What a difference a quarter makes. The S&P 500 has given us a wild ride, going from the worst quarter we have experienced in seven years, to the best quarter in almost a decade. As you can see below, fourth quarter 2018 the S&P 500 dropped 13.97%. At its worst, the S&P 500 was down just shy of 20%, looking at performance from high to low (Sept 20th through Dec 24th respectively).

First quarter 2019 was the strongest first quarter in twenty-one years, rising 13.07% for the quarter. Had an investor lost 13.97% with the market in 4th quarter of 2018, they could have recovered a significant portion of their loses, had they recovered with the S&P 500 in the first quarter of 2019.

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Q1 2019 Highlights:

- Through the first three months of the year, six out of eight asset classes have already posted at least a 5% gain for the year. Last year, for the first time ever, no asset class had a 5% or greater return.
- Growth outperformed value across all three asset class size categories, with mid-cap growth being the top performing area.
- All 11 S&P 500 GICS sectors gained at least 5% for the first time since Q4 2011.
- Of the top five sectors in Q1, four were in the bottom five in Q4 2018.
- The top three performing sectors in the S&P 500 were: technology, real estate, and industrials, up 19.37%, 16.64%, and 16.64% respectively.
- The three lowest performing sectors in the S&P 500 were: health care, financials, and materials, up 6.12%, 7.90%, and 9.68% respectively.
- International equities gained in value but lagged the U.S. markets. The MSCI EAFE Index was up 10.59% and the MSCI Emerging Markets Index was up 9.84% for the quarter.
- 42 of the 44 countries that make up the MSCI All Country World Index grew in value, with only Qatar and Malaysia experiencing negative returns. This is a mirror image of last year, when 42 of 44 countries dropped in value. The top performing countries (performance calculated in their own currency) were Columbia, Belgium, and China, up 22.0%, 18.2% and 17.8% respectively.
- Stocks outperformed bonds, with the S&P 500 outpacing the Bloomberg Barclays Long-Term U.S. Treasury Index by almost 9%.
Where Do Things Go from Here???

History would indicate that the S&P 500 should finish the year higher from where we finished this quarter. When the S&P 500 has gained at least 10% in the first quarter, it has continued to rise for the last nine months of the year 85% of the time. The median return for the last nine months of the year has been 7%.

Another favorable statistic is there have been three other periods with sharp quarterly declines (see the chart below) since the Great Recession. In each situation the subsequent two quarters have produced fantastic performance.

Source: bespoke.com
Another great sign is the S&P 500 just performed what is called in the financial industry “a golden cross” formation (see chart below). This is when the 50-day moving average crosses above the 200-day moving average. It is a sign of strong upward price movement in the index. Historically, the S&P 500’s performance is 8.89% average annual return when the 50-day moving average is above the 200-day moving average, dating back to November 19, 1929. Conversely, the S&P 500 loses 0.53% when it performs a “death cross,” when the 50 crosses below the 200-day moving average.

The S&P 500 is Properly Valued

The S&P 500 appears to be properly valued based upon its historical matrix of valuation measures. Regardless of earning growth, there is still room for price appreciation in the S&P 500.

Source: TD Ameritrade, Polaris Greystone

Source: FactSet, FRB, Robert Shiller, Standard & Poor’s, Thomson Reuters, JP Morgan
**S&P Earnings Look Primed to Go Up**

As we’ve discussed in detail in past forums, we expected a decline in earnings after the government stimulus programs subsided. Fourth quarter 2018 earnings (which were reported during the first quarter of 2019) dropped 4.3% year over year, the first year over year drop since Q2 2016. Earnings season has already started for first quarter 2019. Viewing the chart below, the green bars on the far right are estimated earnings, not actual. The blue arrow points towards Q1 2018 actual earnings whereas the green arrow points towards Q1 2019 estimated earnings. Expectations are in line with last year’s earnings, with future quarters expected to improve and move into record territory.

Source: Compustat, FactSet, Standard & Poor’s, JP Morgan

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Our Economy Looks Fine

One of the things that sent the markets tumbling last year was the fear that our economy might be dragged into a recession due to other major economies slowing down. Last year the U.S. economy grew by 3%. This is above the 50-year average of 2.7%, and significantly higher than our 2.3% historical economic growth since the great recession. As you can see from the chart below, the economy grew as fast as 4.2% during the second quarter of last year. A combination of trade wars and Federal Reserve actions slowed the economy back to its historical averages.

Source: tradingeconomics.com, U.S. Bureau of Economic Analysis
The fear of a global recession is not without warrant. As you can see from the other top economies in the world (chart below), China’s economy slowed substantially, but is still growing at over 6%. Japan’s economy experienced two nonconcurrent quarters of negative growth during 2018. Germany’s economy shrank during third quarter of 2018 and then followed up it up with a zero-growth rate during the fourth quarter, narrowing avoiding a recession. The United Kingdom’s economy seems fine, despite Brexit, bouncing around all over the place.
We track many economic indicators to understand the risk to the United States of slipping into a recession. Two of my favorite indicators are the Index of Leading Economic Indicators and the Index of Coincident Economic Indicators. These indexes have accurately predicted seven of the last seven recessions, dating back to the late 1960s (but keep in mind that past performance is never indicative of future results). As you can see from the chart below, both seem to be growing at a health pace with no indication of a recession.

Source: The Conference Board
We have also written extensively about the Chicago Fed National Activity Index (the chart below). As a reminder, the red line shows change in the economy and the blue line shows the growth of the overall economy. A reading of zero means average growth, any reading above the top dashed green line is considered to be inflationary, any reading below the lower dashed green line is considered to be recessionary. As you can see from the chart, we had above average growth for most of the year and have just recently slipped into the below average historic growth. This does not mean that we are going into a recession. All economies ebb and flow. We just happen to be in the “ebb” part of the cycle at the moment.
Unlike last year, when people were concerned that the Fed might be too aggressive and raise rates so much that the economy would sink into a recession, Fed Futures place a 50% chance of them keeping rates where they are now. The only other action that is priced into Fed Futures is the possibility of cutting rates. This is in stark contrast to probabilities seen last year. An accommodating Fed should be helpful for further upside in the stock market.
Conclusion

We think that investors will be happily surprised where the market is at the end of the year. Fundamentally, the markets are properly priced with strong expected earnings through the next four quarters. Technically, the markets look primed to make new all-time highs. Our macro-economic indicators show no signs of a recession.

Sentimental moves in the market are the only question mark. Unfortunately, they are not easily predicted and are rarely rational. You only have to look back at the last two quarters as a perfect example. The markets dropped 20% when corporate earnings for S&P 500 companies grew 26%. This drop was completely sentiment driven. Just like the reversion we just experienced was also sentiment driven. In this case people decided that the worst was behind us. The markets rallied and grew by over 13%. All the while, the S&P 500 experienced its first year over year drop in earnings in three years.

We will be ever vigilant in our research to determine the best path for you and your portfolio. If you have any questions, please don’t hesitate to call or write.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer