 2.50% during its January meeting. The decision to pause was predicated by slowing economic activity in the 4th Quarter. Recent indicators have pointed to slower growth of household spending and business fixed investment in the 1st Quarter. Fed officials expect that considering the recent global economic and financial developments along with muted inflation pressures, the fed will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes. The market is currently pricing in zero rate hikes in 2019.

Forecast: Great start to the year leads to cautious and dwindling forward expectations.

Slowing growth, low unemployment, and low inflation. *Slowing global growth in the 4th quarter has led to lower earnings and talks of a potential earnings recession if slow growth persists*. Economic growth will continue to moderate although it looks like it will pick back up towards the back end of the year. Unemployment has reached lows not seen since the 1960s and continues to run below historically averages. Inflation continues to run below average, but with continued economic stimulus and a patient Fed do not be surprised if we see inflation pick up.

Earnings Growth & Maintained/Increasing Profit Margins. We need earnings growth to avoid an earnings recession. After all the negative earnings revisions and negative earnings guidance for Q1 2019 the bar has been lowered, so the focus and attention will be on forward guidance. Profit margins will continue to be pressured by rising wage and labor costs.

What risks are out there that might disrupt the recovery?

- **Negative earnings guidance and negative earnings surprises**. There have already been negative earnings revisions from SP 500 companies for their current earnings reports due to tariffs and slowing global growth impacting earnings. If forward guidance is disappointing, stocks will be pressured to the downside. There is not currently a compelling reason to sell based on valuations being too rich. The probability of this scenario is medium but could increase if we see a meaningful increase in negative earnings guidance.

- **Continued Fed Tightening**. Given the recent low inflation, low unemployment and recent economic growth, we think the risk of rate increases by the Fed are low. The fed made 4 .25% increases in 2018 and recently decided to pause rate increases. The recent pause by the Fed is a pleasant surprise because **Nine of the last eleven recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**

- **Inverted Yield Curve.** Recently the yield on the 10-year Treasury bond fell below the yield on a 90-day Treasury bill. This is called a yield curve inversion and usually is followed by an economic slowdown and recession. The average time from an inversion of the yield curve until a recession is ~14 months according to J.P. Morgan Asset Management.

- **Global trade tensions.** We are continuing to see trade tensions which will continue to hold back business and consumer spending, leading to slower economic growth.

We think the biggest threat to the stock market is the uncertainty presented by slowing economic growth as well as rising corporate debt levels. This uncertainty will persist until there is clarity over what the final resolution will be on the trade front. It will also depend on the amount of economic stimulus injected globally to spur growth. Rates on the long end of the yield curve have retreated recently, as prospects for global growth have deteriorated causing the yield curve to invert. After the recent rally to start the year it will not take much negative market sentiment and fear to get the market to head to the downside. We think the SP500 will end the second quarter between 2,750 and 2,850. At this juncture, we venture a guess that stocks will end up somewhere between 15%-17.0% for the year.

For the next six to nine months, the Federal Funds rate should remain near its current range of 2.25%-2.50%. **The 10-year Treasury which is currently priced at ~2.50% may rise toward 2.60% before the end of the 2nd quarter.** By year end we should see the rate between 2.70%-2.90%, assuming that inflation increases and global growth expands.

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

Julian F. Patton, Jr. CFA, CFP®, CAIA
Chief Investment Officer