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Dear Valued Client,

The main reason why financial markets moved lower in Q4 2018 was due to fear that the Federal Reserve would continue raising interest rates against the backdrop of slowing global economic growth, putting economic recovery at risk. Much of those fears were relieved in the first quarter, as the Federal Reserve signaled its intent to keep interest rates steady for 2019. In response, global financial markets rallied strongly in the first quarter, with the Vanguard S&P 500 Index (VOO), Developed International (EFA), & Emerging Markets (EEM) indices gaining 13.62%, 10.34%, and 9.88%, respectively. The Barclays Aggregate Bond Index also posted nice gains of 2.94% in the first quarter as the 10-year treasury yield decreased from 2.68% to 2.41%. The correction and subsequent recovery in stock prices illustrates the amplified effect that interest rate guidance has on financial markets. Volatility is a reflection of uncertainty, which is more common in the later stages of the business cycle as investors worry about higher interest rates undermining the sustainability of economic growth and asset valuations. The unfortunate reality in the stock market is that its comprised of many individual and institutional investors alike that tend to over-react and draw too many conclusions from a limited set of economic and financial market indicators. We saw a good illustration of this during the first quarter when February non-farm job payrolls increased by 33,000, validating investor worries that the economy was slowing down. In March, however, job creation bounced back with 196,000 growth in non-farm job payrolls. Similar hasty conclusions were made in December last year when retail sales growth disappointingly slowed to 1.6%, only to recover to 2.8% and 2.2% growth in January and February.

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The takeaway is that the investors should not miss the forest for the trees and draw too many conclusions from short-term economic data that have little bearing upon long-term business value. Peter Lynch once said: "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves." Volatility is the price of admission for participating in the capital markets, but for those with the discipline to stay the course, it's worth it!

Staying the course not only requires discipline, but also a deeper held faith in the ability of our free enterprise system to correct excesses and misallocation of capital from the prior business cycle and foster conditions that encourage a new phase of capital investment. That adjustment isn't pretty or easy, but it is healthy and largely explains why the United States has significantly outperformed Europe since the financial crisis of 2008. Warren Buffett once said: "I think the most important factor in getting out of the recession actually is just the regenerative capacity of American capitalism." Winston Churchill said: "The inherent vice of capitalism is the unequal sharing of blessings." While the virtues and societal benefits from free market capitalism are voluminous, its flaws are being exposed and attacked to a degree that I have never seen before in my career. The longevity of the bull market and the business cycle has no doubt accentuated "the unequal sharing of blessings" that need to be addressed, but attacking the vices of capitalism unilaterally without acknowledging and appreciating its virtues & history is misguided. Hopefully this troublesome discourse will evolve over time into thoughtful reforms that address its shortcomings while preserving its power.

Another occurrence receiving attention in the first quarter was the flat yield curve. The yield curve is a graph that depicts interest rates (yield) and maturities for bonds. A maturity is the due date when a bond's principal is due.

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The reason it's called the yield curve is due to the positive correlation in most normal environments between a bond's time to maturity and interest rates, reflecting the time value of money principle. The trajectory of the yield curve across a bond's time to maturity is a function of current real interest rates, credit quality, and inflation expectations. Federal Reserve Chairman Jerome Powell recently said: "Inflation expectations are now the most important driver of inflation." If we put aside credit quality and focus on U.S. treasury yields, it depicts a flat yield curve where the current difference between a 2-year & 10-year treasury bond is just .18%. Flat and inverted yield curves are unusual occurrences that undermine the concept of time value of money, but they signal a cumulative belief that inflation expectations are low and real short-term interest rates are perhaps too high. The media has recently highlighted this relationship between flat/inverted yield curves and their historical track record of predicting economic slowdowns. According to Bloomberg, since 1976 there has been an average 16-month lag between the 10yr-2yr yield curve inversion and the start of economic recession. While we are not discounting the predictive nature of this relationship, we do think the current environment is structurally different given the preponderance of low yielding government debt across the developed world. According to Bloomberg, negative yielding government debt reached $10.5 trillion dollars in the first quarter, as both 10-year yields in Japan and Germany turned negative. In short, the current flat trajectory of the treasury yield curve not only reflects the level of real interest rates and inflation expectations, but also the external environment of government debt markets outside the U.S.

As such, we are not overly concerned by the flat yield curve and don't see the evidence across other areas of the bond market that suggest recession is likely in the near term. If we see signs of weakness, it typically shows up in the high yield bond market before anywhere else given its sensitivity to changes in credit conditions.

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In closing, moderate economic growth, stable dollar, stable inflation, stable monetary policy, and increasing optimism over trade negotiations with China collectively produced a favorable backdrop that contributed to the recovery in asset prices in the first quarter.

Moving forward, markets will increasingly focus on the outlooks from companies reporting first quarter earnings as well as geopolitical developments from US-China trade talks. With interest rate policy uncertainty in the rear-view mirror, investor complacency has crept back into the market and market valuations remain elevated. It would not surprise us to see more volatility as the year progresses. Overall, we are pleased with the performance of our model portfolios and investment selections in the first quarter and continue to be vigilant in managing risk. If you have any questions on your accounts specifically, feel free to let us know. Our next client education roundtable is scheduled for May 10th at 9:00 at our Oak Ridge office, so please come join us for the discussion. As always, thank you for the trust that you have placed in us.

Sincerely,

C&J Wealth Advisors

J. Mark King, CFP®
Jeff Loos, ChFC®, LUTCF
Scott Smith, CIMA®

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The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stock's weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance. The MSCI World Index is a market capitalization-weighted index designed to provide a broad measure of equity market performance throughout 23 countries in the developed world.

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Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.