SARSI LLC

First Quarter 2019 Market Newsletter Summary

- Stocks and bonds around the world rose in the first quarter 2019 making it the best start to the year in 10 years.
- The Global economy has slowed down, and central banks around the world have eased monetary conditions to support their respective economies.
- The US treasury yield curve has inverted in some parts. Although that has been a harbinger of a recession in the past, it is not clear if that conclusion can be drawn this time.
- US corporate earnings are expected to have fallen in the first quarter. Revenues are growing and this should help earnings grow for the full year 2019.
- Corporate earnings outside the US are growing below trend and can revert to mean if the global economy continues to grow.
- Non-US stocks have underperformed US stocks for more than a decade, but historically, there have been long stretches of time when the reverse has been true, thus investing in foreign stocks is a good strategy.
- With so many conflicting signals from the global economy, the best advice for investors, as always is to have a plan, build a portfolio of superior investments appropriate to your objectives, monitor them closely and adopt a long-term approach.
- Dollar-cost averaging can help reduce risk (Volatility) and regret aversion. (But with lower expected long-term returns)

(212) 634 4454 deva@sarsillc.com

SARSI LLC

First Quarter 2019 Market Newsletter

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	13.65%	13.65%	9.50%	13.51%	10.91%
S&P Mid Cap 400	14.49%	14.49%	2.59%	11.24%	8.29%
S&P Small Cap 600	11.61%	11.61%	1.56%	12.55%	8.45%
MSCI Emerging Markets	9.97%	9.97%	-7.06%	11.09%	4.06%
MSCI EAFE	10.13%	10.13%	-3.22%	7.80%	2.81%
Investment Grade Credit (C0A0)	5.00%	5.00%	4.94%	3.67%	3.74%
Non-Investment Grade Credit (H0A0)	7.38%	7.38%	5.92%	8.68%	4.71%
Bloomberg Commodity Index Total Return	6.32%	6.32%	-5.25%	2.23%	-8.92%
Dollar Index (DXY)	1.16%	1.16%	8.12%	0.94%	3.96%
Vanguard Total Bond Market Index (VBMFX)	2.93%	2.93%	4.37%	1.88%	2.56%
10 Yr Rate	2.41% 03/31/2019	2.69% 12/31/2018	2.74% 03/31/2018	1.79% 03/31/2016	2.72% 03/31/2014

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 4/5/2019			
	Latest Release	Recent Trend	Notes
Non Farm Employment	196,000	Positive	Jobs situation bounced back to trend after a weak February. Unemployment rate is steady at 3.8%. Wage growth was subdued at 0.1% and is up 3.2% year over year, reducing fears of inflationary pressure in the job market.
Weekly Claims for Unemployment Insurance	202,000	Positive	Claims reflects a strong employment situation. The 4 week average is back to its historic October low.
ISM Manufacturing Index (Number over 50 points to growth)	55.3	Positive	Manufacturing has been strong despite weaker exports. Although weaker from last year this reading above 50 indicates manufacturing is growing.

(212) 634 4454 deva@sarsillc.com

ISM Non Manufacturing Index (Over 50 points to growth)	56.1	Positive	Non manufacturing activity slowed a bit from the previous month but is still well above 50 indicating growth.
Consumer Prices (Month over month change)	0.2%	Positive	Tepid home price growth is keeping inflation anchored. Year over year, CPI rose 1.5% headline and 2.1% core (i.e. excluding food and energy which tend to be volatile)
Producer Prices (Month over month change)	0.1%	Positive	Like consumer prices, producer prices are stable. Year over year, PPI was up 1.9% headline and 2.5% excluding food and energy.
Retail Sales (Month over month change)	0.2%	Negative	Retail sales was weak in January but not as weak as in December. However, excluding Auto sales, retail sales was strong in January.
Consumer Confidence (Conference Board)	124.1	Negative	Consumer confidence took a big drop last month. A significant percentage of consumers polled think the economy is bad.
Durable Goods Orders (Month over month change)	-1.6%	Negative	Durable goods orders continues to be weak. Headline was pulled down by aircraft, but the core capital goods (Which is a reflection of companies investing for the future) was also weak.
Industrial Production (Month over month change)	0.1%	Negative	Except for utilities, which was helped by the weather, all areas of industrial production were weak last month.
Capacity Utilization	78.2	Positive	Capacity utilization remained more or less the same.
Housing Starts	1.162MM	Negative	Housing starts have continued to moderate after the peak set in early 2018. The Western region was primarily responsible for the weakness.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.1%	Negative	Home price growth in the 20 major cities represented by this index continue to moderate. Year over year, home prices have inched up 3.6%
GDP (Real, Annualized)	2.2%	Positive	Fourth quarter 2018 GDP growth was reasonably strong. Consumer spending and business investment provided strength.

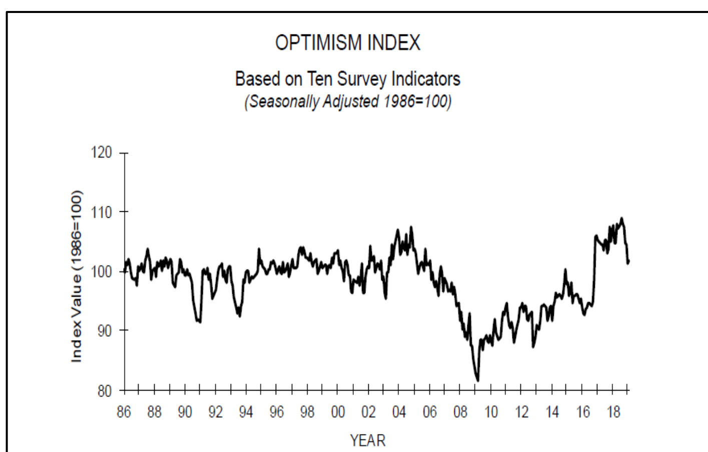
Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

(212) 634 4454 deva@sarsillc.com

Markets around the world bounced back in the first quarter of 2019 following a dismal fourth quarter last year. It was the best start to the year in over 10 years. The rally in equity markets came about even as the global economy showed signs of slowing down, which in turn led interest rates to fall and bonds to rally (Bond prices increase when interest rates fall).

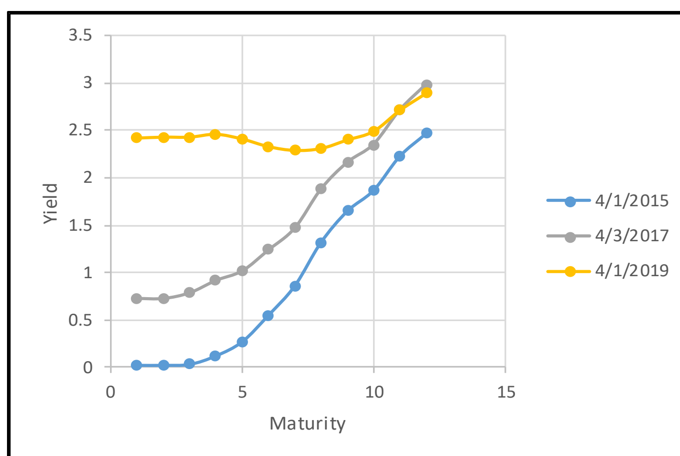
As seen in the table above, there are several areas of the US economy that have weakened since last year. In particular, retail sales and consumer confidence are not as strong as they were last year. The manufacturing and services sector are growing at a lower rate than at the peak last year, but both are still growing. Small business confidence while still strong, has fallen recently (Fig 1). The end of a protracted Government shutdown should improve business confidence. One area of the economy that continues to shine brightly is the jobs situation, which is extremely strong with a historically low unemployment rate and record low claims for unemployment insurance. In response to this mixed but slowing economic situation, the Federal Reserve has backed off on raising interest rates. In its latest meeting it also indicated it would end its balance sheet run off, which is a form of monetary easing. (Very similar to cutting interest rate or not raising it).

Fig 1: NFIB small business optimism



Source: NFIB: Small Business Association

Fig 2: The US Yield Curve



Source: St Louis Fed, Sarsi

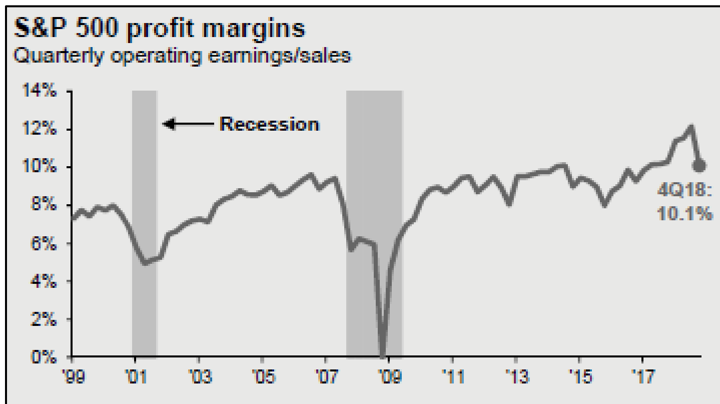
A combination of higher short-term interest rates and market expectation of lower rates in the future has led the yield curve to invert, as seen in Fig 2. Normally, the yield curve is upward sloping (As it was until recently- see 2017and 2015 in Fig 2 above) because lenders demand higher interest rates for longer maturity bonds, which is riskier. However, the bond market is very good at sniffing out a recession and when it forecasts one, it expects interest rates to fall in the future- this usually happens even as the interest rates on shorter maturity bonds are held high by the Federal Reserve. Historically, an inverted yield curve has been followed by a recession shortly afterwards. The timing and extent of the recession and bear market in stocks following an inverted yield curve is not so clear. In addition, there are many ways to define the yield curve and depending on how you measure it, there have been false positives in the past- i.e. the yield curve inverted but a recession did not follow shortly afterwards. Also, a recession has followed only after the yield curve stayed inverted for more than just a few days. As seen in Fig 2, as of early April the yield curve was inverted in some areas but not in others. The 3month yield versus the 10-year yield, which the New York Fed follows, is still positive i.e. not yet inverted. In fact, a model that the New York Fed maintains pins the probability of a recession one year later at 27%- significant but still not certain.

US corporate earnings which are very important for stock market performance are expected to have slowed in the first quarter. According to FactSet, earnings are expected to decline by 3.9%- if that happens, it would be the first decline since the second quarter of 2016. Energy, Materials and Technology are expected to be the primary reason for the decline. Earnings are expected to grow by single digits in the remaining quarters of the year, but if the past is any indication, that is likely to be revised down. Revenues for the quarter is expected to increase by 4.8%, but a falling profit margin is driving earnings lower. This should not come as a surprise since margins are at a record high, with companies cutting expenses to

(212) 634 4454 deva@sarsillc.com

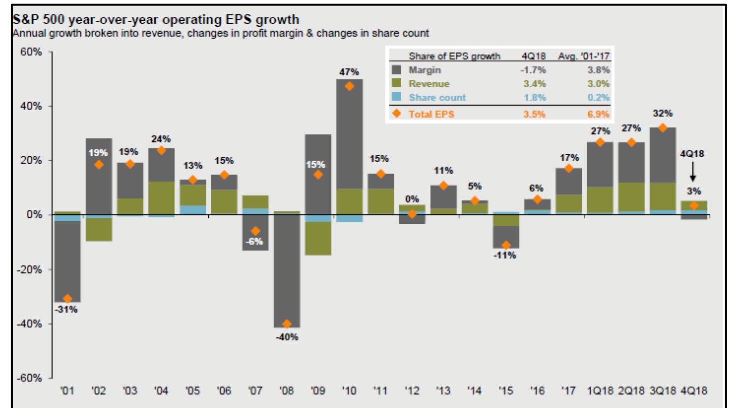
the bone. With costs, especially labor costs increasing, margins have fallen recently. Apart from margins, stock buybacks have been a source of support for earnings, contributing 1.8% to earnings growth in the fourth quarter of 2018 and 0.2% for the entire year 2018. (Fig 3) Margins and stock buybacks are unlikely to contribute anymore to earnings growth, leaving most of the heavy lifting to revenue growth.

Fig 3 US corporate margins have been declining



Source: JP Morgan

Fig 4: Contributors to corporate earnings growth

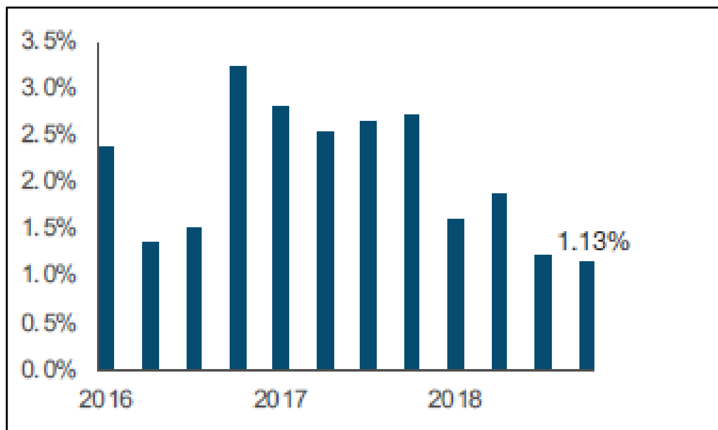


Source: JP Morgan

The US stock market is rising even as analysts have been cutting earnings estimate, this has resulted in stocks becoming more expensive on a forward earnings basis as compared to the fourth quarter of 2018. Currently, 12-month forward price earnings ratio for the S&P 500 is 16.4 which is right around its 25-year average average. Stocks are not cheap but still not very expensive. If the economic and geopolitical situation stabilizes, price earnings multiple can expand further helping stocks rise.

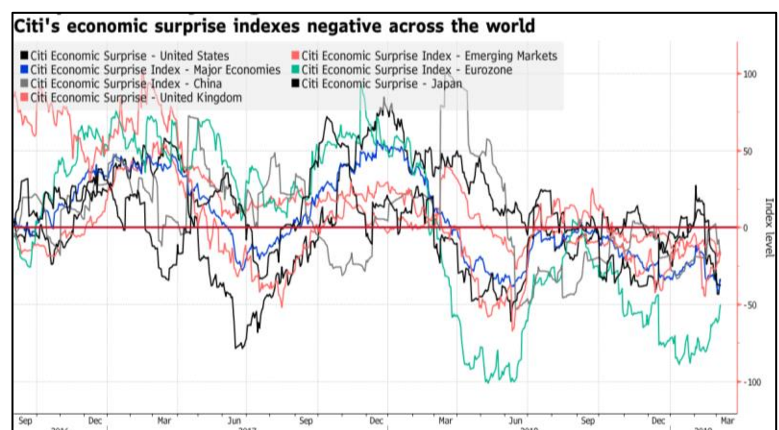
Economies overseas are also showing mixed signs. Euro area countries saw a significant slowdown in their economies (Fig 5) hurt by slowing exports because of the trade wars and turbulence in the Chinese economy (A major trading partner for the Euro region). In Germany, the largest economy in Europe, manufacturing sector is slowing sharply- the latest level of the composite Purchasing Managers Index (Manufacturing and Services) was 51.3, dragged down by the manufacturing sub component. Geopolitical events such as Brexit (Which has dragged on for months) and uncertainty regarding local elections have added to the negative sentiment in the region.

Fig 5: European Union GDP (quarterly change, annualized)



Source: T Rowe Price

Fig 6: Citigroup Economic Surprise Index various regions



Source: Bloomberg

(212) 634 4454 deva@sarsillc.com

The European Central Bank has pushed back the date of its first interest rate hike and recently announced a plan to stimulate lending in the Eurozone, both of which should support the economy and stock prices. A positive development in trade talks between the US and China should provide additional support. The Citigroup economic surprise index for Eurozone, although still negative, like in the rest of the world, is improving as seen in Fig 6.

In Emerging markets, the Chinese economy, which plays a significant role (As it also does for global economic growth), is testing multi decade lows in growth rate because of the Government's efforts to rebalance the economy (From investment/export dependent to consumer focused). The trade war with the US is an additional source of pain to the economy. In order to alleviate the pressure on the economy and avoid a sharp slowdown, the Chinese Government has implemented changes to its tax policy such as a cut in value added tax. These measures have led to some stabilization in the economy and the stock market has responded- the China A shares index is up almost 30% year to date.

Valuation of stocks outside the US continue to be cheaper than in the US. Earnings, especially in Europe are also below their long-term trend making an upward reversion to mean a possibility. Non-US stock performance outside the US has trailed US stock performance in the last decade. Historically, there have been long stretches of time when the reverse was true. For example, between the years 1999 and 2009, a period punctuated by two bear markets, US stocks were up only 10%, while developed markets outside the US returned 43%. Emerging markets were up a whopping 323% in that period. Therefore, having non-US exposure in your portfolio makes sense.

What should investors do?

With so many conflicting signals from the economy, the best advice for investors, as always is to have a plan, build a portfolio of superior investments appropriate to their objectives, monitor them closely and adopt a long-term approach. Questions that often comes up in conversations with investors are "when will the market fall" and "is this a good time to invest?" Our answer is always, we don't know when the market will fall (Nobody does) and now is as good a time to invest as any. We know that based on history, the probability of stocks going up at any point in time is higher than the probability of stocks going down. In addition, the stock market exhibits extremely high momentum towards the end of a bull market, so waiting for the markets to fall to invest, is a money losing strategy. We have written extensively about this in the past (See our 2Q 2017 letter, for example). If market gyrations are intolerable, then you should either build a conservative portfolio or add to your portfolio over time (Dollar-cost averaging). Dollar-cost averaging helps reduce risk and especially helps overcome regret aversion (The sinking feeling experienced when the market falls immediately after investing). However, dollar cost averaging also reduces potential long term returns for the same reason that waiting for a crash to invest does**. In short, if you are investing for the long term, investing immediately with an appropriate asset allocation is the best option. The second-best option is dollar-cost averaging. Sitting in cash waiting for the market to crash is the worst option. The only exception to this is if you have a very strong view on the economy/market or if stocks are extremely overvalued. While judgement about when the market is extremely overvalued can be made (Such as in the late 90's when the internet craze had made stocks very frothy), the track record of investors (Including professional investors) on predicting recession or bear market in stocks is extremely poor. Therefore, staying invested is the best strategy-as we say, it is about time in the market and not timing the market.

There have been many research reports written on this topic. For example, "Dollar-cost averaging just means taking risk later" by Vanguard, July 2012.

Disclaimer: Sarsi LLC ("Sarsi") is a Registered Investment Advisory Firm regulated by the State of New Jersey in accordance and compliance with applicable securities laws and regulations. Sarsi does not render or offer to render personalized investment advice through this newsletter. The information provided herein is for informational purposes only and does not constitute financial, investment, tax or legal advice. Investment advice can only be rendered after delivery of the Firm's disclosure statement (Form ADV Part II) and execution of an investment advisory agreement between the client and Sarsi.

(212) 634 4454 deva@sarsillc.com