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Nauset Market Commentary
First Quarter 2019

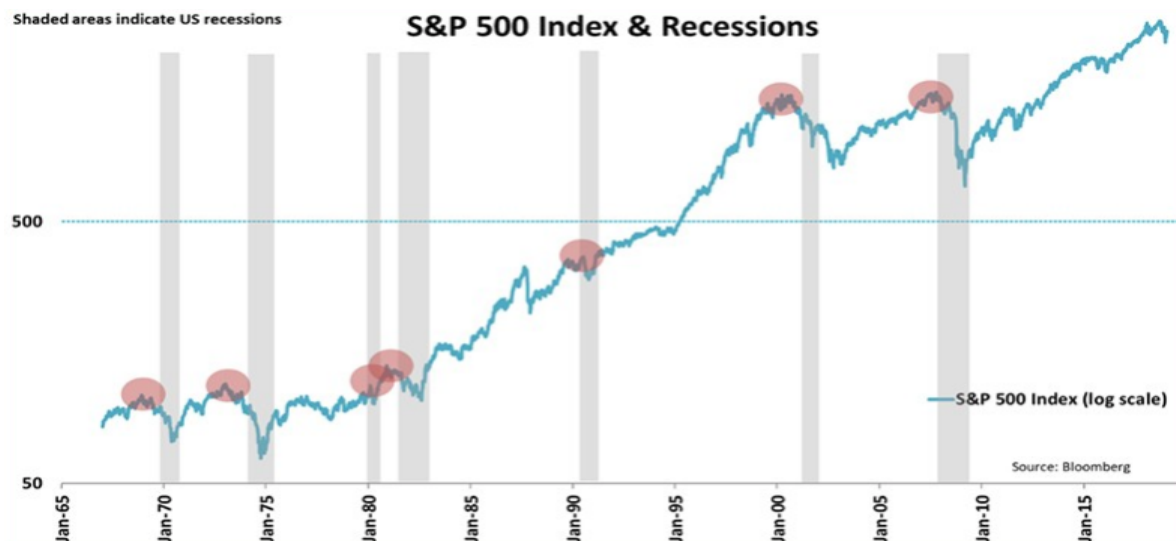
Market Performance Recap: **V is for Victory?**

In a replay of recent rebounds, major US and global stock indices rallied sharply in a V-formation from late December lows to post double-digit gains in the first quarter of 2019. The pause by the Fed in raising rates coupled with attractive stock valuations set off the rally, which was reinforced by an earnings season that was acceptable despite slowing growth across many sectors. The Russell 1000 US stock index moved up +14.0% in Q1, paced by strong gains in tech, real estate and industrials. International stocks also rebounded as the MSCI EAFE index increased +10.0%. The MSCI Emerging Markets index rallied +9.9%. For the quarter, bond prices boosted by the Fed pause in rates led to a +2.3% gain in the Barclays Intermediate Gov't/Credit bond index.

Economic & Market Discussion: **R is for the Next Recession?**

Rising rates, decelerating growth, yield curve inversion. All point to the dreaded "R" word – recession. So, is the next recession right around the corner, sometime in 2020, or maybe even 2021? Let's take a closer look at the indicators and implications.

- Market Returns & Recession – Nearly all US stock bear markets are the result of, or at least coincide with, an economic recession as shown in the chart below. A stock bear market is defined as a decline of -20% or more in the S&P 500. Thus, monitoring economic signals to determine when a recession is close is vital. The problem is that recessionary indicators can be unreliable. Often, these recession indicators flash red even as the economy chugs along or they fail to predict a recession until one is underway. As well, the next recession is never the same as the last one. So, while the possibility of a recession may be higher now than in prior years, the timing is not crystal clear.



- Yield Curve Inversion – Signal or Siren Song? – Given the fickle nature of recession indicators, how should we interpret the recent yield inversion signal? An inverted yield curve – when short-term rates are higher than long-term rates – has historically signaled a recession will occur within the next twelve months. A deeper look at the recent inversion shows that it was not as definitive as those in the past. It was brief, is no longer inverted, and only the 3-month T-bill was inverted to the 10-year Treasury, not the usual 2-year Treasury bond. So, the signal may have gotten more attention than it deserved.
- Our View: Type More Important than Timing – In our estimation, the type of recession may be more important than the timing. A shallow recession induced by high interest rates usually leads to a less damaging market downturn and a faster recovery. Whereas a recession caused by financial crisis like in 2008-09 results in a harsher decline and longer recovery. Our view is that a US economic

recession is unlikely before 2020, and a shallow one is more likely given the lack of excessive build-ups in key areas like leverage, industrial capacity or wage inflation. As always, we continue to monitor all economic fronts and adjust our views accordingly.

Portfolio Strategy: **Eye on Growth**

While we don't currently see a near-term recession, market levels are very sensitive to late business cycle growth indicators – both earnings and revenue results and forecasts. We are managing most portfolios at or near target weight for equities according to each portfolio's investment policy. And we remain slightly underweight in real assets and alternatives in favor of higher cash and income holdings.

- Equity Emphasis – The late business cycle dynamics have led us to favor tech for its persistent growth characteristics and healthcare for its defensive benefits. And we have built up low-volatility exposure in US large cap equity to assist in managing market volatility.
- Fixed Income Defense – Although rates ticked down in the first quarter of 2019, we remain defensive in our income allocation as we expect rates will move higher from current levels. We continue to monitor rates closely and will seek new opportunities as rates fluctuate.
- Count on More Volatility – With the recent stock rebound and economic uncertainty going forward, we are using multiple tools to manage risk. With few effective options available in alternatives, we are managing risk using low volatility securities as well as non-traditional bond exposure and cash.

Market Performance **% Change for Periods Ended 3/31/2019**

Market Index	First Quarter	2019 YTD	1-Year	3-Year Annual.	5-Year Annual.
Russell 1000	14.01	14.01	9.30	13.52	10.63
MSCI EAFE – Non-US	9.98	9.98	-3.71	7.27	2.33
Russell 2000	14.58	14.58	2.05	12.92	7.05
MSCI Emerging Markets Equity	9.91	9.91	-7.41	10.68	3.68
DJ US Real Estate	17.07	17.07	19.41	8.08	9.67
NASDAQ 100	16.81	16.81	10.63	17.97	14.29
Barclays Gov't/Credit Interm. Bond	2.32	2.32	4.24	1.66	2.12
Wilshire Liquid Alternative	3.19	3.19	-0.20	2.09	0.72
3-Month T-Bill	0.60	0.60	2.11	1.17	0.72