Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

First Quarter 2019 Commentary

First Quarter Recap

The first quarter was an unusually strong period for equities. It also marked a striking reversal from the end of 2018. After posting their worst December since 1931, U.S. stocks surged to their best January since 1987, followed by further gains in February and March. Large-cap U.S. stocks gained 13.6% for the quarter. As a reminder, last year's fourth quarter drop was over 14%. Once again, the markets surprised the consensus and demonstrated the folly of trying to predict short-term performance. Investors who bailed out of stocks during the year-end selloff experienced severe whipsaw as the market rallied.

March Benchmark Returns			
	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	1.9%	13.6%	13.6%
iShares Russell 1000 ETF	1.8%	13.9%	13.9%
iShares Russell 1000 Value ETF	0.7%	11.8%	11.8%
iShares Russell 1000 Growth ETF	2.8%	16.0%	16.0%
iShares Russell 2000 ETF	-2.1%	14.6%	14.6%
Vanguard REIT	4.2%	17.3%	17.3%
iShares MSCI ACWI ETF	1.6%	12.5%	12.5%
Vanguard FTSE Developed Markets ETF	0.6%	10.6%	10.6%
Vanguard FTSE Europe ETF	0.8%	10.9%	10.9%
Vanguard FTSE Emerging Markets ETF	2.3%	11.8%	11.8%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	2.0%	2.9%	2.9%
Vanguard Intermediate-Term Tax-Exempt	1.3%	2.6%	2.6%
iShares TIPS Bond ETF	2.0%	3.3%	3.3%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	1.0%	7.4%	7.4%
S&P/LSTA Leveraged Loan Index	-0.2%	4.0%	4.0%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.2%	2.6%	2.6%
Bloomberg Commodity Index	-0.2%	6.3%	6.3%
SG Trend Index	5.5%	2.9%	2.9%
3-Month LIBOR	0.2%	0.7%	0.7%

Foreign stocks also rebounded sharply in the first quarter. Developed international markets gained 10.6%. Emerging-market (EM) stocks rose 11.8%, after holding up much better than U.S. stocks on the downside in the fourth quarter of 2018.

Fixed-income markets were also strong. High-yield bonds gained 7.4% and investment-grade bonds rose 2.9%. The 10-year Treasury yield fell to 2.39% during March, its lowest level since December 2017.

What Caused the Rebound: The Fed not the Fundamentals

The key catalyst for the rebound in equity markets was a significant shift in the Federal Reserve's stance on monetary policy. In late December and throughout January, the Fed became much more dovish. After hiking interest rates four times in 2018, including at their mid-December meeting, and indicating further tightening would occur in 2019, Fed officials suddenly reversed themselves. They emphasized they would be "patient" and pause any further rate increases. In early January, Fed chair Jerome Powell said the Fed could also slow down or stop shrinking its balance sheet of bonds purchased during quantitative easing. This came just two weeks after saying the Fed's balance sheet reduction program (quantitative tightening) was "on autopilot." The U-turn in Fed policy was music to the ears of the financial markets, which had become concerned about ongoing policy tightening in the face of slowing economic growth in the United States and abroad.

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There were other positives for the markets as well: The federal government shutdown, which had started to weigh on sentiment, ended in late January. Signals from the U.S.-China trade talks turned more positive, although far from anything definitive. The likelihood of a “hard Brexit” also seemed to wane, but again, far from anything definitive.

In sum, the market rebound was due more to improving investor sentiment and risk appetite—caused largely by the shift in Fed monetary policy—than any meaningful improvements in underlying economic or business fundamentals.

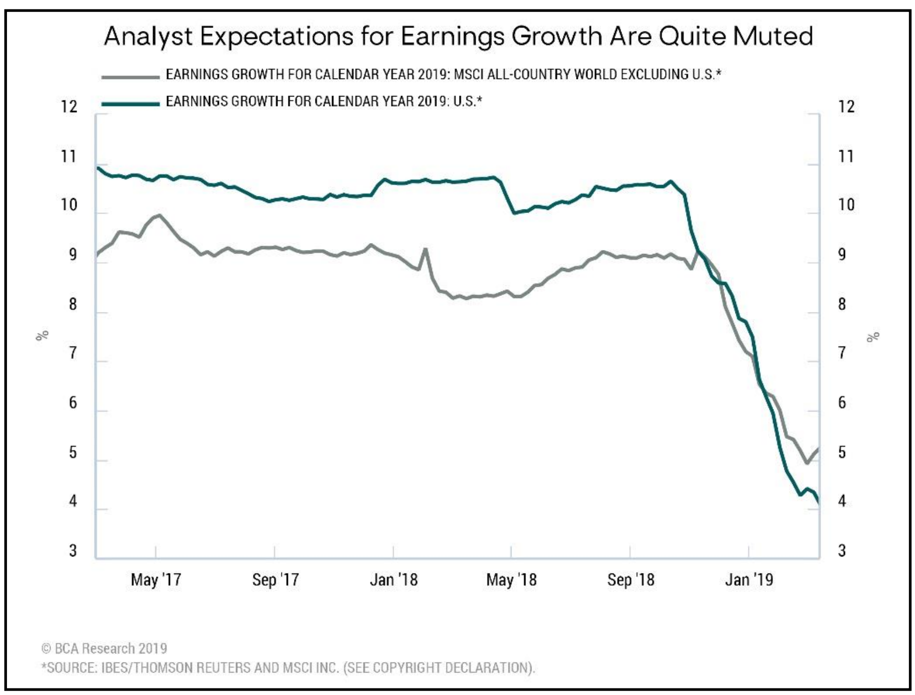
Global Growth is Slowing

Most economic indicators show a continued deceleration in global growth this year. For example, as reported by Ned Davis Research, the OECD’s composite economic leading indicator fell for the 16th straight month in January to its lowest level in nearly a decade. Other broad global economic indicators, such as BCA’s Global Leading Economic Indicator and Citigroup’s Economic Surprise Index reflect similar headwinds.

The U.S. economy is in better shape than most, but even here growth expectations have been coming down. At its Federal Open Market Committee (FOMC) meeting on March 20, the Fed downgraded its median GDP growth estimate to just 2.1% for 2019 and 1.9% for 2020, citing the effects of economic slowdowns in China and Europe, fading stimulus from the 2017 Trump tax cuts, and ongoing uncertainty around Brexit and trade policy.

At its March meeting, the Fed reiterated the dovish stance it had signaled in prior months. It made clear the majority of FOMC members no longer expect to raise rates at all in 2019. (In contrast, in December it was expecting two more hikes this year.) It reiterated it will remain patient and “data dependent” regarding any future changes in the policy rate, raising the possibility that its next move could be a rate cut.

It’s also worth noting that two days after the Fed’s March announcement, the 10-year Treasury yield fell to 2.44%, causing an inversion in the yield curve between the 10-year Treasury and the 3-month T-bill, which yielded 2.46%. A *persistently* inverted 10-year/3-month yield curve has been a consistent leading indicator of recession in past U.S. economic cycles, although the lead time has been variable and lengthy—anywhere from four to 16 months prior to the onset of recession.



Besides the indicators of a slowing economy, U.S. corporate earnings growth expectations have also continued to decline, albeit from unrealistically lofty levels last year. The chart to the right from BCA shows 2019 consensus earnings-per-share growth estimates for the S&P 500 dropping from 12% (as of 12/31/18) to just 4.1% as of mid-March. Even with the Fed now on hold, earnings growth will need to improve for stocks to appreciate meaningfully from current levels, given their sharp rebound in the first quarter and high valuations.

So far, investors appear to be looking past the near term weakness in profits. In fact, profits will likely decline verses last year in Quarter 1 and profit growth may be flat in Quarter 2. Investors are betting on faster profit growth during the second half of the year as economic growth should improve and year over year earnings comparisons become much easier.

First Quarter Portfolio Performance & Key Performance Drivers

Our portfolios generated strong performance for the first quarter, benefiting from the aforementioned rebound in the financial markets. Returns were driven by our allocations to U.S., international, and emerging markets stocks, as those categories offered double-digit returns. Our actively managed investments in these categories performed very well, with returns generally consistant with the benchmark averages.

Bonds offered solid returns as well. Core bonds returned 2.9% and our primary investment in this space, Dodge & Cox Income rose by 3.7%! Moving on to the specialty bond markets, our positions in Osterweis Strategic Income, Templeton Global Bond and Weitz Short-Intermediate advanced 3.64%, 1.91% and 1.51%, respectively.

Finally, regarding alternative strategies, Merger Fund advanced 2% for the quarter whereas Arbitrage Fund gained 1.1%.

Please recall our balanced accounts had minimal losses in 2018 and far outpaced balanced accounts nationally. Combining 2018 results with our solid performance so far in 2019 results in substantially higher returns verses any balanced fund peer group we monitor.

VCS Forecast

Looking out over the next year or so from this point in the economic and market cycles, we see the potential for either of two quite different macro scenarios to play out: (1) stabilization and improvement in global growth; or (2) continued declining growth resulting in a U.S. and global recession.

Most economists agree that China and the United States are key to whether Scenario 1 or 2 happens. It is clear the Chinese government is once again trying to boost their economy via fiscal and monetary policy (including tax cuts, lower interest rates, and expanded bank lending), after trying to reduce some of the debt-related excesses during the prior two years. (This deleveraging effort has been the key driver of China's recent growth slowdown.) It is not yet clear if they will be successful, as these policy changes flow through to the economy with time lags and uncertain impacts. But there is some evidence, such as a rebound in credit growth, that the tide may be turning. A revival in Chinese growth would have positive ripple effects across the global economy. It would benefit other emerging markets and Europe in particular, as China is a major importer of their goods. Meanwhile, the U.S. economy, while weakening, doesn't seem to be in imminent danger of slipping into recession.

While we worry about global growth stalling further, resulting in a recession and sharply lower stock prices, we currently feel Scenario 1 is more likely to take place. We believe a global growth rebound is likely in the second half of 2019. Scenario 1 would be positive for our portfolios as a rebound in growth would benefit our specialty bond fund investments. Core bonds would underperform, but we'd maintain exposure in this category in case our outlook is wrong. Our investments in alternatives such as merger/arbitrage funds would also produce solid absolute returns. Most importantly, stocks, here and abroad would perform well based on the continued economic growth resulting from Scenario 1.

Depending on the strength of the market rally in this scenario, we would expect to eventually reduce our portfolio's equity exposure as riskier asset classes would become less attractive and the likelihood of this bullish market cycle coming to an end increases. The latter could be triggered by a resumption of Federal Reserve monetary policy tightening in response to rising inflation.

Closing Thoughts

The first quarter of 2019 was certainly a nice change from the last quarter of 2018, but it would be almost impossible for the markets to continue to advance at what was almost a hyperbolic pace. We remain prepared for the renewed market choppiness which always takes place towards the latter stages of an economic expansion. But the positive scenario we project, with increased growth later in the year driven by the Fed's policy U-turn combined with China's economic stimulus may enable the cycle to extend for another few years. If so, we have exposure to a wide range of investments that will particularly benefit from such an outcome.

As always, we appreciate your trust and confidence in Virginia Capital Strategies, and we work hard every day to continue to earn it.

Sincerely,

Steve Bowery, CFA, CFP