Making Sense of Finance

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First Quarter 2019 Review

STOCK MARKET

The substantial increase in the stock market in the first quarter of 2019 was a reversal of the dip in the fourth quarter of 2018. The S & P 500 increased 13% in the quarter. Other widely followed indexes did well also with the Dow Jones Industrial Average up 11% and the tech laden Nasdaq Composite gaining 16%. By the end of 2018, the market was considered by many to be oversold. The S & P 500 currently is almost back to the level it was at the end of September 2018. Why the change in sentiment? Most market observers contribute this optimism to the Federal Reserve leaving the Fed Fund target rate unchanged and signaling that it may not raise rates at all in 2019. This was an about face to previous comments made by the Federal Reserve chairman. The Federal Reserve also announced plans to stop its quantitative tightening (selling of bonds issued or backed by the Federal government which the Federal Reserve had purchased after the financial crisis) this year. Stock buybacks by corporations, last year estimated at $1 trillion, are expected to continue at a fairly high level this year. This continues to be a tailwind for the stock market. However, earnings growth for the S & P 500 companies in the aggregate is forecasted to be negative for the first quarter of 2019 (the first decline in earnings since second quarter of 2016). Expectations are for earnings to have positive growth later this year.

Stock sector performance in this last quarter was a mirror image of the fourth quarter 2018 (which in turn was the opposite of the third quarter 2018). Technology (which has the highest weighting in the S & P 500 at 21%), real estate and industrial stocks led the way, far exceeding the overall market increases. All S & P 500 sectors had positive returns in the first few months of the year. Energy stocks were also among the better performing groups, benefitting from the 32% increase in the price of oil in the first quarter. (Again this was the direct opposite from the previous quarter oil price decline of 38%). Health care and financial stocks, although posting gains, lagged the overall market. With market views changing so radically from quarter to quarter, as investors we need to keep our focus on the long term.

Foreign stock markets also produced decent gains last quarter. The MSCI EAFE index, which represents developed country markets, increased 9% in US dollar terms. In local currency terms. European markets did best among developed countries even with the threat of Brexit. France (12%), Germany (9%) and United Kingdom (8%) all rebounded nicely in the first quarter after a dreadful ending to 2018. Emerging market

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

Contributors:

Seaver T. Wang

Christine Terry

1 Baltic Place suite 201D

Croton On Hudson, NY 10016

www.toinvest.com

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stocks also bounced back in the first quarter, helped by a stable dollar (not strengthening like last year) which has an effect on emerging market debt owed in US dollars. The Chinese market in particular did well helped by the government stimulus of their economy.

BOND MARKET

A majority of bonds increased in price last quarter as bond yields decreased. The Bloomberg Barclays Aggregated Bond Index which is a measure of various investment grade bonds in the U.S. had a total return of 2.9% in the first quarter. Corporate bonds in particular contributed to the gain in this index. Treasury prices increased slightly as yields dropped; the longer the term the better the performance. Yields on a 10 Year Treasury fell from 2.69% at the end of 2018 to 2.41% at the end of March. Short term yields also decreased from 2.63% for a One Year Treasury on Dec. 31st to 2.40% at end of the first quarter, primarily because the Fed chose to hold the Fed Fund rate steady instead of indicating more increases for 2019. The "real" Fed Fund rate (rate of return after adjusting for inflation) has averaged approximately 1% since 1971. Since the financial crisis of 2009, we have been below that average, which has hurt "savers" who are looking to get a safe return on their money, but has been a boon to "borrowers" because the price of money has been very cheap for a while. This was intentional in that the Federal Reserve was trying to stimulate the economy after the last major recession. Now though, as the Federal Reserve calls it, we are at the point of "Policy Normalization".

High yield (non-investment grade bonds) were the best performing bond sector in the first quarter as investors were willing to take on more risk for better yields. Energy related debt is a large portion of the high yield market, and reacted favorably to the huge increase in oil prices. Emerging market debt also did well as riskier assets returned to favor last quarter.

OUTLOOK

The flat yield curve means that waiting to get back your principle is not being rewarded with higher interest rates. This is not likely to change until we go into a recession and the "bears" can look forward to the next economic expansion. This makes short-term bonds the only appealing area and then only for holding cash. With the Federal Reserve unlikely to raise rates, we view real estate's positioning as improved and behind stocks in attractiveness, followed by bonds.

Nothing goes up in a straight line, which is why the stock market goes down frequently but ends up higher over longer periods of time. A lot has been made of the 10 year stretch of positive returns for the stock market (2009- most of 2018), but 2018 was technically a down year (down 4% after dividends), so do we reset the clock? Another 5 years before the next downturn? It doesn't work like that. When the next downturn occurs is anyone's guess, but what we are more concerned with is the magnitude of a downturn. We still don't see any bubbles, even though greater consumer debt does continue to become a greater threat to this. Last year, we identified Bitcoin as a bubble which has since lost over 2/3 of its value from its highs. This year, cannabis (marijuana) companies are the high fliers that we would stay away from. They are similar to early internet companies in that they are new, have very few sales, and are nowhere close to profitable.

The sudden crash in December and the immediate rise in January speak volumes as to why we do not time the market. Remember, you have to be correct twice to profit; when to get out and then when to get back in. The investors who cashed out after the initial drop are now holding on to losses that may take years to recover from. The buy and hold investors are about even, and the opportunistic investors with some cash used the correction to add to their favorite positions at more attractive prices.

We have noticed some short-term memory bias from many investors. The financial crisis and the Internet bust remain on their minds and the assumption is that the next downturn will be similar doozies. People have forgotten about smaller corrections that are healthy for the markets and can help sustain bull markets. If we look further back in history we would see that for the 25 years prior to 2000, the worst negative year was only -7% (including dividends). That's an entire generation without a bear stock market in a calendar year. A child could be conceived, raised, graduate from a 4-year college and finish graduate school within this time period. While we are likely near the end of this economic cycle, a brief pause or dip is possible before moving onto the next stages of growth. And if one doesn't believe in the long-term growth of corporations, then they should not be involved with owning corporations. That said; we can foresee another 12 months of strong economic activity in the U.S. with a chance of re-acceleration should Europe and China's economies recover from their current weakened state.

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