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Investment Briefing

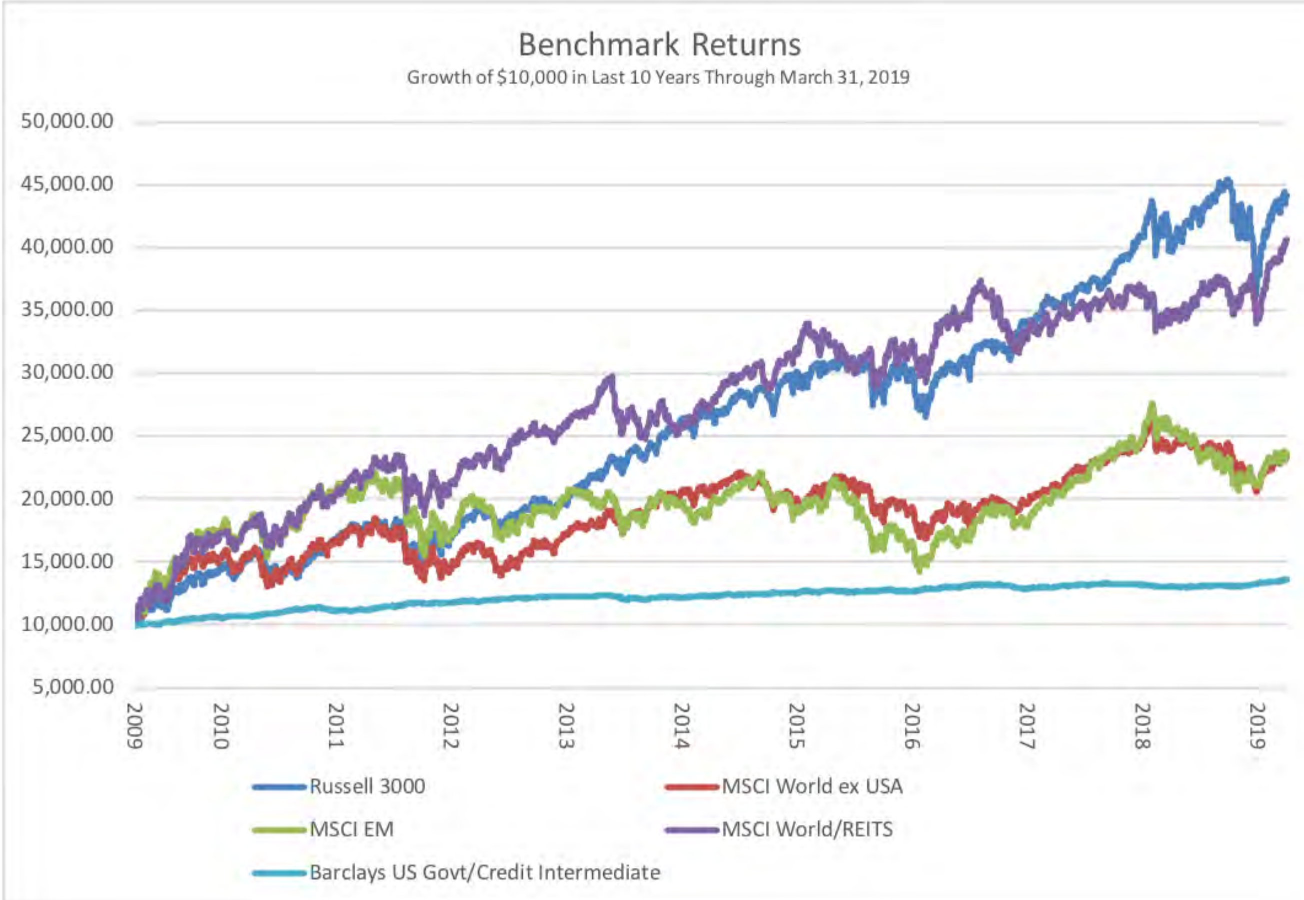
First Quarter 2019

Introduction

Markets came back strongly in the first quarter, with many stock markets gaining double-digit returns.

Real estate securities were the best performer while bonds were the lowest, although they were also nicely positive. Many asset classes made up the losses they incurred at the end of 2018. Looking longer term, U.S. stocks were generally the best performers. Since the market bottomed in March, 2009 in the financial crisis, some of the 10-year numbers in the chart below look almost otherworldly.

Asset Class[1]	1st Quarter	12 Months	5 Years (annualized)	10 Years (annualized)
U.S. Stocks (Russell 3000)	14.04%	8.77%	10.36%	16.00%
International Developed (MSCI World ex U.S.)	10.45%	-3.14%	2.20%	8.82%
Emerging Markets (MSCI EM)	9.91%	-7.41%	3.68%	8.94%
Real Estate Investment Trusts (MSCI World REITs)	16.15%	16.63%	8.08%	15.04%
Taxable Bonds (Barclays US Govt/Credit Intermediate)	2.32%	4.24%	2.12%	3.14%
Municipal Bonds (Barclays Muni 1-10 Yr)	2.21%	4.63%	2.54%	3.2%



References

1. Return data and charts are from Morningstar Direct.

U.S. Stocks: The Star, our Sun

Stocks in the U.S. came back strongly in the first quarter after their rout at the end of 2018

Some indexes completely captured their prior losses. The stars of the show were Real Estate Investment Trusts (REITs) rising 15.7% and stocks of smaller companies, rising 14.5%. The S&P 500 had its best quarter in 10 years and its best first quarter since 1998.

Why did we see so much negative volatility last quarter and so much good volatility in Q1? Some thought the concerns about rising interest rates, Brexit, tariff talks, etc. had finally hit the market. However, those concerns didn't disappear this year. Rather than trying to predict the future, we remained patient and stayed invested. Investors who cashed out in Q4 probably missed this latest increase as they continued sitting on the sidelines.

Getting past the noise in short-term market movements, let's take a look at what's been happening in our economy. Probably the most notable point is that the

Federal Reserve softened its thinking about increasing interest rates. You may recall that last year they were planning to increase rates more than once this year, now they're saying they will probably remain where they are. There are a number of reasons for this, including inflation staying under control and mildly slowing international economies. Unemployment also ticked up a bit in January (to 4%), although the economy continued to rapidly produce new jobs. We also have the bond market that inverted the yield curve, a classic indicator of impending recession (more on this when we discuss bonds)

Here are a few other notable points in the U.S. during Q1:

- The level of national debt breached $22 trillion for the first time, prompting talk about long-term dangers of deficit spending and prompting us to write a separate piece last month about it.
- Increases in corporate earnings for Q4 were up over 10%, which was good, but not as good as the prior year when they benefited from the tax cut.
- The U.S. government experienced the longest shut down in history (35 days) due to budgetary disputes in Washington. Some believed this affected spending in January.

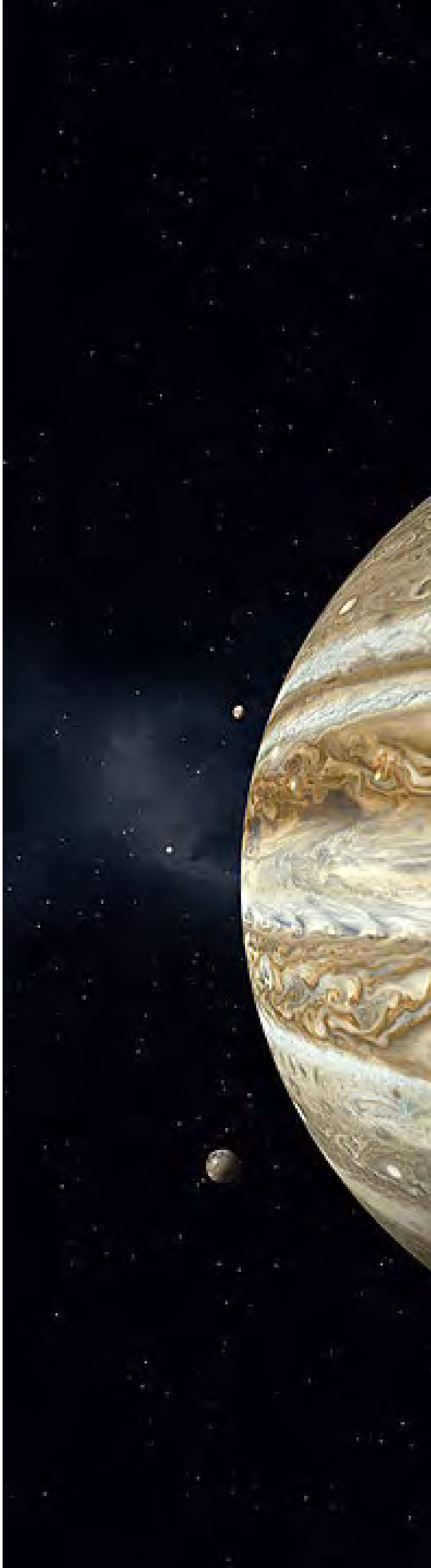
International Developed Stocks: Jupiter, the Jovial King

International developed markets also had a very nice quarter, up over 9%.

Among the drivers of returns were the stocks of small companies, up 10.9% in Q1. The news in international economies was mostly negative but judging from the market's responses, those economies may have bottomed in Q1 and are now ready to recover. Either that or the talk of stimulus has given the markets renewed confidence in the future.

As usual, there was both negative and positive in the news during the quarter. Here are some specifics:

- The unemployment rate in the EU fell to 7.9% in Q4, its lowest rate since 2008.



- The European Commission downgraded its growth forecast for 2019 from 1.9% to 1.3% as Germany's manufacturing powerhouse continued to slow to levels last seen in 2012. Italy and France were also concerns.
- Japan's exports to China slowed, leading to Japan's largest trade deficit in 5 years.
- Italy made motions to become part of China's Belt and Road Initiative in order to increase trade between them.
- Theresa May, Prime Minister of the U.K., continued to cobble together a coalition for her plan to exit the European Union. She was not successful and early in April received an extension from the EU until October 31, 2019 for the U.K. to exit the trade group.
- Mario Draghi, head of the European Community Bank, said the temporary slowdown in Europe was not necessarily foreshadowing an oncoming recession and that he would further delay any interest rate hikes if necessary.

Emerging Markets: Saturn, God of Seeds

Emerging markets also had a good quarter.

They hadn't fallen quite as hard in Q4 and their rise in Q1 wasn't quite as robust, but nobody should be disappointed with their more than 9% return in three months. Emerging markets continue to produce important growth opportunities.

Here are some of the high points:

- China cut its Value Added Tax by 3% to help spur domestic consumer spending. China also dropped her growth target for 2019 from 6.5% to 6.0%.
- Saudi Arabia promised to spend the equivalent of $27 billion on its industrial development program in 2019 and 2020.

- China and the U.S. pushed finalization of their trade agreement from March to June, but talks continued to sound positive overall. One of the primary negotiations was over intellectual property.
- MSCI, the stock index firm, announced it would quadruple the number of China's stocks in its global benchmarks, which should draw more funds to China's stock markets via index funds (note that Vista does not use index funds so that country exposure is more carefully controlled).
- India's government approved a cash distribution to farmers and a tax cut to lower-income workers to help spur the economy.
- The relative value of Turkey's lira fell under suspicion that the country is propping up its currency amid local elections that may be showing President Erdogan's power is declining. Turkey's economy fell into recession at the end of 2018.

Bonds: Earth, Well-Grounded

Investors breathed easy as the Federal Reserve backed away from rate increases during the first quarter of 2019.

The fed funds rate remained unchanged, contrary to many previous signals from the Fed that rates would continue to climb upward this year. This was the first quarter since Q3 2017 that the Fed decided not to increase interest rates. The Federal Reserve has changed its outlook moving forward and expects rates to remain steady in 2019, despite pressure from the White House to lower rates.

Bond prices jumped in the first quarter after the news from the Fed. For bond investors, we're now back to a place that is very familiar: low yields and minimal interest rate increases. While this may sound like a bad combination, bonds remain an important element of most portfolios because their low price volatility provides

a strong shelter from the inevitable stormy environment other investments will experience.

Municipal bonds also performed well in the first quarter partly due to a limited supply and changes from the tax reform of 2017. The Tax Cuts and Jobs Act of 2017 prohibits municipalities from issuing advanced refunding bonds, a federally tax-exempt vehicle municipalities would use to pay off outstanding bonds nearing their maturity date, essentially refinancing the debt obligation. However, demand for tax-free bonds remains high, particularly in high tax states like California and New York.

Despite the likely respite from rate hikes in the near future, the possibility of lowering rates has many concerned because the yield curve has inverted (meaning that short-term rates are higher than long-term rates). An inverted yield curve has historically signaled a recession, although the timing of a recession following an inversion has never been predictable.

Banks typically “borrow” money from their depositors by issuing certificates of deposit. Banks then loan money out long-term, for example by making 30-year mortgages. When the yield curve is positive, banks make money on the difference between the interest rates of the CDs they issued and the mortgages or other longer-term loans they make. When short-term rates are higher than longer-term rates, banks don’t make money on loans and are less likely to make them. When banks don’t make loans, businesses and people can’t borrow to make large purchases and the economy slows down. Of course, the simple example we gave is an extreme, but hopefully you get the message that whenever the difference between short-term and long-term yields lessens, our economy may tend to eventually slow down and may even drop into a recession.

Since the Great Depression, the market has experienced twelve recessions, lasting between six and eighteen months. Conversely, bull markets have thrived for as long as 120 months. While we will inevitably experience periods of recession, we fully expect growth and prolonged periods of economic expansion over a long time horizon.

Summary: Planets Aligned in Q1

Rewards came to patient investors for staying the course through the disappointing performance of stock markets at the end of last year. Given strong employment and steady growth from the economy and an accommodating Federal Reserve, it was something of a foregone conclusion that the markets would eventually come back.

But our expectations can never be completely positive. While the stock market's increase was giving an "all clear" for more growth, the bond market was giving a signal of "slow down". These opposing views have some short-term bettors taking money out of the stock market as a cautionary measure. We know that the market will drop again, that is a given. However, when trying to time these moves, we would have to be right twice, knowing both when to pull out as well as when to reinvest. In a world as complex as ours, there are too many variables to confidently hit both of those times accurately.

The economy is still growing and the Federal Reserve still has an accommodative policy. There has even been talk that U.S. economy may avert a recession in the next couple of years and continue on the rather slow growth pace it established after the financial crisis 10 years ago.

While we've enjoyed a nice turnaround, we shouldn't become too comfortable. We still live in an uncertain world that will always struggle with change. Having a well-diversified portfolio with the right allocations to

stocks, bonds, and real estate, while staying invested, is still the best alternative to meet your financial goals.

Thank you for the trust you have placed in Vista.

Your Vista Wealth Management Team

Source of all charts and data: Morningstar Direct
Economic data is from BCA Research, Dow Jones, and The Economist Newspaper Limited.