TOWNELEY
CAPITAL MANAGEMENT

FIRST QUARTER 2019

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Global equity markets made a V-shaped rebound, rallying throughout the first quarter as all asset classes earned positive first quarter returns (see quarterly market review). The S&P 500 Index notched one of the best calendar year starts since 1998, posting solid gains simultaneously with headlines of progress in trade talks with China and the Federal Reserve's suspension of rate increases. These positive developments spurred share price advances around the world; global equities surged to recover a large portion of the recent losses.

	U.S. Stock Market	International Developed Market	International Emerging Market
4th Quarter 2018	-14.30%	-12.54%	-7.40%
1st Quarter 2019	14.04%	9.98%	9.97%

Stock and bond markets are responding differently to current economic conditions. While domestic equity markets' all-time highs suggest a booming economy, the Treasury bond yield curve's recent inversion is a recessionary indicator. Although we do not expect that a recession is imminent, several exogenous factors (uncertainties about trade, economic growth and monetary policy) may mean more stock market volatility in 2019. At this late stage of the economic cycle and bull market, the long-running easy money policies of the world's central banks may begin to lose their effectiveness.

Since the 2008 financial crisis, central banks around the world have used monetary policy in attempts to stimulate their economies. Policies, such as initiating large purchases of government bonds (quantitative easing) and repressing long-term interest rates, can have a major influence on how markets determine prices which, in turn, can affect portfolio performance. For this reason, this quarter we discuss the economic stimulus programs pursued by some of the major central banks around the world.

U.S. Federal Reserve (Fed): During their March meeting, Fed officials noted that the U.S. economy was slowing and they projected GDP growth of 2.1% in 2019, far less rosy than the White House's forecast of 3.0% or better. The Fed also signaled that they would not raise interest rates, and they seem to have little appetite to do so anytime soon. In the midst of the Great Recession, the Fed began buying government bonds to help stimulate the economy, driving its assets up from $870B in August 2007 to $4.5T by January 2015. Since October 2017, however, the Fed has trimmed assets to $3.9T as of the end of March. Last month, Fed officials announced that their effort to trim the central bank's massive holdings of government-backed securities would slow down in May and end in September. The Fed's continued large balance sheet is concerning while interest rates remain historically low, as it limits the Fed's ability to boost the economy in the event of a downturn.

European Central Bank (ECB): In March, ECB officials further postponed future interest rate hikes and announced a new program to stimulate bank lending in the Eurozone.

[1] U.S. Stock Market represented by the Russell 3000 Index
[2] International Developed Market represented by the MSCI EAFE NR Index
[3] International Emerging Market represented by the MSCI Emerging Markets GR Index

"A new series of quarterly targeted longer-term refinancing operations (TLTRO-III) will be launched, starting in September 2019 and ending in March 2021, each with a maturity of two years," the central bank said in a statement.

The TLTRO III program is the third injection of stimulus of this kind from the ECB. TLTROs are low rate loans that the ECB makes to banks in the Eurozone. Commercial banks that lend this money into the real economy receive cash rather than having to pay interest on the loans, in essence, free money with an incentive attached to it. The ECB initiated the program to help stimulate economic growth following the release of weak economic data and declining growth forecasts.

China's Stimulus Package: In early March, officials announced government tax and fee reductions totaling 2 trillion yuan, or around US$298B in 2019. That's almost twice as much fiscal stimulus than originally planned. Last year, as the Chinese economy showed signs of slowing amid the U.S. trade war, the government cut taxes that resulted in a 1.3 trillion yuan reduction in tax revenues. Beijing's current opportunities for stimulating demand appear much more limited than in the past. The impact of monetary easing and fiscal stimulus is much smaller due to surging debt at the provincial level that has led President Xi Jinping to crack down on shadow banking. Despite recent signs of stabilization in China, it's unclear whether their policy responses and trade negotiations will be enough to reaccelerate growth.

Bank of Japan (BOJ), the kingpin of easy policy: The Bank of Japan maintained its pledge to keep the short-term interest rate target at minus 0.1 percent, and 10-year government bond yields near zero percent. Japanese exports largely declined during the first quarter as slowing global demand took its toll. Some in the BOJ expect the country's current economic weakness to be temporary, and that China's stimulus will help Japan's economy emerge from its current softness later this year, but the BOJ faces longer term difficulties.

Many believe that the BOJ's years of printing money has dried up market liquidity, hurt bank profits, and created a vicious cycle of easing. After several years of aggressively buying government bonds and ETFs in an unsuccessful attempt to reach its 2% inflation target, the BOJ owns close to 80% of Japan's ETF market. Unlike bonds, ETFs don't mature and "fall off" the balance sheet, they must be sold. This raises concerns about what effect the BOJ's future attempts to unload the ETFs may have on the market and what impact the BOJ's ETF position (which constitutes 5% of Japan's total market capitalization) is having on equity valuations and corporate governance.

Quarterly Growth Rates of Real GDP (Annualized)

	Q4-17	Q1-18	Q2-18	Q3-18	Q4-18
U.S.	2.3	2.2	4.2	3.4	2.2
Canada	2.9	2.2	1.7	1.9	1.6
Euro Area	2.7	2.4	2.1	1.6	1.1
Japan	2.4	1.3	1.5	0.1	0.3
China	6.7	6.8	6.7	6.5	6.4
Australia	2.4	3.1	3.1	2.7	2.3
UK	1.6	1.2	1.4	1.6	1.4
Germany	2.8	2.1	2.0	1.1	0.6

Source: www.tradingeconomics.com

As we enter the second quarter of 2019, we are watching the economic data from those countries that have exhibited the most weakness over the past several quarters (Japan and Germany) for an indication that their central bank stimulus policies are working as intended. While the U.S. continues its "Goldilocks" economy with strong job markets, contained inflation, and growth that hasn't been too hot or too cold, we are mindful that "America is not an island" and that economic slowdowns in other countries can hurt our economy.

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