MARKET COMMENTARY

1st Quarter 2019 April 3, 2019

SILVER HAWK PRIVATE WEALTH

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"The investor's chief problem…is likely to be himself" - Benjamin Graham

The first quarter of 2019 (Q1) was the best quarter for the S&P 500 total return index (S&P) since the second quarter of 2009. The S&P returned 13.65% during Q1, which oddly enough almost exactly offset the losses from the dismal 4Q18 return of -13.52%. The two quarters are near polar-opposites in terms of both performance and sentiment of the markets.

From 4Q18 to 1Q19, you had major policy reversals from the Federal Reserve (The Fed) regarding their future rate-hike program and balance sheet "normalization". In the latter part of 4Q18 the Fed communicated they will be "patient" in terms of further rate increases, which set the tone for markets heading into 2019. You also had an increased probability of a China/US trade deal; however, the two sides are still not in full agreement and we are not confident this will happen over the next quarter.

Strength in the US Economy (albeit declining) continues to be the underlying driving force behind market gains, with external risks such as Political risks and potential Federal Reserve Policy errors, largely causing the bouts of high volatility.

When these two issues are subdued or muted, the market generates solid performance and lower volatility. When these two issues are elevated, the market becomes volatile and performance often suffers.

Sean Puckett, CFA
Chief Investment Officer

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The market thus far seems to have been operating under the assumption that the economy will continue its upward trajectory, and the only real risks to the economy are the Trade war and Federal Reserve policy errors.

It is possible that because the Fed has subdued those woes for now, and the US/China trade issues are out of the spotlight, conversations will begin to center around "how much does this economy have left in the tank?". This is a hard question to answer with many scenarios; however, we think that growth in both the US and global economies could continue to slow.

We are at a point in the economy in which growth is slowing, we are approaching previous all-time highs, and complacency seems to be heightened as data continues to refute growth, yet we drift higher in the equity markets. The second quarter should test that complacency as we expect continued global growth slowdowns, and as we approach previous all-time-highs set in September 2018. As such, we are anticipating higher volatility during the second quarter and will be actively managing our downside.

Things we will continue to monitor to determine appropriate portfolio positioning will be the US/China Trade talks, the Federal Reserves reaction if we continue to see decelerating growth, and Corporate Earnings/revisions by companies as we head into the later innings of the late-cycle phase of the economy.

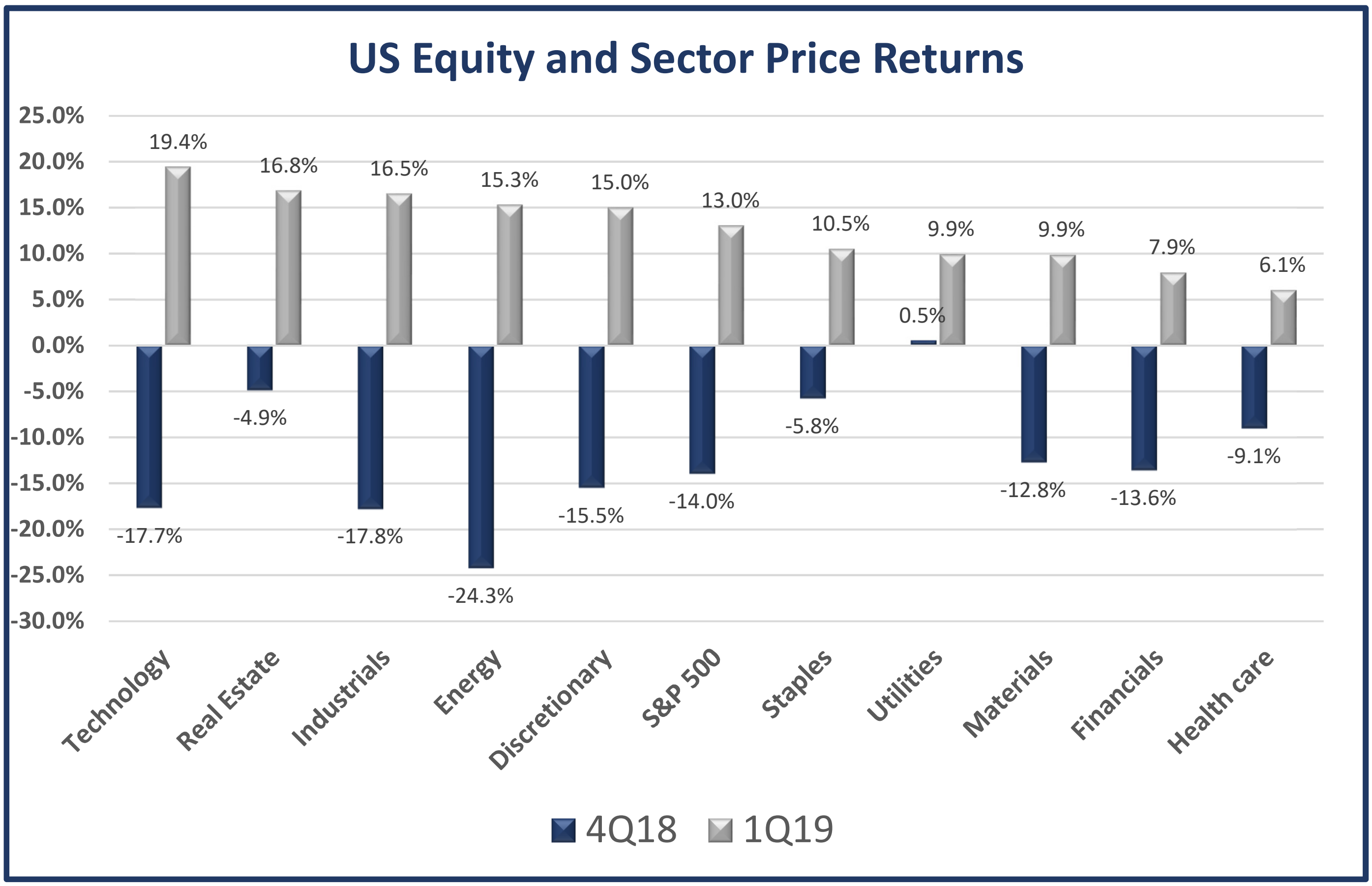
We tend to agree with the minds over at the Economic Cycle Research Institute (ECRI) in that the economy goes through growth cycle phases, and recessions are brought on by a shock to the economy (oil price shock, asset bubble shock, financial crisis, etc.) during a "window of vulnerability" in which the economy is in a decelerating growth phase.

Based on the economic data, it appears we are continuing a growth cycle deceleration both domestically and abroad, which warrants a more defensive strategy as we enter this "window of vulnerability".

Shocks are unpredictable by definition, but you can react and adjust faster and with more conviction if you understand where you are at in the growth cycle, and what you will do when the inevitable downturn does occur.

Domestic Markets

The US Stock market ripped upward during the first quarter off of the massive momentum reversal we experienced in late December 2018. That end of year momentum carried us to 2834 on the S&P 500 (S&P), and a total return on the quarter of 13.7%. Technology, Real Estate, Industrials, Energy, and Discretionary led the way, posting returns of 19.4%, 16.8%, 16.5%, 15.3%, and 15.0%, respectively. The rally in Tech was spearheaded by Semiconductors (Advanced Micro +38.2%, NVIDIA Corp +34.6%, and Xilinx +49.3%) and Software Publishers (Cadence Design +46%, Synopsys +36.7%, and Intuit +33.1%). These two industry groups have trended upward since we found the bottom of the market late December of 2018 and have contributed 2.2% out of the 13.7% returned by the S&P this quarter (about 16.2% of the total return). The purpose of this exercise is to peel back the returns on the S&P to determine if gains are industry-wide, or if they are concentrated in a handful of sectors and industry groupings. In particular, tech and discretionary are highly cyclical sectors with high beta exposures and so if the "what goes up must come down" theory holds true, then the high returns we've experienced this quarter may lead to a large correction over the next two quarters if economic data continues to validate a cyclical slowdown. Tech has been both a leading sector for positive gains and also for negative gains the past two years. As such, we will monitor the performance of both Tech and Discretionary as "canaries in the coal-mine" sort of speak, for anticipating a potential downturn in the broader market.



The biggest laggards on the quarter were Health Care and Financials, returning 6.1% and 7.9%, respectively. Financials underperformed largely due to the flattening of the yield curve during the quarter, leading to anticipated higher short-term borrowing costs (deposits, savings accounts, CDs) and lower returns on their long-term assets (largely mortgages and commercial loans) on a relative basis. We anticipate financials to be one of the better performing sectors during the quarter as the yield inversion, to us, is a function of bond market recalibration (see below) in an otherwise healthy environment for bank profitability.

US Government bond Yield Curve Inversion: Does it Matter?

Our view remains the same on what causes recessions, which is external shocks to the economy during growth cycle downturns. The yield curve inverting was nothing more than the bond market reacting to the Fed's announcements during their January meeting. As inflation came in lower than expected, the Fed went from a 3 month "wait and see" to more of a full year "wait and see" and the market reacted accordingly by reducing the expected inflation premium in the yield curve. The Fed has achieved its dual mandate of maximum employment and stable prices, and until we see inflation pick up in a material way that leads the Federal reserve to increase their benchmark federal funds rate, the market will continue to price in lower future interest rates.

Proponents of the yield curve inversion as a pre-cursor to recessions believe that, despite the small sample size normally cited (the past 6 recessions – there have been 33 since the National Bureau of Economics (NBER) has recorded business cycle dates), the inverting yield curve accurately predicts recessions. You might even hear that the inversion has predicted the last two recessions. These are all true statements, but they are misleading. Data from the Federal Reserve Bank of St. Louis (FRED) shows that since 1953 there have been 10 recessions, and only six were preceded by a 10-year treasury – 3-month treasury spread going negative (inversion). These types of articles are normally populated by large media outlets that have a very targeted goal: get people to click on their content rather than provide the entire research and supporting information that contradicts their statement.

Why did the curve invert? The rally on long term government bonds on March 22nd drove yields down to 2.439% on the Benchmark 10-year Treasury. This rally was global and likely triggered by one of the worst readings on European manufacturing in almost 6 years. Data released also showed German manufacturing activity slowed, which drove the 10-year German bund yield negative which has not occurred since 2016. The US Treasury bond has historically been the safe-haven asset of choice for global economies due to our nation's currency being the "world's reserve currency" and strength of the US Government. As deterioration in global economic conditions were to continue, you would see more and more demand for US assets (in particular, the US Treasury bond) which drives the price higher and thus yields lower. Couple this with lower than expected inflation and the Fed's policy reversal on rate hikes and you get the yield curve inversion.

Does it matter? Even when the yield curve inversion does predict recessions, the average time between the inversion and actual recession is about one year (sometimes nearly two years), with a range of 140 to 487 days based on Bianco Research. Do inversions precede recession? The answer is yes, but the real question we care about is WHEN the recession will occur. **And to that end, a yield curve inversion is far from useful.**

So, in our view, yield curve inversions alone are meaningless when trying to calculate the odds of a recession in the near term. In addition, the curve normally has inverted because the Fed was raising rates to fight increasing inflation, which historically occurs near the end of economic cycles as labor demand pushes wags higher, which leads to companies increasing prices to maintain their profit margins. The Fed controls (normally) the short-end of the interest rate curve, so as they raise to fight inflation, this also generally coincides with a "flight to quality" by large asset managers as they sense we are at the end of a cycle. This drives longer term bond prices up, and thus their yields decrease. This effectively "flattens" the yield curve. This time, however, inflation is absent and well below its historical average and the equity markets showed resiliency. So, while history does have its place in helping to forecast future events, it is not perfect.

A LOOK AHEAD TO 2Q2019

Signs of potential trouble ahead continue to come in such as the manufacturing slowdown in Europe, the growth cycle downturn here domestically, and the signal by the Federal Reserve that the economy is not healthy enough to withstand another interest rate increase. None of these alone are enough to push us into recession anytime soon; however, if we were to experience any time of external shock on top of the slowdown such as an oil price spike (unlikely), interest-rate hikes (unlikely per Fed), or asset bubble (most likely), this could be the event that drives the economy into recession as we become more vulnerable to such shocks this late in the cycle.

Recessions happen but knowing when they will occur or trying to predict when that will happen is not something we attempt to do. Rather we look at the economy through multiple lenses (consumers, businesses, trade, Government policy) to adapt and survive as the cycle moves through each of its stages of growth.

We expect to see a volatile 2nd quarter as we 1) approach previous all-time-highs set in September 2018, and 2) as we get to review more economic data that we anticipate will confirm the global growth slowdown actually has teeth. It seems that the markets have become complacent to the point of this calm, upward drift in the S&P despite clear divergences in economic data and global growth. Benjamin Graham stated that "…the investor's chief problem – and even his worst enemy – is likely to be himself." We follow a systematic, rules-based approach to avoid human-error and judgement in the decision-making process for our investors. This eliminates this chief problem, and we will continue to encourage investors to do the same. This late in the cycle it is as important as ever to check our expectations of future returns, and to think pragmatically about how to react if/when an external shock does occur.