



MIDWEST CAPITAL  
ADVISORS™

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To Our Clients and Friends:

We are pleased to bring you our report for the first quarter of 2019.

The equity market recovery that started in early January continued and strengthened during the first three months of 2019, with the S&P 500 Index having its best quarter in nearly a decade and best start to the year since 1998<sup>1</sup>. This came directly on the heels of one of the worst quarters for equities in recent memory<sup>2</sup>, which in turn followed the S&P 500 Index's best quarter since 2013. The Index is now less than 2% below its all-time high set in September. It has bounced nearly 23% off its late-December low. Bonds made a nice comeback as well, with the Bloomberg/Barclays U.S. Aggregate Bond Index rising almost 3% in the quarter<sup>3</sup>.

What are the reasons for the market's swift recovery? The Federal Reserve stating at its January 30 meeting that it would be "patient" regarding future rate increases (which it made even more definitive at its March 20 meeting when it said that it is not likely to hike rates in 2019 and sees only one rate hike in 2020<sup>4</sup>) is a big one. At that meeting the

Fed also announced reduced GDP expectations, lower inflation expectations and slightly higher unemployment. While initially the markets dipped on fears that the Fed's stated economic expectations were, on balance, worse than the benefits of keeping rates steady, the very next day the S&P 500 Index gained almost 31 points (over 1%) and has pretty much continued its climb since then.

Another reason for the recovery is what appears to now be the apparent oversimplification (if not misinterpretation) of the dreaded "yield curve inversion" by some experts and nearly all of the financial media. The "yield curve" is nothing more than a graphical representation of the yields available for treasury instruments that have different maturity dates. Yields are plotted on the vertical ("Y") axis and maturities are plotted on the horizontal ("X") axis. A "normal" yield curve (i.e., one that is associated with positive economic growth) slopes upward, with longer-term treasuries yielding more than shorter-dated ones<sup>5</sup>. When longer treasuries yield less than shorter ones, the curve is said to invert, that is, become downward sloping. The significance of this? Longer bonds yielding less than shorter bonds is a condition that has preceded recessions. However

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<sup>1</sup> Source: CNBC. For the quarter the S&P 500 Index gained 13.65%; international markets did well too – the MSCI World ex-USA Index (gross dividends) was up 10.60% - but clearly market and economic momentum is in the U.S. To put this in perspective, the S&P 500 Index returns have now *averaged* 6.56 percentage points (15.92% vs. 9.36%) better than the MSCI World ex-USA Index every year since the end of the 2008 bear market. Data source: Dimensional Fund Advisors.

<sup>2</sup> The S&P 500 Index dropped a gut-wrenching 13.5% in the fourth quarter of 2018.

<sup>3</sup> To put this in perspective: Over the last five years the Index has had annualized average returns of 2.74%. The MCSI World ex-USA Index, an *equity* index, not only had smaller annualized returns over the period (2.71%) but over three times the volatility! Data source: Dimensional Fund Advisors.

<sup>4</sup> Interestingly, this announcement came only three months after the Fed said that two hikes in 2019 would be appropriate.

<sup>5</sup> The most watched area of the yield curve is the spread between the 3-month Treasury bill and the 10-year Treasury note. It is also the most reliable indicator. Source: San Francisco Federal Reserve.

(and this is what few in the financial mass media failed to point out) while there have not been recessions without a yield curve inversion, not all inversions lead to recession. And, if and when a recession comes, it is usually many months after an inversion. Not only that, historically equities tend to outperform for months even after the bond market is flashing a recession signal<sup>6</sup>. By the way, as of this writing, yield curve is upward sloping, albeit barely<sup>7</sup>. While all this does not necessarily give the economy and the stock market the “all clear” signal, it is yet another reason to not panic.

Improvements in manufacturing activity in both the U.S.<sup>8</sup> and China<sup>9</sup> are reducing fears of a worldwide recession. While the improvements were relatively modest on a percentage basis, they do show at least a temporary reversal of a downward trend that had investors on edge (if not on the sidelines). And, in China’s case, readings are now above the psychologically important level of 50. Although manufacturing activity accounts for a fraction of U.S. GDP, it nonetheless has a significant impact on investor psyche and confidence. While the U.S. and China numbers are good and getting better, pockets of weakness in other areas persist<sup>10</sup> making definitive conclusions about the world economy difficult to draw. The next DOL jobs report (due out tomorrow) will add another data point to the analysis of the health of the U.S. economy.

Trade is likely to be the next big catalyst for a movement one way or the other now that the Fed has pretty much shown the hand it intends to play for the next 18 months or so. Today stocks opened higher on optimism that today’s meeting between the president and Chinese Vice Premier Liu He at the White House could be one of the last steps before a trade deal is announced<sup>11</sup>. Both sides have expressed optimism, but until a deal is announced (and signed), it is certainly possible that things could get off track. Even when a deal is signed, there are likely to be challenges ahead<sup>12</sup>: Many people think the deal that is being negotiated does not provide enough protection<sup>13</sup> to the U.S.; there are questions about the longer-term benefits of the deal (a large proportion of the commodities purchases to which China supposedly has agreed would come just before the 2020 election), and, of course, enforcement. Whatever its terms, it seems unlikely that any current trade deal is going to be sufficiently comprehensive to materially reshape the long-term economic relationship between the two countries.

With the market’s swift recovery have equity valuations gotten ahead of themselves? Not yet anyway, at least when compared to history. The S&P 500 Index is currently trading at ~14.4 times consensus forward 12 month earnings, which is below the 25-year average of 16.1 and about where it

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<sup>6</sup> In fact, the S&P 500 returns typically remain at or above their historical average for around 30 months after a sustained inversion. Source: Marko Kolanovic, global head of macro quantitative and derivatives research at J.P. Morgan, March 26, 2019).

<sup>7</sup> The 3-month T-bill is at 2.44% and the 10-year T-note is at 2.51%. Source: U.S. Department of Treasury.

<sup>8</sup> The U.S. Institute for Supply Management’s monthly PMI rose to 55.3 in March from 54.2 in February. Anything over 50 is considered expansionary. Source: *Wall Street Journal* 4/2/19, page A1.

<sup>9</sup> China’s PMI rose to a six-month high of 50.5 in March from 49.5 in February, well above the estimates of many economists. *Ibid*, p. A9.

<sup>10</sup> For example, Germany, a bellwether for Europe, saw its PMI drop below 45, continuing the downward trend from 57 just one year ago. Source: *Wall Street Journal* 4/2/19, page A9.

<sup>11</sup> According to today’s *Wall Street Journal*, *The Financial Times* reported yesterday that the U.S. and China have resolved most of the sticking points preventing an agreement to end the continuing tariff dispute.

<sup>12</sup> Source: Yahoo Finance 4/4/2019.

<sup>13</sup> Tariffs are one thing, but on a long-term basis, things like intellectual property protection and structural reforms such as curbing (or at least providing some transparency on) allegedly illegal (under World Trade Organization rules) Chinese state subsidies of a variety of industries are far more impactful.

was five years ago<sup>14</sup>. International stocks are cheaper, both relative to U.S. stocks and their own long-term history. At some point this is bound to change, which means that appropriate exposure to this asset class should not be forgotten.

First quarter earnings are likely to be lower than they have been in the past<sup>15</sup>. Much of this has been priced into current market levels, however, since for months companies have been telegraphing the challenges they face from slowing growth, narrowing profit margins and ongoing trade issues. Markets are most impacted by how reported earnings compare to earnings *expectations*, which in turn are based on what company executives are saying. For the current quarter such expectations are modest and probably pretty well priced into current market levels. The bigger impact is going to come from what company executives say about upcoming quarters. With earnings season beginning next week, we won't have too long to wait to find out to what extent the market has correctly discounted any fears and uncertainty.

Many things are in play right now. As always, our best advice is to stick to your long-term plan and ignore the short-term noise.

MCA is very pleased to announce that Jack Tunge and Mark Satkoski have become owners in our firm, in recognition of their significant past and ongoing contributions to the success of not only our clients, but to our firm as well. Congratulations, Jack and Mark!



Did you know that Midwest Capital Advisors has a presence on social media? Follow us on [LinkedIn](#) and [Facebook](#) for both informative and fun updates.

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<sup>14</sup> Source: JP Morgan Asset Management.

<sup>15</sup> According to FactSet, analysts are projecting an earnings decline of -4% in the first quarter of 2019 and flat earnings growth in the second quarter. They are, however, projecting earnings

growth of ~8.2% in the fourth quarter. The most bearish equity strategist, Morgan Stanley's Michael Wilson, is projecting a year-end level for the S&P 500 of ~2,750, which is 4.5% lower than it is today.