MALVERN CAPITAL MANAGEMENT

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# First Quarter 2019 Market Review and Outlook

April 2019

## The First Quarter in Review

Following a rather dismal fourth quarter 2018, global equities rebounded sharply in the first quarter 2019. The S&P 500 Index rose by 13.65% for the first quarter. Mid-cap and small-cap stocks did even better by advancing 16.54% and 14.58% respectively. The technology heavy Nasdaq 100 did the best by rising 16.89% for the quarter.

Interest rates fell in the first quarter 2019 which lifted bonds as the Bloomberg Barclays U.S. Aggregate Bond Index was up by 2.94%. High yield bonds, or junk bonds, did very well by tacking on an additional 7.26% for the quarter. High yield bonds should only do well if investors' attitudes about the economy were positive.

The pessimism of the fourth quarter quickly disappeared just prior to the end of 2018. It was replaced by optimism as investors saw the glass as "half-full" instead of "half-empty." The fears of an impending recession, an inverted yield curve, a trade war with China, slowing earnings growth and falling oil prices dissipated as rational expectations for the economy and stocks prevailed. Investors discarded those fears and awaited the start of earnings season in early 2019. They also welcomed positive economic data along the way as we entered the new year.

As we proceed through 2019, will investors' patience following the fourth quarter continue to be rewarded or is another pause on the horizon? We believe that continued gains in both equities and fixed income markets are likely and we discuss those reasons as follows.

### Index Performance

| Category | Representative index | March 2019 | 1st Qtr 2019 | 12 Months | 3 yr* | 5 Yr* | 10 Yr* |
|---|---|---|---|---|---|---|---|
| Mature US Large Company | DJ Industrial Average | 0.17 | 11.81 | 10.09 | 16.37 | 12.21 | 15.97 |
| Broad US Large Companies | S&P 500 Index | 1.94 | 13.65 | 9.50 | 13.51 | 10.91 | 15.92 |
| US Small Cap Companies | Russell 2000 Index | -2.09 | 14.58 | 2.05 | 12.92 | 7.05 | 15.36 |
| US Mid Cap Companies | Russell Mid Cap Index | 0.86 | 16.54 | 6.47 | 11.82 | 8.81 | 16.88 |
| Largest 100 NASDAQ Companies | NASDAQ 100 Index | 4.03 | 16.89 | 13.36 | 19.43 | 16.84 | 20.89 |
| Developed International | MSCI EAFE Index | 0.63 | 9.98 | -3.71 | 7.27 | 2.33 | 8.96 |
| Emerging Markets | FTSE All Emerging | 1.47 | 10.41 | -5.68 | 10.46 | 4.13 | 9.18 |
| Broad US Bonds | Bloomberg Barclays US Aggregate Bond | 1.92 | 2.94 | 4.48 | 2.03 | 2.74 | 3.77 |
| High Yield Bonds | Bloomberg Barclays US Corporate High Yld | 0.94 | 7.26 | 5.93 | 8.56 | 4.68 | 11.26 |
| Commodities | Bloomberg Commodity | -0.18 | 6.32 | -5.25 | 2.22 | -8.92 | -2.56 |
| Total US Market (all cap stocks) | Russell 3000 Index | 1.46 | 14.04 | 8.77 | 13.48 | 10.36 | 16.00 |
| Real Estate Investment Trusts | Wilshire US REIT Index | 3.20 | 16.02 | 19.34 | 5.45 | 9.00 | 18.69 |
| Oil | West Texas Crude Intermediate Oil | 5.21 | 33.31 | -7.21 | 17.67 | -9.94 | 1.95 |
| Cash | US T-Bill 90 Day | 0.20 | 0.59 | 2.15 | 1.23 | 0.77 | 0.43 |

** 3 year, 5 year and 10 year returns are annualized. All periods ending March 31, 2019.*
*All returns include the reinvestment of dividends.*

## *Why Did the Equity Market Recover in the First Quarter?*

There are several reasons for the equity market recovery in the first quarter 2019 and we focus on those that we believe were most important.

First, the reporting of fourth quarter earnings began in early 2019. Investors were fearful that earnings would begin to show a slowdown or even a decline from the previous quarter. To investors' surprise, earnings were better than many expected. By the end of the quarter, 68% of the S&P 500 Index component companies had beat their estimates while 25% missed and 7% met expectations. Earnings drive stock prices, and investors were pleased with what they saw for the fourth quarter which helped the stock market rebound.

Second, another big driver of the turnaround in the stock market during the first quarter was the acknowledgement of the Federal Reserve's (the "Fed") restraining from raising interest rates. It appeared through public comments from Fed officials and the commentary following the Federal Open Market Committee (FOMC) meetings (meetings in January and March 2019) that the Fed could pause and stop raising rates, perhaps for the duration of 2019. The Fed is data dependent and the facts were showing that the economy was not heating up and inflation was not a problem. The Fed has a dual mandate between maximum employment and price stability which is a tremendous balancing act at times.

Third, as we moved into the first quarter, it became more apparent to investors that the economy was not as bad as feared in the fourth quarter 2018. The data released throughout the first quarter confirmed the health of the economy. By pushing those fears aside, it gave investors' confidence to move back into equities.

Fourth, in the fourth quarter 2018, the yield curve inverted. An inverted yield curve has preceded most recessions and when the two-year U.S. Treasury note yield exceeded the five-year U.S. Treasury note yield in the fourth quarter (giving us an inverted yield curve with shorter term yields higher than longer-term yields), investors feared a recession may be looming. In the first quarter the yield curve normalized with longer-term rates exceeding shorter-term rates. However, late in the first quarter the yield curve did invert a second time as the 10-year U.S. Treasury note yield dropped below the yield on three-month U.S. Treasury bills. The inversion again brought up recession fears.

## *Tailwinds for the Market*

To continue with the rebound in equity prices, certain tailwinds should act as catalysts. We identify the tailwinds we believe will be most prominent.

First, it is likely that as long as corporate earnings remain positive and continue growing, stock prices should be positive. For the full year of 2019, the Standard & Poor's Corporation projects earnings on the S&P 500 Index companies to be $165.34 per share. For the full year of 2018, those earnings are projected to finish the year at around $151.60 per share (full year reporting for 2018 is yet to be completed). That represents a growth in earnings of around 9% year-over-year. Standard & Poor's projects earnings to continue growing into 2020 with full year earnings of $186.35 per share representing earnings growth of 12.7% year-over-year 2019 to 2020.

Second, the operating margin for the S&P 500 Index companies is projected to be 10.10% for the fourth quarter of 2018. The operating margin is a measure of the profitability of a company's sales. The recent trend has been for operating margins to increase every quarter over the past few years, but the 10.10% operating margin in the fourth quarter is a drop from 12.13% in the third quarter 2018. One data point does not make a trend and should not be looked at as a negative toward corporate profitability.

Third, one of the components of better earnings are the benefits derived from lower corporate income taxes that began in 2018. Taxes are an expense of doing business and lower tax rates help drive more profit to the bottom line. The average Federal corporate income tax rate for the S&P 500 Index companies dropped from 25.44% in September 2017 to 18.38% in September 2018. This represents a reduction in tax rates of some 28%. Nearly every sector in the S&P 500 Index benefited from lower tax rates year-over-year. Corporate tax rates have become very political and there are a lot of calls to reverse the tax cuts. However, such a reversal is not likely to happen as long as Trump is president. But when (in either two or six years) there is a change in the resident of the White House, these lower corporate taxes may go away and the stock market will likely need to go through an adjustment in valuation based on the reduced profitability from higher corporate taxes.

## S&P 500 Index and Sector Tax Rates

| S&P 500 tax rates | |
|---|---|
| Sep-18 | 18.38% |
| Jun-18 | 19.58% |
| Mar-18 | 18.81% |
| Dec-17 | 20.38% |
| Sep-17 | 25.44% |
| Jun-17 | 25.89% |
| Mar-17 | 25.44% |
| Dec-16 | 24.29% |
| Sep-16 | 26.93% |
| Jun-16 | 26.70% |
| Mar-16 | 27.89% |

| SECTOR | Q3 2018 | Q3 2017 |
|---|---|---|
| **S&P 500** | 18.38% | 25.44% |
| **Communication Services** | 15.72% | 34.53% |
| **Consumer Discretionary** | 17.66% | 31.53% |
| **Consumer Staples** | 19.94% | 27.35% |
| **Energy** | 27.09% | 20.05% |
| **Financials** | 19.56% | 29.16% |
| **Health Care** | 16.91% | 21.57% |
| **Industrials** | 37.06% | 29.16% |
| **Information Technology** | 11.54% | 18.39% |
| **Materials** | 24.16% | 27.33% |
| **Real Estate** | 2.65% | 2.99% |
| **Utilities** | 16.30% | 29.93% |

*Source: Standard & Poor's Corporation, 3/29/19*

Fourth, another component of earnings growth is a result of a reduction in the number of shares of stock outstanding year-over-year. Companies have taken some of the profits derived from the tax cuts and bought back company shares. Fewer shares available in the market means that company profits are divided by the fewer shares causing earnings per share to grow. 65.6% of the S&P 500 Index component companies had fewer shares at the end of 2018 than they had at the end of 2017. 18.7% of companies had greater than 4% fewer shares outstanding year-over-year 2018 versus 2017.

Fifth, despite the benefits from expense management, tax cuts, and share buybacks, companies are also still growing organically. The benefits from margin expansion, tax cuts and share buybacks may have a ceiling at some point and it will require growth of company sales to propel earnings further. For the full year 2018, it is projected by Standard & Poor's Corporation that sales grew by 9% from full year 2017 for the S&P 500 Index companies. Sales grew from fourth quarter 2017 to fourth quarter 2018 by 5.2% (note that fourth quarter sales numbers are only estimates at this point as some companies still need to report).

We believe that other reasons will act as tailwinds to the market. First, a trade war with China will likely be

averted. Second, the economy is still growing and no contraction is seen on the horizon. Third, the yield curve should normalize again. And fourth, the Federal reserve should continue to show restraint at least through 2019.

## *Headwinds for the Market*

What could go wrong or stand in the way of further market appreciation? We identify the biggest reasons why the market could falter if it were to meet the following headwinds.

First, there is a risk that the Federal Reserve doesn't get it right and it fails to raise interest rates to avert inflationary pressures that suddenly arise or it raises interest rates too far in an attempt to slow (currently unforeseen) inflationary pressures and applies the brakes to the economy.

Second, Washington and politics could also cause the markets to retreat. The Democrat led House gained its majority last November because Congressional candidates promised to work on healthcare legislation and infrastructure spending. If Congress fails to get anything constructive done for the country, it would be viewed as a negative for the markets. Also, it appears that some of the Democrats in Congress want to investigate the president and possibly impeach him. Investigations and impeachment hearings will also be viewed as a negative by the markets in our opinion.

Third, a continued and unresolved trade war with China will likely lead to negative stock returns. A prolonged trade war could also adversely affect economic growth. Nobody will win as a slowing economy in China is not good for global economic growth.

Fourth, although there are no current signs of declining corporate earnings, should earnings decline stock prices will need to adjust downward as a result. We monitor the trend and outlook for corporate earnings very closely for signs of things that could disrupt further market gains.

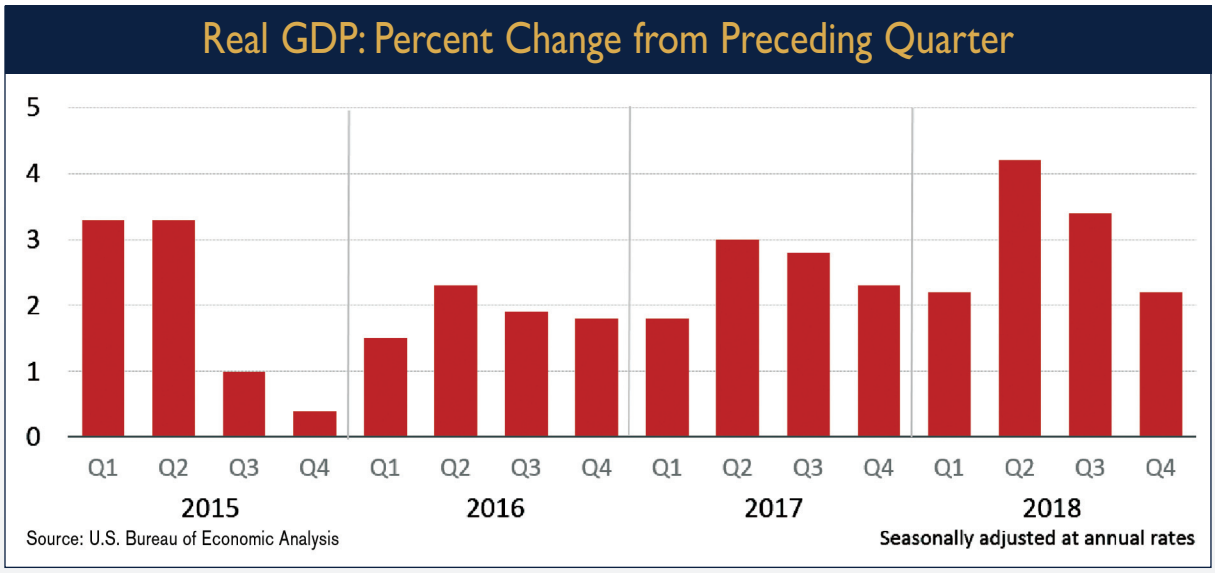
## *Outlook for Interest Rates*

Following the March 2019 FOMC meeting, the Fed left the Fed Funds rate alone at a target range of 2.25% to 2.5%. It signaled that it may not raise rates for the rest of 2019. It also went one step further to be a little more accommodative than it has been in the recent past. It stated that it would slow the "roll-off" of longer-term bonds held on its balance sheet beginning in May 2019. The bonds on its balance sheet were acquired as part of the four quantitative easing programs implemented over the years following the financial crisis. The Fed began in October 2017 "rolling off" longer-term bonds from its balance sheet by approximately $50 billion a month. That is, the Fed would not replace $50 billion of bonds each month that had matured which would enable its balance sheet to shrink. By not replacing the maturing bonds, the Fed would be allowing for upward pressure on longer-term interest rates. Slowing the "roll-off" should have the opposite effect and there could be downward pressure on longer-term interest rates as a result.

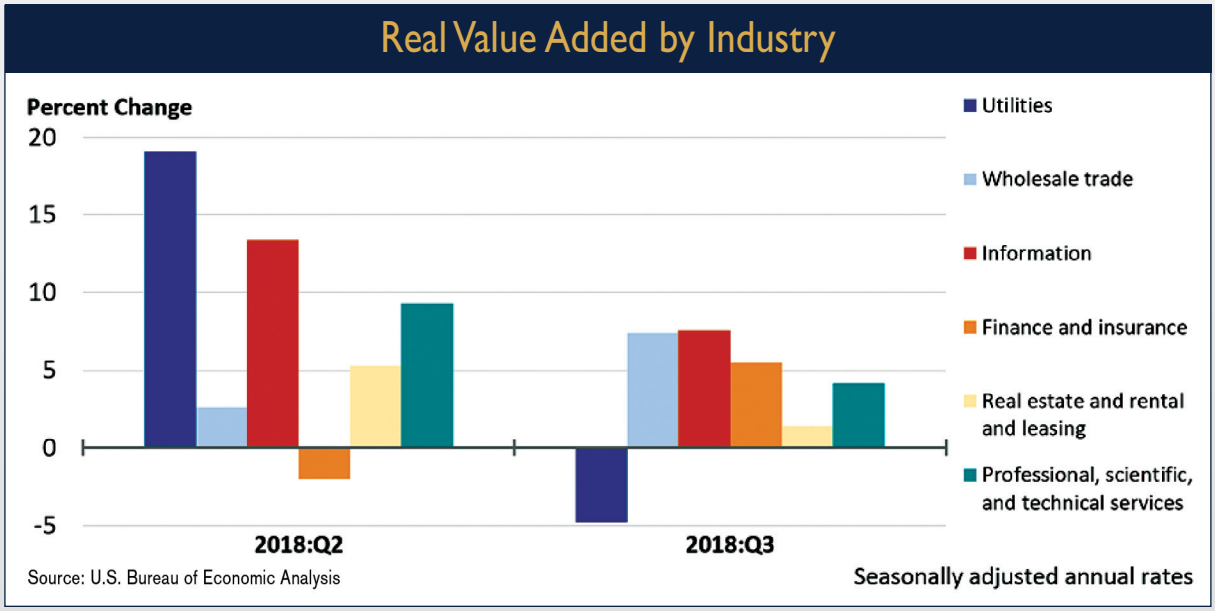
After the Fed meeting on March 20, 2019 when it announced the slowing of the bond "roll-off" from its balance sheet, the 10-year U.S. Treasury note yield fell from 2.61% to a low on March 28, 2019 of 2.36%. Our anticipation at the beginning of 2019 was for the 10-year yield to rise to between 3.25% and 3.5%. We anticipate the 10-year yield rising from the low level hit in the first quarter 2019, but we temper the outlook to 2.7% to 2.8% by year-end.

## *The Economy*

Real Gross Domestic Product (GDP) for the fourth quarter of 2018 increased by 2.2%. In the third quarter of 2018 it increased by 3.4% followed by a second quarter growth rate of 4.2%. For the full year of 2018, real GDP grew by 2.9% in comparison to a growth rate of 2.2% in 2017 and 1.6% in 2016 according to the Bureau of Economic Analysis (BEA). The economy is expanding at least partly as a result of both individual and corporate tax rate cuts.




The leading industry contributors to the increase in GDP for the third quarter of 2018 were Wholesale Trade, Information and Finance and Insurance. Of the 22 industry groups, 19 contributed to the overall third quarter increase in real GDP according to industry statistics provided by the BEA.



Wage growth in the United States has been nearly nonexistent for many years but we may now be seeing improvement. For February, personal income increased .2% after a decrease in January. The largest component of personal income is wages and salaries and they increased by .3% in February. They also increased by .3% in January.

Along with faster wage growth is a low unemployment rate. As workers become scarcer and jobs openings go unfilled, pressure on wages heats up. At the end of March 2019, the U.S. Unemployment rate stood at 3.8%. 156.7 million persons are working while 6.2 million are unemployed. In addition, it was reported for the month of March 2019 that 196,000 new jobs were added to the economy as reported by the Bureau of Labor Statistics.

In the fourth quarter 2018, the U.S. current account deficit (preliminarily) increased by $134.4 billion from a revised $126.6 billion in the third quarter of 2018. The current account balance is one of two components of a country's balance of payments (the other component being the capital account). In the fourth quarter 2018, the deficit was 2.6% of current-dollar GDP, up from 2.5% in the third quarter 2018.

President Trump often refers to the current account deficit as a negative. However, one really should not look at the deficit as a negative or a positive. One reason we tend to run deficits is because Americans have one of the highest standards of living in the world and we can afford to import more goods than we export. Our importing more than we export leads to the current account deficit.

Inflation has also been under control despite the faster growth in the U.S. economy. The Fed is monitoring inflation and its target is 2% annually. As we mentioned, wage growth has been picking up which can lead to inflation accelerating.

On balance, the statistics are pretty good for the economy and there are no apparent signs of a recession on the horizon.

## *Market Forecast Update*

As we entered into 2019, we projected that we would see the S&P 500 Index advance by 16.4% in 2019 based largely on expectations for corporate earnings and the then current valuation levels of the market at the beginning of 2019. We further stated our expectations for mid-cap stocks to return around 15.7% and small-cap stocks to perform the best domestically in 2019 at 17.5%. We had lower expectations for developed international stocks but high views of emerging markets.

As discussed earlier, we have seen strong equity market returns in the first quarter. We continue to affirm our earlier views for the equity markets in 2019. If the S&P 500 Index in fact returns at least 16.4% for 2019 (including the reinvestment of dividends), the Index value will be around 2868 per share. With a forecast of earnings on the S&P 500 Index by the Standard & Poor's Corporation at $165.34 per share, the year-end trailing price to earnings (P/E) ratio would be 17.3 times (2868 divided by $165.34). The 20-year average trailing P/E ratio (quarter-ending average) is 19.5 times. A P/E ratio of 17.3 would represent a market that is not expensive historically. If the earnings estimates do in fact materialize (and we earn $165.34 per share), it would be reasonable to expect our price forecast (2868 per share) to be realized. Furthermore, if the P/E multiple would expand to 19.5 (from the aforementioned 17.3) along with the materializing of the earnings estimates, that would suggest that the price for the market could be as high as 3224. Such a price would

assume a total return (with dividends reinvested) of some 15% from the first quarter-ending price of 2834.40 through the end of the year. That would result in a fairly robust total return for the full year 2019.

High quality bonds will do fine earning their coupons but they will see some pricing pressure if the rising longer-term interest rates occurs. High yield bonds should fare better as the economy remains strong.

We realize there are a lot of "ifs" in our forecast. A lot of things can change between now and year-end. The markets are not without risk and caution is in order with all projections.

## *Conclusion*

The just concluded first quarter 2019 was fabulous by every metric. Equities rebounded sharply from the depths of a deep sell-off in the fourth quarter 2018. Investors' attitude of optimism replaced pessimistic beliefs even though fundamentals really didn't change much between the fourth quarter 2018 and first quarter 2019. More clarity with regard to Fed policy was pervasive. The economy continues to fire on all cylinders and the numbers continue to show growth. The yield curve "normalized" before inverting again toward the end of the first quarter.

A trade war with China may still be there on the horizon. Politics are hard to avoid. Will things get done in Washington other than investigations and impeachment hearings? Will the Fed find reasons to resume raising interest rates? Will the economy begin to slow? Will earnings growth slow or disappear?

Our forecast for equity market returns remain very positive especially in the United States. Bonds will do reasonably well at least earning their coupons as interest rates may see some upward pressure.

As such, we are here to listen, counsel and provide direction to all of our clients.

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