Market Commentary | 1Q 2019

Below is our Market Commentary as of the quarter ending March 31, 2019.

U.S. equities rallied sharply throughout the quarter. The S&P 500 posted a total return of +13.65% and ended the quarter +20.56% above its December 24, 2018 close, which marked the low point of 2018, and 3.61% below its all-time high level of 2,940 (posted on September 21, 2018).

Midcap and small cap stocks (+14.49% and +14.57%, respectively) were the best-performing segment of the U.S equity market during the first quarter; growth stocks (+16.10%) outperformed value stocks (+11.93%).

International equity returns lagged U.S. equity returns but were still strongly positive: developed international equities had a total return of +10.42%, and emerging market equities had a total return of +11.77%.

March 9 marked the tenth anniversary of the current bull market for U.S. stocks. Since March 9, 2009, the S&P 500 has a total return of +416.80%, or +17.73% annualized.

In assessing the strong performance in the quarter, it is apparent that equities responded favorably to three developments:

1. The Fed communicated a less hawkish tone early in January, in response to softer economic data released during the fourth quarter.

2. There was progress made in the trade discussions/negotiations with China.

3. Fourth quarter corporate earnings were somewhat better than implied by the sharp downdraft in equity prices in December.

As we look ahead, the most salient risk for investors is the fact that the strong price performance for stocks in the first quarter discounts, or assumes, a combination of 1) a benign Federal Reserve policy, 2) the achievement of an acceptable trade deal with China, and 3) continued solid corporate earnings growth over the course of 2019. Disappointing news regarding any of these factors would likely result in a material pullback in stock prices; disappointing news on all three factors would likely result in a retest of the late December 2018 lows, at around 2,350 on the S&P 500 Index.

While stock prices moved appreciably higher during the first quarter, aggregate valuations for stocks as measured by the S&P 500, remain somewhat below our estimate of fair value for year-end 2019. At present, the consensus earnings estimate for the S&P 500 for 2019 is $166 per share (down from $178 at the end of the third quarter of 2018), and $185 per share for year-end 2020. We believe the S&P 500 is fairly valued at 16x forward earnings, which would imply a fair value estimate of 3,000 for the Index at year-end 2019, about 6% above current levels (the Index closed the first quarter at 2,834).

Longer-term, we believe equities are priced to provide total returns of 7 to 9% from current levels, which is reasonably attractive relative to the current 10-year Treasury yield of 2.40%. The current equity risk premium – the earnings yield of the S&P 500 relative to the 10-year Treasury yield – is 3.5%, somewhat above its historic average level, implying that stocks remain relatively more attractive than bonds.

Bond yields fell from 2.69% to 2.40% during the first quarter, as the Fed moderated its commentary around its policy given a slowing in U.S. and global economic conditions into the end of 2018.

At present, low nominal and real interest rates lead us to remain circumspect with respect to both bond weightings in portfolios, and the positioning of bonds within portfolios. We remain underweight bonds relative to targets and defensively positioned with respect to bond portfolio durations. That said, we have reduced our year-end target for the 10-year Treasury yield from 3.50% to 3.00%, given 1) the Fed's ostensibly more dovish stance and 2) signs of economic softening.

In sum, we expect the remainder of 2019 to be challenging and volatile, as the strong first quarter removes much of the undervaluation that existed at year-end.

Longer term, equities remain attractive, albeit with implied forward nominal returns that are somewhat below historic levels. Low interest rates make bonds less attractive relative to stocks, in our view.

We appreciate your continued confidence in our Firm, and we encourage you to contact us if you would like to discuss your portfolio and/or our outlook in greater detail.

Thank you for the continued confidence and trust.

The Bridges Trust Investment Committee