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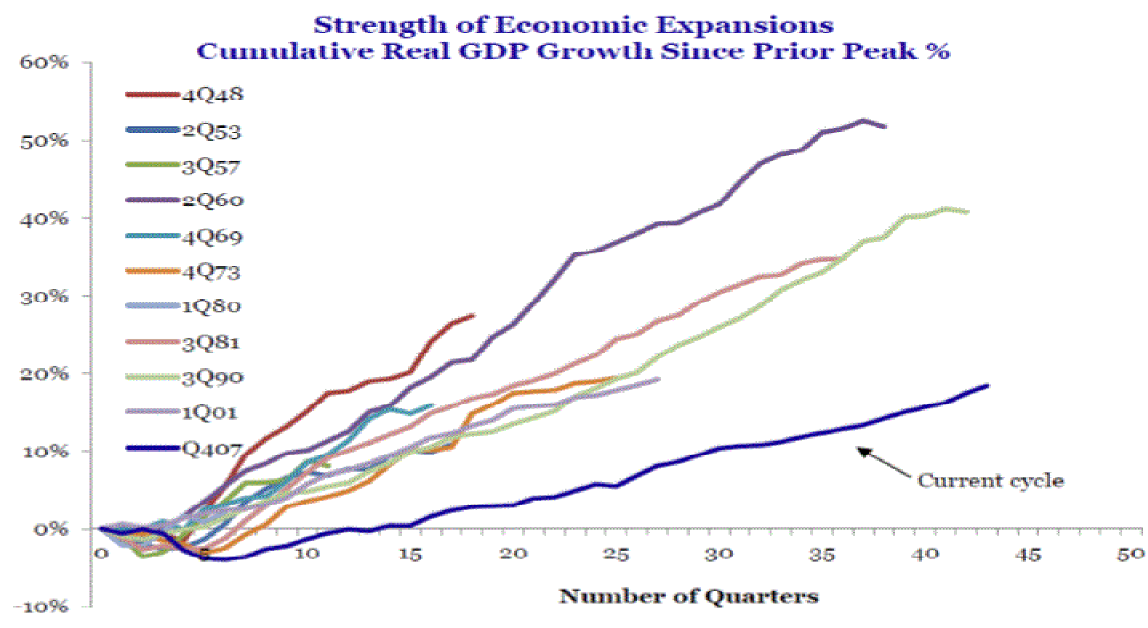
<u>Market Outlook as of April, 2019</u>

"Banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."
- Thomas Jefferson, 3rd U.S. President, 1743-1826, Letter to John Taylor of Carolina

After enduring the worst December since 1933, the markets have recovered well due to the Fed adopting a much more "dovish" tone. The current consensus is that the Fed is done tightening for now. The Federal Reserve's dovish pivot has extended the economic cycle, but we are concerned that it's allowing more excesses to build which could make the next recession either longer, severer or both.

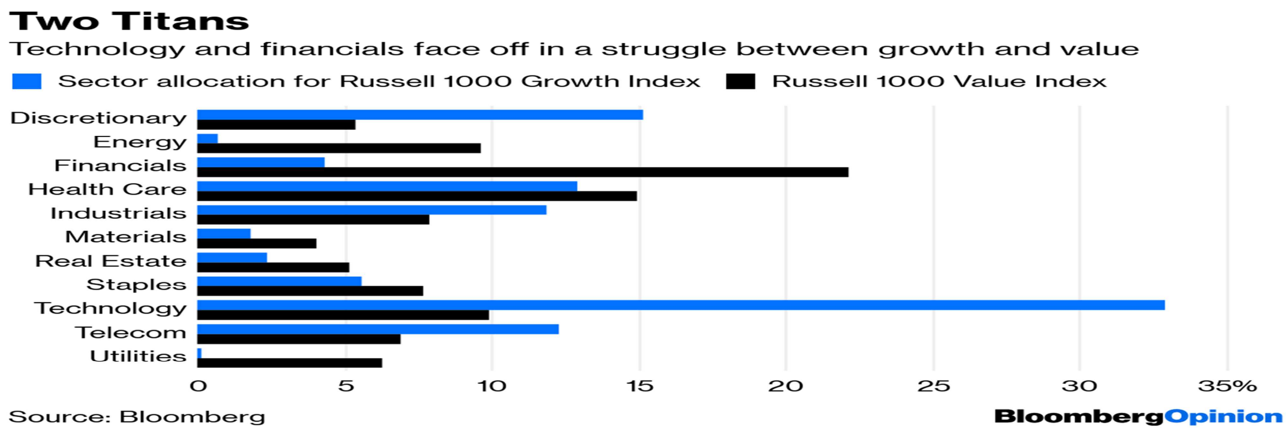
Trade talks with China have de-escalated and there are expectations for some type of deal to be worked out. However a softening global economy and a return of trade tensions between the US and its main trading partners China and Europe has the potential to derail our expansion.

Europe is still weak, China is stabilizing, Japan is in the doldrums, and the U.S is still the best game in town. By July of this year the current economic expansion will be the longest on record, but has been weaker than past expansions and at some point we will get a recession (See chart below).



Source: Strategas, as of 02/04/19

Investors have been chasing growth stocks relative to value since after the 2008 financial crisis. A big reason value has lagged, has to do with the banks. The financial sector represents 22 percent of the value index, by far its biggest sector. By contrast, the sector makes up just 4.3 percent of the growth index, its seventh-largest sector exposure and a fraction of its 33 percent stake in the technology sector. (See Chart on next page)

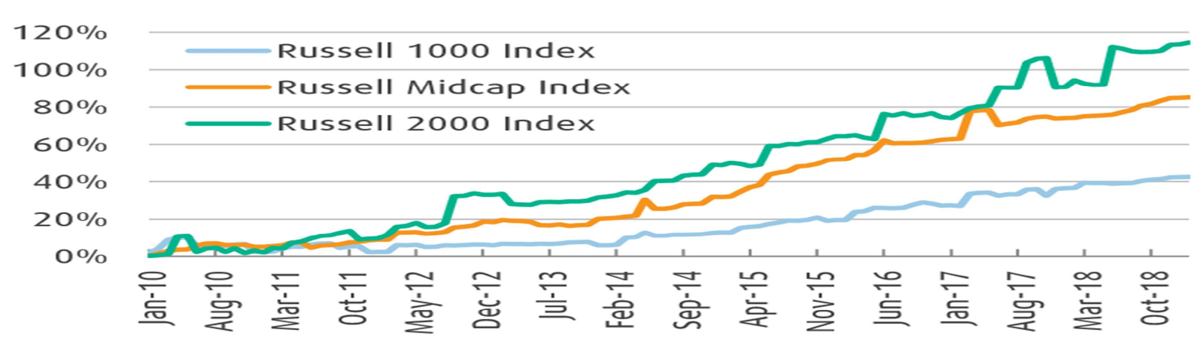


Banks got into distress during the 2008 crisis primarily because they loaded on mortgage loans to boost profitability. **Banks' newfound caution may come to be their silver lining. It wouldn't be the first time value bucked the conventional wisdom by holding up better than growth, in fact by many reliable studies; value beats growth in the long run.** Investors have had little trouble choosing between exciting internet-based stocks and uninteresting banks, resulting in a growth index more expensive than the value index by the widest margin since the dot-com era. (As measured by 12-month trailing price-to-earnings ratios.)

Jamie Dimon, chief executive officer of JPMorgan Chase & Co., released his extensive letter to shareholders last week. Dimon says: "When the next real downturn begins, banks will be constrained — both psychologically and by new regulations – from lending freely into the marketplace, as many of us did in 2008 and 2009". **Dimon's remark seems predictable, but that same defensive posture may have a less obvious impact on markets. Namely, it could deliver a boost to <u>value orientated</u> investors like ourselves especially if we have a non-financial recession.**

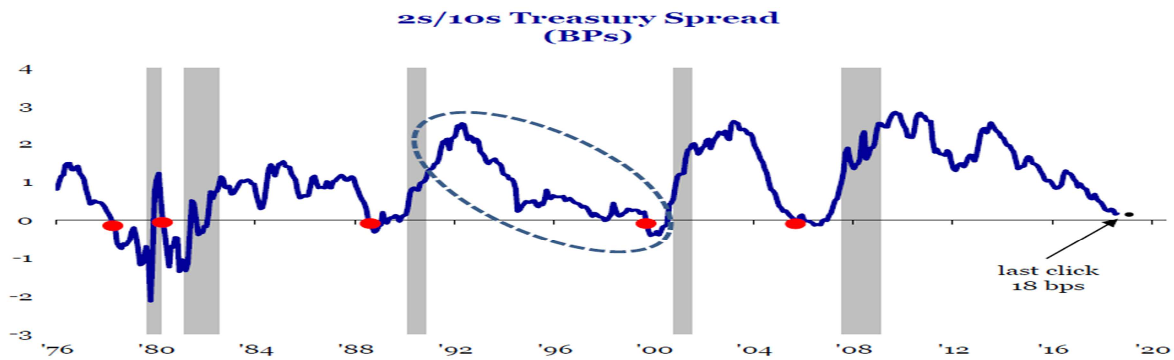
Two prior bear markets in which value outpaced growth resemble the current environment. In the period prior to the 1973-4 bear market, investors reached for growth stocks they thought would never fail, the so-called "Nifty Fifty", driving up their prices to irrational levels. In the ensuing bear market, value beat growth by more than 20%. More recently, investors piled into "Dot.com" stocks in the late 1990s. In the bear market from 2000 to 2002, value beat growth by 28%.

Excesses Building up in our system that could exacerbate an economic downturn. There is over $4 trillion in corporate debt that will either need to be refinanced or paid off over the next 5 years; mostly concentrated in <u>smaller cap companies (as represented by the Russell 2000 Index)</u>. Traditionally smaller Cap companies have less robust free cash flow to meet interest of debt repayments. ***See chart below of Corporate debt build up since 2010.***



Source: Bloomberg Financial; BMO Wealth Management Strategy

There is currently concern of an "inverted yield" curve, where the 10 year treasury actually falls below the 3 month bill rate. The concern is well placed as six of the past recessions were preceded by an inverted yield curve. While we are close to inverting, this has NOT yet happened. Even if it does invert, most of the ensuing recessions take about a year to transpire, are mild and over in less than six months.



Source: Strategas, as of 02/04/19

Going forward, a strong economy and in turn robust labor markets will continue to sustain rising household income, but wage inflation could speed up Fed tightening. The stock market action will be punctuated by bouts of negative volatility as the unusual length of the current recovery keeps market participants on edge and overly concerned of any signs of an impending recession.

Looking ahead, it is not feasible for markets to continuously rise, so don't get caught up in the hype. While records can be broken, we can't lose focus of our long-term goals. Staying disciplined during times of uncertainty, complacency and times of euphoria is an essential characteristic of a successful investor.

We continually look for great companies, with compelling valuations, quality balance sheets, strong cash flows, sustainable competitive advantages and growing dividends that are better able to weather a recession. We are confident that longer term, level-headed investors who stay the course should be rewarded over time, but we also expect market volatility to continue. We remain committed to diversified portfolios, with overweighting in areas that we believe offer value. Diversified portfolios have the drawback of underperforming in concentrated times, but more than make up with better downside protection when markets correct, move sideways or rotate into value which we think is currently the case.

It is always advisable to review ones individual circumstances and tolerance for risk. If any of your financial circumstances have changed, or you want to adjust your portfolios risk profile <u>we always encourage your input should you want to make any changes to your portfolio allocation.</u>

As always, please feel free to contact us with any questions or concerns.

Brian

Brian Chait
President, April 15th 2019

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