Investment Update

April, 2019

2019 First Quarter Update

Review: The S&P 500 rose 13.6% in the first quarter, dramatically reversing the sell-off in the last quarter of 2018. The rebound was triggered in large part by a speech given by Chairman Powell in early January indicating that the Federal Reserve would be patient in raising rates. International equities also rose, though less than the S&P 500, as investors anticipated a favorable outcome on the U.S.-China trade talks. Bond markets posted solid returns based on the Fed's decision in January not to raise rates with the majority of the return captured in March.

Period	1Q19	4Q18	2018 FY
S&P 500	13.6%	-13.5%	-4.4%
MSCI EAFE[1,2]	10.1%	-12.5%	-13.4%
MSCI Emerging Markets[2]	10.0%	-7.4%	-14.3%
Barclays U.S. Aggregate Bond	2.9%	1.6%	0.0%
Barclays Municipal Bond	2.9%	1.7%	1.3%

[1]Europe, Australia, Far East
[2]MSCI returns are in U.S. Dollars

Why Was The Federal Reserve's Decision So Important?

An ongoing focus for the financial markets has been the stated and implied actions taken by the Federal Reserve. The Governors voted at their January 30-31 meeting to keep the Federal Funds rate unchanged, which was constructive but already anticipated by the markets. The official statement confirmed Chairman Powell's remarks during a speech earlier in January that they would be patient regarding further rate increases citing "global economic and financial developments and muted inflation pressures". In addition, at the press conference following the January meeting, Chairman Powell alluded to the idea that shrinking the Federal Reserve's balance sheet, which would contribute to higher interest rates, was no longer "on autopilot", a term he used at their December meeting. These two changes made it clear to the markets that the Federal Reserve's decision was influenced by the poor equity performance and corresponding flight to safety into bonds in the fourth quarter, in addition to weaker economic data. As a result, equities rebounded as price/earnings multiples recovered and concerns over the Fed overtightening were reduced.

Another widely debated topic has been the significance of the inversion of the U.S. Treasury yield curve, and in particular its usefulness as an indicator of approaching economic recessions. The chart on the next page (courtesy of Alpine Macro) shows the curve, using the Federal Funds Rate and the 10-year U.S. Treasury yield, in relation to recessions, which are represented

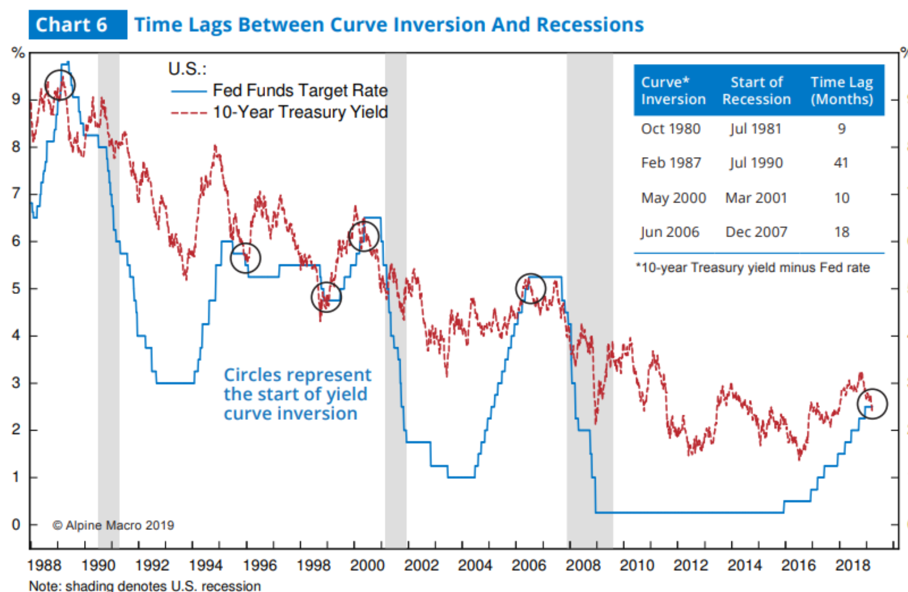
600 Atlantic Avenue
18th Floor
Boston, MA 02210-2211

Phone: 617-357-5101
Toll-free: 800-357-5101
Fax: 617-357-7199

info@middletonco.com
www.middletonco.com

by the gray shaded bars. The data shows that, going back to 1980, an inversion has preceded a recession by 9-41 months. For the two most recent recessions, the time lag has been 10-18 months.

Today, the relationship is not yet inverted and slightly positive with the Target Federal Funds Rate at 2.41% and the 10-year Treasury yielding 2.51%.



Source: Alpine Macro, "Ice" And Fed Easing, March 29, 2019

Outlook: Despite the current economic soft patch, with first quarter GDP expected to be less than 2%, we do not forecast a recession in the next twelve months. U.S. economic fundamentals are expected to improve as the year progresses, primarily due to steady consumer spending and an anticipated uptick in business capital expenditures. Eurozone and Emerging Market growth remain under pressure with China's latest effort to stimulate its economy key to reviving global growth. Dollar strength or weakness will also be a factor.

Globally, inflation is expected to remain below Central Banks' 2% target, helping to minimize the potential for higher bond yields. We continue to monitor building U.S. wage pressures, both as an influence on further Federal Reserve rate hikes as well as company profit margins.

Consensus estimates for the S&P 500's earnings growth in 2019 currently center around mid-single digits with the forward P/E multiple somewhat above the historical average of 16x. International equity valuations, though relatively appealing, still lack the underlying fundamentals supportive of attractive earnings growth with tailwinds from China's stimulus too early to assess success.

Strategy: We continue to favor domestic equities on the assumption that economic growth will steadily improve for the remainder of the year. Given the recent sharp drop in yields, we prefer shorter maturities for fixed income investments.