The Cobblestone Advisor
Investment Brief

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COBBLESTONE CAPITAL ADVISORS

A Study in Contrasts: 1Q19 vs. 4Q18

The opening sentence of Charles Dickens' *A Tale of Two Cities* could certainly be used to contrast first quarter financial market activity with the last quarter of 2018: *"It was the best of times, it was the worst of times… it was the spring of hope, it was the winter of despair…"*

Equities rebounded strongly during the first quarter, and the S&P 500 was up 13.6%. This marked the best quarter for domestic equities since the three months directly following the 2008-2009 Global Financial Crisis. Gains were broad-based, with all 11 S&P 500 sectors delivering positive returns, the first such feat since 2014. Risk-taking was back in vogue, as US small cap stocks, technology shares, and sectors tied to the economic cycle outperformed. It wasn't just equities that delivered exceptional performance during the period. Broadly positive, strong returns materialized across asset classes, including bonds and real assets. There as well, the strongest returns accrued to riskier areas of the market, such as high yield bonds and commodities. The year-to-date price moves underlined a divergence between economic fundamentals and asset price performance: data out of the US and Japan supported the narrative of slowing economic growth, while China and Europe both experienced further deterioration in economic conditions.

Absent a backdrop of accelerating growth, what drove markets higher? Investor sentiment looks to be the likely catalyst, supported by data which show multiple expansion as the primary driver of equity returns during the first quarter. After falling to overly pessimistic levels in December—typically a contrarian indicator—investor sentiment bounced back to more optimistic levels in the first quarter (below chart). Improved sentiment came amid a more accommodative policy stance by the Federal Reserve, the European Central Bank's injection of new stimulus to support bank lending in the region, continued easing in China, and marginally improved US/China trade rhetoric.

Making Sense of an Inverted Yield Curve

Against this dynamic backdrop, strong Treasury buying pushed long bond rates lower, and the spread between 3-month and 10-year Treasury yields moved below zero on March 22 (i.e., the yield curve inverted). Many in-

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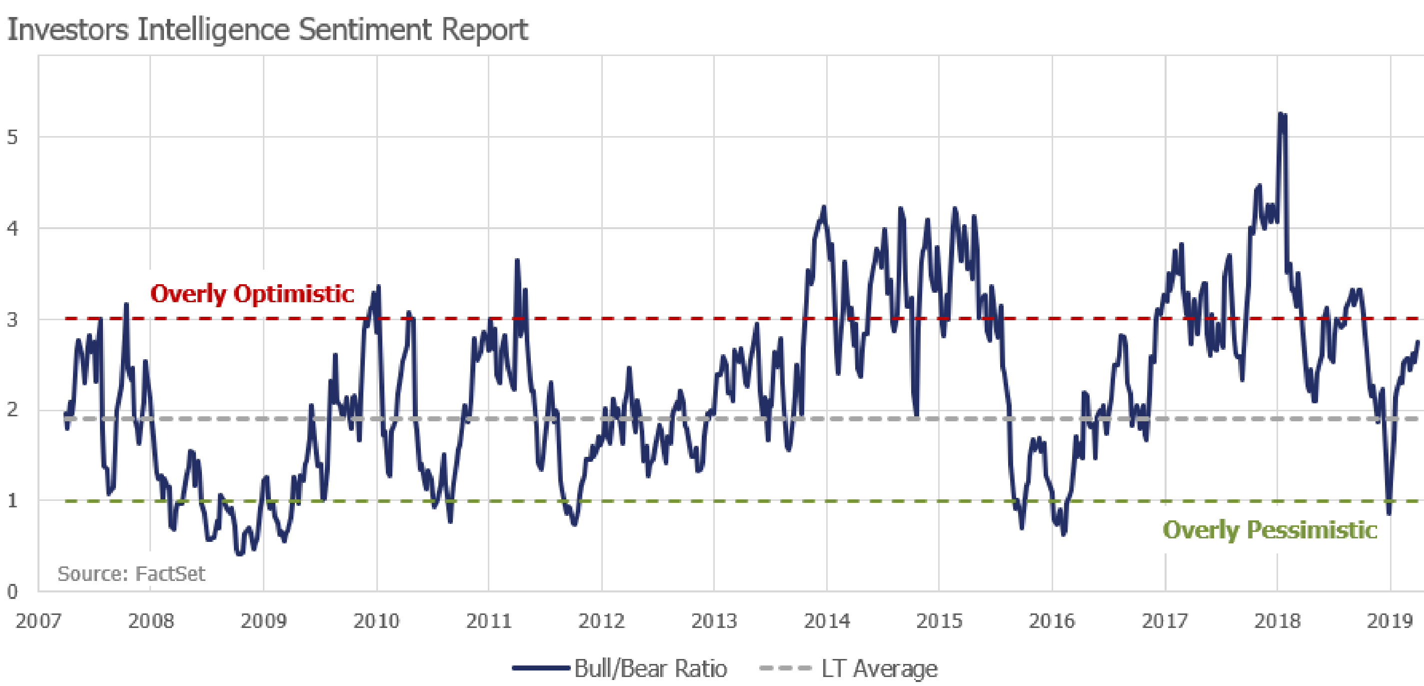

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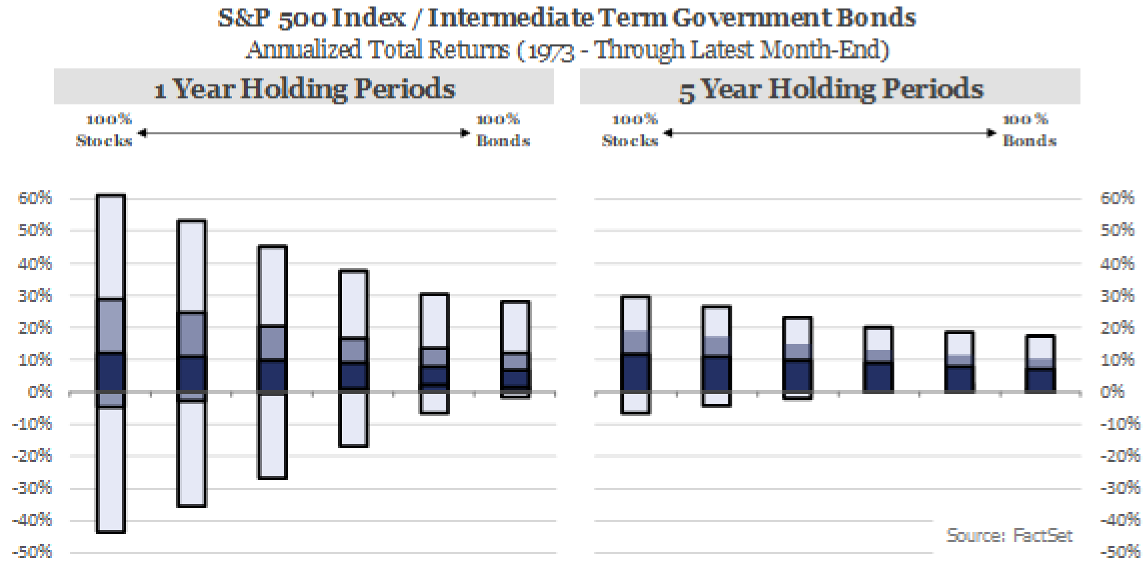
vestors view the inversion as a sign of impending recession, an understandable perspective since each of the last nine US recessions was preceded by an inverted yield curve. Taking a more comprehensive view, however, it is apparent that the yield curve is unreliable at timing the onset of recession. The lead time is unpredictable, highly variable, and sometimes very long. Looking at the last five recessions, for example, the average lead time was approximately 20 months with a standard deviation of ± 9 months. It is also worth noting that if the yield curve were a robust leading indicator of recessions, its forecasting ability would transcend markets, which hasn't been the case if you simply look at Japan and Europe over the past three decades. Specifically, Japan has experienced six recessions since 1995, but no yield curve inversions over that timeframe, whereas Germany's yield curve has only inverted prior to two of the last five recessions.



This brings up an important point: investors who trade in and out of markets in a reactionary fashion based solely on one indicator, as opposed to taking a more holistic view, run the risk of missing out on strong returns. As exhibited by the data surrounding the last five US recessions, the S&P 500 has appreciated each time, often meaningfully, between a curve inversion and the official start of a recession (return range of +2% to +20%; average return of +11%).

Prudence requires a broader outlook of market and economic conditions. From that perspective, the US is decidedly late cycle and losing momentum. Yet while economic indicators suggest growth is slowing, this does not mean an end to the current cycle is imminent. In fact, when looking at economic and market indicators in aggregate, the data suggest that the current cycle still has room to run. This view is supported by The Conference Board Leading Economic Index (LEI), a composite indicator consisting of ten underlying leading indicators such as average weekly manufacturing hours worked and initial jobless claims. Although the LEI's growth rate has slowed over the past six months, its latest readings suggest that the US economy will continue to expand in the near-term.

In all, the prior six months remind us as investors that over short periods of time, the range of investment outcomes can be quite dispersed. This is true even over one-year holding periods (above left chart). When looking over a longer time horizon, however, return dispersion is relatively lower (above right chart). Therein lies one of the keys to investor success: cutting through the noise and maintaining a long-term perspective.

Total Return (%), Ending 3/31/2019			Annualized		
	Qtr	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	13.65	9.50	13.49	10.87	15.87
Russell 2000 (Small Cap Stocks)	14.58	2.05	12.91	7.03	15.31
MSCI EAFE (International Stocks)	9.98	-3.71	7.26	2.32	8.93
MSCI EMF (Emerging Markets)	9.92	-7.41	10.67	3.67	8.92
Barclays US Aggregate Index	2.94	4.48	2.02	2.73	3.75
Dow Jones US Select REIT	15.72	19.73	5.28	8.90	18.44
Consumer Price Index (% Change over Period)	0.56	1.86	2.21	1.49	1.81

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