CBIS®
Christian Brothers Investment Services

MARKET PERSPECTIVE 1Q 2019

Markets Roar Back Despite Fears

Catholic Responsible Investments℠

CAPITAL MARKETS REVIEW

I. Global Overview

II. U.S. Equity Markets

III. Fixed Income Markets

IV. 10-Year Treasury

V. Fed Funds Are Not Yet Restrictive

VI. Economic Stress Indicator

MARKET MUSINGS

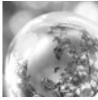
Global equity markets were as strong in 1Q 2019 as they were weak in 4Q 2018. At this point, talk of an impending U.S. recession appears overblown.

Despite the strong performance of global equity markets in the first quarter, headlines have focused on the inversion of the 3-month and 10-year Treasury curve and whether it portends a recession. And although the monetary tightening of the past year continues to add fuel to the debate, interest rates are still far from restrictive. The usual caveats about downside risks remain, but key market indicators support optimism that the strong recovery will continue.

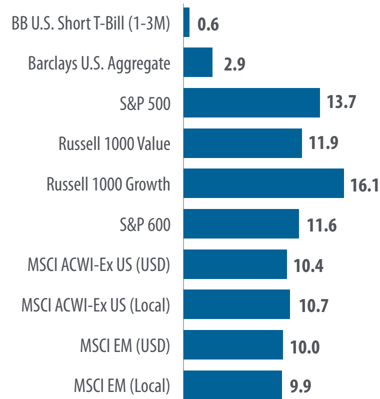
"All economic life should be shaped by moral principles. Economic choices and institutions must be judged by how they protect or undermine the life and dignity of the human person, support the family and serve the common good."

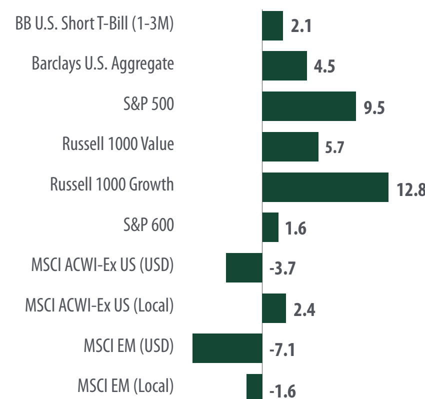
US Conference of Catholic Bishops,
Economic Justice for All, 1986

Capital Markets Review



I. GLOBAL OVERVIEW



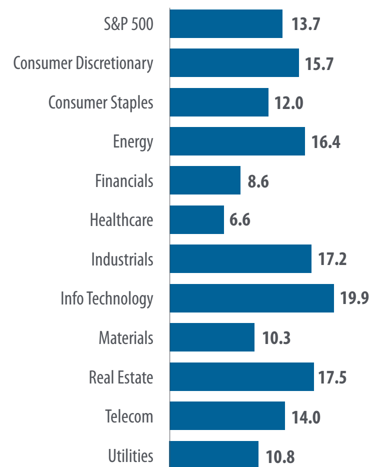


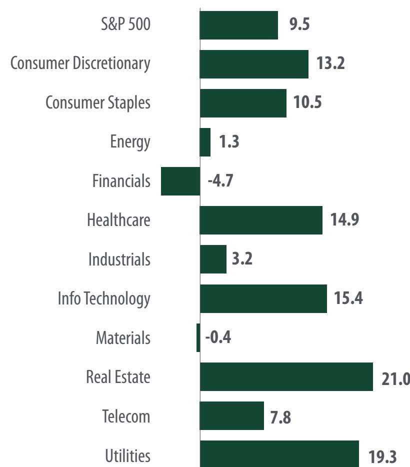
Source: FactSet

- Global equity markets rebounded from declines experienced during fourth quarter of 2018.
- Interest rates declined as the Federal Reserve signaled a pause in rate increases.

The growth sectors of the equity markets continue to outperform.

II. U.S. EQUITY MARKETS



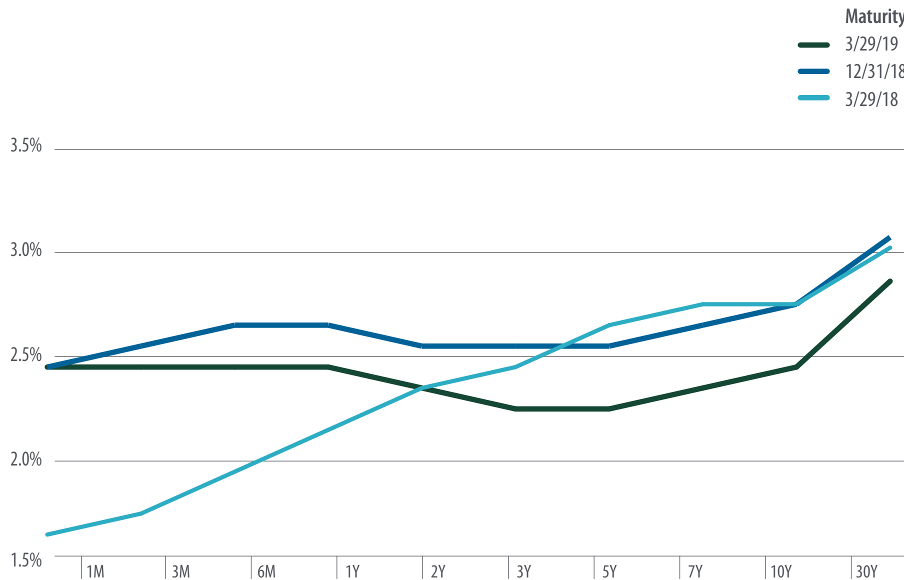


Source: FactSet

- Performance relatively consistent across sectors for the quarter with exception of Finance and Healthcare.
- Over the last 12 months, Financials were notably weak.
- Interest sensitive sectors led market over last 12 months despite rising short term rates

III. FIXED INCOME MARKETS

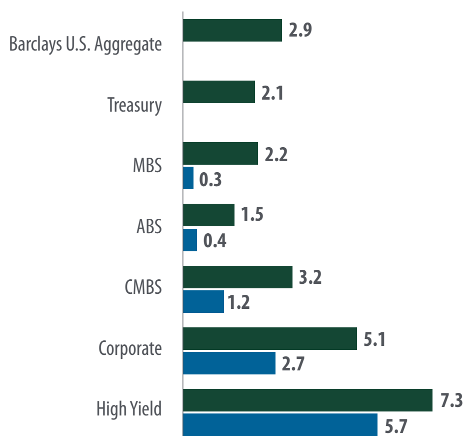
Treasury Yield Curve



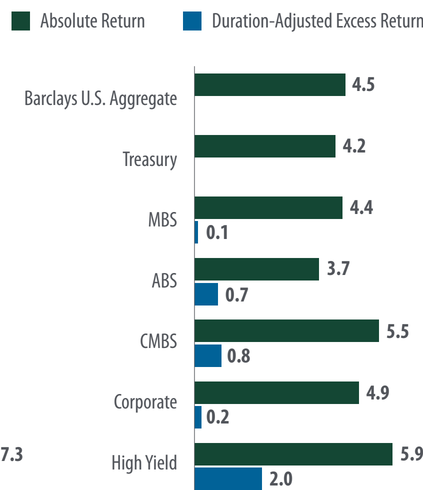
Source: U.S. Department of Treasury

- During first quarter, long-term interest rates declined, resulting in a modest inversion in the curve.
- The last 12 months witnessed a significant flattening of the curve, with short-term rates rising while long term rates declined.

Market Performance: 3 Month



Market Performance: 12 Month



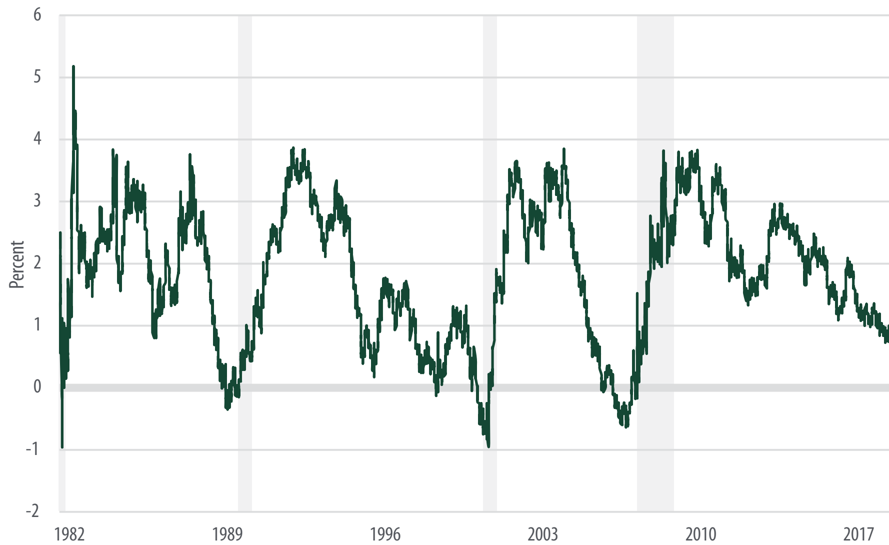
Source: Factset, Bloomberg

Reflecting strength in the equity markets, corporate bonds across the entire quality spectrum outperformed the Benchmark.

- Investment grade corporate bonds experienced modest outperformance over the last 12 months, while high yield outperformed.
- CMBS and ABS outperformed, though MBS were basically flat due to higher interest rate volatility.

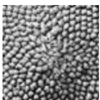
IV. 10-YEAR TREASURY MATURITY

10-Year Treasury Constant Maturity Less 3-Month Constant Maturity



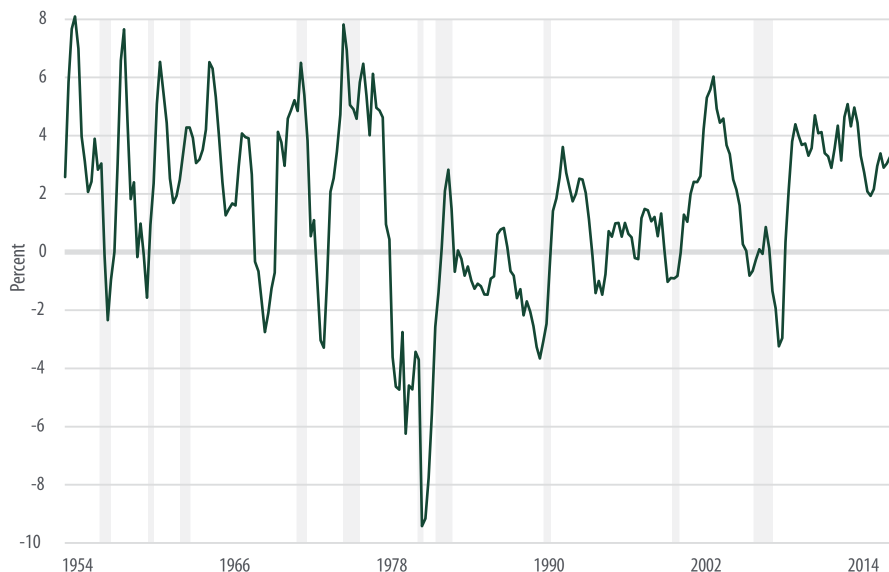
Source: Federal Reserve Bank of St. Louis *Shaded areas indicate U.S. recessions*

- Recessions have been preceded by yield curve inversions.
- Is the inversion this quarter foreshadowing a recession?



V. FED FUNDS ARE NOT YET RESTRICTIVE

Nominal Gross Domestic Product Less Fed Funds



Source: U.S. Bureau of Economic Affairs *Shaded areas indicate U.S. recessions*

- Recessions rarely occur when Fed Funds are less than Nominal GDP.

Interest rates are below economic growth rate, which is stimulative.

- Fed rate pause is positive for continued growth.

VI. ECONOMIC STRESS INDICATOR

- Corporate bond spreads are not confirming economic weakness.
- We are watching impacts of trade wars and Brexit.

Market Musings

The global equity markets were as strong in the first quarter of 2019 as they were weak in the fourth quarter of 2018. Yet, headlines were not dominated by the strong recovery, rather they were dominated by the US yield curve inversion and the implications for growth.

There is a reason the yield curve inversion caught investors attention this quarter. Since the early 1980's, as seen in graph IV, recessions in the US have always been preceded by a yield curve inversion (10 year yields less than 3 month yields). However, is there causality, or is the inversion an indicator of economic stress and weakness? We would argue it is the latter. Free market economies have a natural propensity to grow. Recessions occur because of 1) policy mistakes, or 2) pressure that has built up within the economy; for example, excess inventory buildup, or inflationary pressures-particularly wage driven. Historical yield curve inversions have typically occurred as short-term interest rates rise, constraining near-term economic growth. Lower growth leads to reduced inflationary expectations. As a result, longer term yields increase at a slower rate than short term rates, leading to an inversion. An inversion can be thought of as reflecting expectations that future levels of interest rates will be lower than current levels. Inversions also tend to be significant (25-100 basis points) and last for a period of time. Other indicators tend to confirm the increased risk of a slowdown in growth in advance of a recession.

Commentators may continue to debate whether the US interest rate increase in December last year was appropriate. The debate makes for great press, but we must recognize monetary policy is a blunt instrument at best.

Rarely do yield curves invert with a constant short-term rate and declining long term yields as we see today. Furthermore, other market indicators are not signaling financial stress as a precursor to a recession.

First, corporate yield spreads have historically widened during an inversion and in advance of a recession. This is not the case today (graph VI). Corporate bonds are outperforming treasuries on a duration adjusted basis this quarter in a reversal of the performance witnessed in 2018.

Second, Federal Reserve policy becomes restrictive when short-term rates exceed the growth of nominal GDP (graph V). Currently, interest rates are well below a level where one would consider policy to be restrictive.

Finally, equity valuations are still attractive relative to other investment alternatives. Despite monetary tightening over the last 12 months, equities remain attractive relative to bonds. (Graph II).

We believe it is appropriate for the Federal Reserve to have signaled a pause in interest rate tightening. Legitimate growth concerns persist in the form of:

1. Brexit fallout
2. EU political situation
3. US-China trade wars

Commentators may continue to debate whether the US interest rate increase in December last year was appropriate. The debate makes for great press, but we must recognize monetary policy is a blunt instrument at best. Indicators of a Federal Reserve overshooting on policy result in much larger curve inversions and are confirmed by other indicators. While it is prudent to recognize the ever-present downside risks, at this point, talk of an impending US recession appears to be overblown.

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