ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending March 31, 2019

Economic Activity

GDP growth for the fourth quarter of 2018 was finalized at 2.2% and full-year GDP growth was 3.0%. One of the major bright spots in U.S. economic growth in 2018 was capital investment in intellectual products—it contributed an average of 16% of total growth in 2018 and grew at 10.2%. The capital investment in intellectual products in the U.S. has become a vital part of the overall economy and is one of the driving forces in why the President's administration is going after China on "fair trade" and China's constant efforts to steal U.S. intellectual property. As expected personal consumption contributed the lion share of economic growth in 2018 aided by the tax cuts.

Housing data has come in softer as of late from a slowing U.S. economy and a 2018 that was mostly filled with rising interest rates. The increase in the price of homes, based on the S&P Case-Shiller home price indices, reported the smallest YoY change in January (+3.58%) since September 2012 and U.S. housing starts fell by 8.7%—the largest decline since June 2018. The positive within housing has been its methodical slower price growth and not the crash we experienced in 2008—we see a soft landing within housing.

Germany provided a fresh round of economic concern in Europe as manufacturing data in March pointed to a third consecutive month of contraction in Germany and new manufacturing orders were at their lowest since April 2009. The 10-year German government bond now yields less than 0%—to clarify, that's a negative yield to maturity.

Interest Rates

Interest rates took a nose dive in the first quarter as the two-year treasury exceeded the yields on 3- and 5-year Treasury notes throughout most of the first quarter. The 10-year Treasury note ended 2018 at a yield 2.68% (down from its almost 8-year high of 3.259% on October 19, 2018) and since then has continued its declined to hover around 2.4%. After a rough 2018 fourth quarter, risk assets within fixed income have rallied strong as high yield bonds are up approximately 7.0% year-to-date after declining by 4.5% in the fourth quarter of 2018. We have recently reduced our allocation to riskier assets within fixed income and reinvested the proceeds in our core fixed income portfolio of investment grade corporate and government bonds.

The Federal Reserve provided better guidance on their Balance Sheet at their most recent meeting and how they are going to tailor their plan of how much in U.S. Treasuries and agency mortgage-backed securities ("MBS") that they will hold. In September the Fed will no longer allow the U.S. Treasury portfolio to runoff and will hold that size constant going forward except for additions from the agency MBS that will be reinvested in Treasuries starting in October up to $20 billion/monthly. Long-term interest rates have likely found a near bottom unless the Federal Reserve begins to cut their Target Rate sooner than later—the thought of the Fed raising rates again this year is practically off the table.

Stock Market

Equity markets rebounded strongly in the first quarter after a tumultuous end to 2018 which saw the worst quarterly performance for the equity market since the third quarter of 2011. For the quarter the S&P 500 was up 13.65% and the small cap Russell 2000 was up 14.57%. The NASDAQ led all major equity markets up 16.81% for the quarter led by the strength in software and semiconductor companies. International equity markets lagged U.S. markets as concerns over an economic slowdown in Europe intensified and the Brexit on again and off again debate continued. The MSCI EAFE (developed international) was up 9.53% and the MSCI Emerging markets was up 8.55%.

The catalyst for the strength in equity markets was a combination of a Federal Reserve pivot to be more patient about future rate hikes and an end to the balance sheet runoff in September. The February testimony from Chairman Powell provided relief to the equity markets which were concerned the Federal Reserve would continue raising interest rates without acknowledging the growing risks of a global economic slowdown. Also, investor sentiment which is a contrarian indicator turned decidedly negative in the fourth quarter of 2018. The American Association of Individual Investors sentiment gauge turned overly pessimistic late in December with the percentage of bearish investors climbing to 50.3% equal to a level set in the Fall of 2011 when U.S. debt was downgraded. This fear along with investor's redemption of record amounts of equity funds in December ignited a market rally that continued throughout the first quarter.

Corporate earnings in 2019 will slow considerably from the tax reform induced 20% growth to a more sustainable mid - single digit rate. Consensus earnings estimates for the S&P 500 in 2019 have been slowing throughout the quarter with earnings expected to be $175, and applying a 16x PE (price to earnings) yields an S&P 500 of 2800. It's hard to argue for a multiple higher than 16x with an uncertain economic backdrop and a slowing corporate earnings environment. An equity market above 2800 will require an uptick in global economic growth along with a trade agreement between U.S and China.

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ABOUT THE INVESTMENT ADVISORS

1st Source Bank has been providing comprehensive financial planning and wealth management services since 1936 and currently manages over $3.5 billion in assets.

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