ADVISER INVESTMENTS

Adviser Outlook

SECOND QUARTER 2019

QUICK TAKES

- ✔ Domestic and foreign stock markets rebounded during the first quarter despite recurring headlines about recession, China trade, Brexit and a global economic slowdown
- ✔ Economic and earnings growth may be slowing, but consumer strength, tepid inflation, low interest rates and a Federal Reserve on hold are pluses for the economy
- ✔ Smart diversification remains key to managing near-term obstacles on the path to achieving long-term goals

Stocks reversed course in the first three months of 2019, bounding ahead after their rapid decline late last year. The S&P 500 index delivered its best calendar-quarter performance since 2009 and the best first quarter since 1998. Foreign developed and emerging markets stocks rose as well, along with the bond market. As we head into the second quarter, many of the challenges investors faced in both the fourth quarter of 2018 and thus far this year are yet unresolved.

It appears to us that, for now, investors have turned their focus to the fundamentals of growing corporate earnings, low interest rates, a strong job market and continued improvements for a host of economic data rather than to fears of the unknown.

In March, the contentious Brexit issue again became fodder for headline writers as the deadline drew near (before the European Union granted the U.K. a six-month reprieve in April), but we think that the biggest threat to global economic and market stability is the outcome of ongoing U.S.-China trade negotiations. Unlike last year, the current thinking is that negotiators are finding some common ground and that a deal, even if longer on rhetoric than concrete terms, may be in the offing. The true measure of any deal's strength will be how concerns over intellectual property are resolved. The level of investor optimism over a U.S.-China resolution is priced in to the markets; how much so will be known once the details are ironed out.

It's worth noting that despite the uncertainties concerning both the U.K.'s Brexit (or not) and our dispute with China, both countries' stock markets rallied during the first quarter. The U.K.'s stock market (measured by MSCI) gained 11.9% over the first three months of the year, making it the top-performing large European market for the period. China's stock market rose a stunning 17.7%. So, as we said above, investors looked beyond the short-term unknowns and, we suspect, took an optimistic view on future growth for both economies.

If Brexit, a U.S.-China trade war and concerns surrounding the Mueller report on Russian election interference were (and are) near-term hurdles, our greater focus is on slowing economic growth in Europe and China. Both the International Monetary Fund and the World Trade Organization downgraded their estimates for 2019's global growth. This concern was clearly shared by Federal Reserve policymakers, who downshifted expectations from two or more interest-rate hikes in 2019 to none. Still, there is no suggestion of vanishing global growth, simply for the pace of it to slow.

QUARTER REVIEW

- ✔ Mid- and small-cap U.S. stocks delivered the best returns in Q1 though the broader stock market also posted double-digit gains across the board
- ✔ Overseas stock markets lagged U.S. markets, but also had a strong start to the year
- ✔ Every U.S. stock sector returned more than 8.0% in Q1: Technology stocks led the way with a 20.7% gain; health care stocks were the caboose with an 8.2% return
- ✔ U.S. bonds gained ground and yields moved lower

We do not think that a U.S. recession is imminent and are confident that Fed officials are focused on the data. Their statements and recent track record suggest they will be as hands-on or hands-off as the economy requires, ready to provide a safety net for investors.

Keep in mind that unemployment is low and wages are on the rise. Households are in solid financial shape by most measures, which means the consumer is in a position to continue consuming. While corporate earnings growth may have slowed, it has not disappeared and interest rates and inflation are still favorable tailwinds for businesses as well as individuals.

Any one, some or all of the above factors, or an unexpected shock out of left field, could result in short-term market disruptions or a correction (a loss of 10% or more). Even so, we see room for measured optimism when we look at the fundamentals and think the managers we invest in alongside of our clients will find ways to take advantage of short-lived fears to deliver long-term gains at discounted prices when meritless market declines occur.

We remain optimistic.

First Quarter Review

U.S. stocks led the charge into 2019. Mid- and small-cap stocks outpaced large-caps, contributing to the MSCI U.S. Broad Market index's 14.1% first-quarter return. The S&P 500 index was not far behind, gaining 13.6%, while the Dow Jones Industrial Average advanced 11.8% on a total return basis. Over the last 12 months, the three indexes were up between 8.8% (MSCI) and 10.1% (Dow). Through the first few trading days of April, the S&P 500 and Dow total return indexes were less than a percentage point below their all-time highs.

Developed and emerging stock markets delivered a strong quarter, returning 10.0% and 9.9%, respectively, over the three months. These gains were not enough to overcome last year's declines though; the MSCI EAFE is down 3.7% over the last 12 months while the MSCI Emerging Markets index is off 7.4%.

All 11 sectors of the U.S. stock market generated positive returns over the first quarter, and all but three are showing gains over the last 12 months. Technology stocks led the pack with a 20.7% return to start the year, followed by industrials (17.3%) and energy stocks (16.8%). Tech stocks were helped by the increasing optimism that U.S.-China trade negotiations are progressing well.

Meanwhile, health care, financials, and utilities stocks were the laggards in Q1, with 8.2%, 9.4%, and 10.8% returns, respectively. Intra-quarter, financials stocks became less attractive to traders following the Fed's statement that it is unlikely to raise rates again this year and the concomitant dip in bond yields. Health care stocks were impacted in part by renewed uncertainty over drug-pricing policy. Meanwhile, the Trump administration has also persisted in its attempts to dismantle Obamacare. Health care will consistently be a politicized topic, but our view is that *Demograyphics*™ (the graying of America) and growing overseas demand, along with innovation, make the sector an excellent long-term overweight in a diversified portfolio.

Over the last 12 months, REITs and utilities stocks were the top performers, with returns of 20.7% and 19.9%, respectively. These interest-rate-sensitive and higher-yielding sectors have benefited from investors seeking income alternatives to bonds. Financials, down 4.7%, lost ground for the reasons listed above.

Stocks Around the World Rallied

	Q1	12-MO.
MSCI U.S. Broad Market	14.1%	8.8%
S&P 500	13.6%	9.5%
Dow Jones Industrial Average	11.8%	10.1%
MSCI EAFE	10.0%	-3.7%
MSCI Emerging Markets	9.9%	-7.4%
Bloomberg Barclays U.S. Agg. Bond Index	2.9%	4.5%

Note: Ranked by Q1 returns. Performance numbers are total returns, reflecting reinvested dividends through 3/31/19. Source: Morningstar.

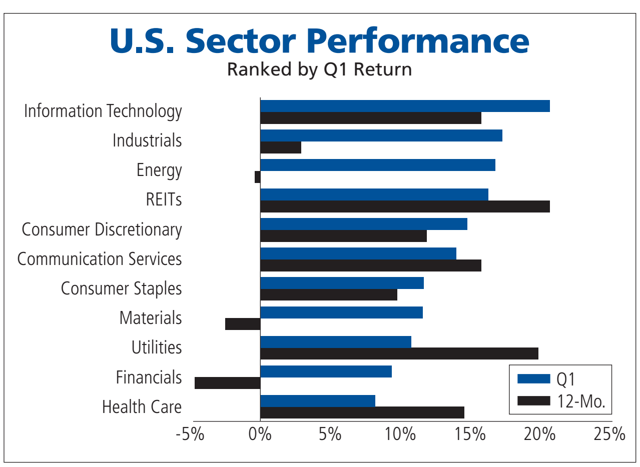
OUR OUTLOOK

- ✔ Client portfolios are prepared for volatility to return to the markets (from Mueller report wrangling, trade war, slowing global growth or other concerns) and positioned for a range of outcomes according to clients' goals and comfort for risk
- ✔ Recessions are inevitable but unlikely in 2019; risk of recession is greater in Europe and China than in the U.S.
- ✔ Consumer strength, low inflation and interest rates, and a more reasonable pace of earnings all point to further slow growth in U.S.
- ✔ We continue to evaluate our intermediate-term outlook and portfolio allocations for potential risk mitigation and return enhancements

Materials stocks, off 2.5%, looked less attractive as inflation hedges as well as suffering at the hands of those who think slower economic growth will hurt demand for raw materials.

While U.S. bond market returns were modest compared to stocks, the 2.9% gain over the first three months of the year and 4.5% rise over the last 12 months were solid. Higher yields in 2018 may have hurt prices initially but ultimately meant higher income and better total returns over time. The yield on the 10-year Treasury note ended the quarter at 2.41%, down from 2.69% at year-end. In the meantime, yields of short-maturity bonds are elevated following the Fed's rate hikes over the last two-plus years. At the end of March, this dynamic caused a brief, partial yield-curve inversion and ignited recession fears, something we'll discuss in detail below.

After the first quarter's remarkable rally, U.S. stocks are looking more expensive compared to historical valuations, but with interest rates and bond yields still low, stocks continue to offer selective opportunities. Bonds remain our well-reasoned diversifier and risk buffer to offset stock market volatility.



Source: Morningstar.

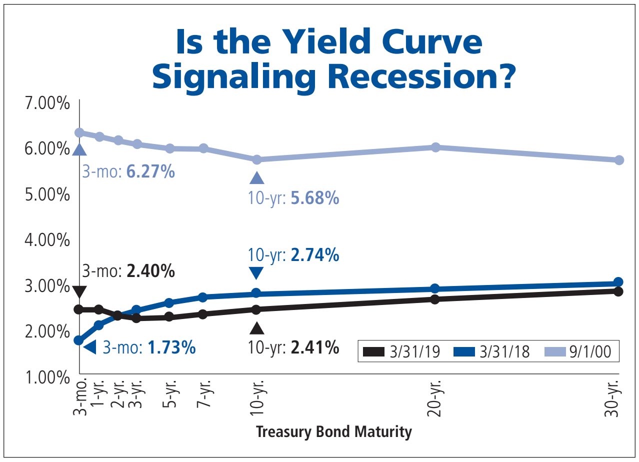
Our Outlook

Fundamentals support the case for further slow economic growth and the potential for stocks to move moderately higher. With that in mind, we don't assume that the path to gains will be as smooth as it was in the first quarter and any number of the challenges we outlined above could present obstacles.

One new factor could be mistaking slowing earnings growth with no earnings growth. The term "earnings recession" is catchy, sounds dire and is being tossed about with abandon. But we knew, and have written in our regular client communications, that once the boost from the 2018 corporate tax cuts was accounted for, tougher earnings comparisons would be this first quarter's result. Estimates suggest that earnings per share for S&P 500 companies grew at a slower pace over the first three months of 2019. It's no surprise to us that companies couldn't maintain last year's 20%-plus earnings growth rate quarter in and quarter out, and a lower earnings trend is different from no earnings. Companies are still making profits, benefiting from low interest rates and strong consumers.

From "earnings recession," it's not much of a leap to worries about a wider economic recession. Toward quarter-end, that specter cropped up when something called a "yield curve inversion" took place. The yield curve plots the yields of Treasury bonds from short to long maturities; it's said to invert when short-term bonds have higher yields than long-term bonds. A yield-curve inversion is widely seen as a precursor to recession, but it does not predict how soon it might occur nor how steep it might be.

In March, the yield on the 10-year Treasury note moved lower than the yield on the 3-month Treasury bill. The difference between the two yields never dipped more than five basis points (0.05%) into negative territory and only stayed there for five days, a rather shallow



Source: U.S. Department of the Treasury.

and short-lived inversion by historical standards. There is also some debate about which bonds' yields should be contrasted; the so-called "10–2 spread" comparing the 10-year and 2-year Treasury bonds' yields that many investors look to has yet to go negative. The chart above shows the yield curve as of quarter-end, where it stood a year ago and, for comparison, what it looked like in September 2000, after it had fully inverted ahead of the recession that followed in 2001. The 2019 version pales in comparison.

We have no doubt that another recession is a given, what we can't tell you is when it will start or how long it will last. Based on just a handful of data points, on average, recession followed an inverted yield curve by about 13 months (the range of lag over the last five occurrences was nine to 17 months). During the period between the yield curve inverting and a recession's start, the stock market gained an average of about 6%. In that light, we think recession concerns are premature.

We're actively assessing the risks and opportunities in the market, as are the fund managers we invest with. Adviser Investments clients rest assured that we are focused on the facts we know and will continue to invest their assets using the risk-aware investment discipline that has served them well over the past 25 years. Partnering with our clients to help them reach their long-term investment and financial planning objectives is our sole focus. If you would like to know more about Adviser Investments' approach to the markets, wish for a review of your own portfolio or would like to talk in detail about how our wealth management experience can help you secure your future, please call us. As *the Adviser You Can Talk To*, we're always happy to help.

Daniel P. Wiener
Chairman

James H. Lowell III
Chief Investment Officer

Christopher Keith
Senior Vice President, Fixed Income

Jeffrey D. DeMaso, CFA
Director of Research

Charles M. Toole, CFA, CFP®
Vice President, Portfolio Manager