After the dismal equity returns and high volatility seen in the fourth quarter, financial markets reversed course at the start of 2019. Equity market volatility fell in the first quarter and broad market indices marched steadily back towards their 2018 highs. Though economic data softened slightly during the quarter, we believe that softening risks have driven the recent market rally. Looking forward, most investor uncertainty seems to hinge not on what will happen, but on the timing and magnitude of these events' effects.

A Rally Without A Driver. U.S. economic data softened slightly in the first quarter, with the Bloomberg consensus estimate for U.S. economic growth in 2019 declining from 2.6% to 2.4%, below the 2.9% growth that we witnessed in 2018. The Markit U.S. Manufacturing PMI Index also declined, from 53.8 to 52.4, with similar implications. While slower, and somewhat below expectations, recent economic data is clearly not supporting the near-term recessionary concerns that prompted December's sell-off. In addition, several high-profile risks have diminished. The Federal Reserve Board has indicated a more dovish posture, and investors no longer anticipate any increases to the Federal Funds rate in 2019 or in 2020. After five long weeks, the Federal government shutdown ended as well, easing concerns that an extended shutdown might push the economy into a recession. While the shutdown likely contributed to the weakness of economic growth during the first quarter, markets reacted positively to its resolution. Finally, while the White House has not achieved a trade resolution with China, it has postponed prior threats of tariff hikes and has suggested that negotiations are progressing. These positive developments appear to have captured a greater share of investor attention than softening economic data, as equities rose steadily throughout the first quarter.

A now familiar set of political and economic events are driving markets as we enter the second quarter.

The Uncertain Timing of Expected Events. A now familiar set of political and economic events are driving markets as we enter the second quarter, and while many investors agree about how they are likely to unfold, their timing remains critical and highly uncertain. Concerns about trade with China have weighed on markets since President Trump's election, and many investors expected to see a resolution in March. While trade agreement is likely to benefit both economies, and continues to be the base case for most investors, we do not know when that is likely to happen. In the meantime, tariffs already imposed will continue to hurt U.S. exporters and consumers. Similarly, the British Parliament has prolonged their Brexit negotiations with the European Union beyond their March deadline. While investors began incorporating the effects of Brexit into their forecasts before it passed in 2016, the actual resolution remains incomplete. Even when these negotiations conclude, there will be years of uncertainty around the magnitude of their effects on participating economies.

The Uncertain Impacts of Known Events. A corollary cloud of uncertainty surrounds the ultimate effects of recent monetary and fiscal policy. While the 2017 tax bill provided a generous boost to after-tax corporate profits in 2018, we have scant evidence showing that the bill is meaningfully stimulating revenue growth. The Tax Policy Center also estimates just 1% of the law's benefits will accrue to the 20% of taxpayers with the lowest incomes, which is likely to limit the bill's intended effect on consumer spending. With neither strong capital nor consumer spending increases materializing, earnings forecasts have been trending lower through the first quarter. Meanwhile, markets have celebrated the perceived end of the Federal Reserve's interest rate hiking cycle, but recent hikes will continue to have delayed effects on the economy over the coming years. While on a positive note, the overall perceived risk related to these events has decreased, the persistence of so many uncertainties adds noise to the investment environment, making it harder for any investor to understand what is driving markets and where they will move next into the mid-year.

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First Quarter Performance. Global equity markets performed well during the first quarter, recovering most of their late-2018 losses. The S&P 500 returned +13.65% during the quarter, while the small capitalization S&P 600 gained +11.59%. The Russell 1000 Growth Index returned +16.10% during the quarter, and the Russell 1000 Value Index returned +11.93%. The MSCI All Capitalization World Index, excluding the U.S., returned +10.44%. While positive returns were common across all major equity indices, the outperformance of large capitalization, growth, and domestic stocks reflects a growing market preference for stability amid macroeconomic risks. Bond markets rallied as the Federal Reserve affirmed the market's expectation that its interest rate hiking cycle is over for the time being. The Bloomberg Barclays US Government/ Credit Intermediate Index returned +2.32% for the quarter, while the Bloomberg Barclays Intermediate 1–10Y Municipal Bond Index gained +2.90%.

Valuation and Positioning. Equity valuations also increased during the first quarter, with the price-to-earnings ratio of the S&P 500 ending March at 16.4 times next twelve month earnings. The cyclically-adjusted P/E ratio, which is based on the past ten years of earnings, climbed to 29.9, 0.5 standard deviations above its 25-year average. These changes are the result of both increases in equity prices and downward revisions to corporate earnings expectations. If earnings forecasts continue to trend lower, these valuations may appear stretched, and could put downward pressure on equity returns moving forward. The earnings yield of the S&P 500 decreased to 6.1% during the quarter, while 10-year TIPS yields decreased to .53%, suggesting that stocks will return approximately 5.6% more than bonds in the next year. Increasing valuations, especially in the context of weak economic data, can suggest increased risks. However, as we witnessed in 2017, neither high valuations nor the presence of significant risks preclude strong equity performance. We continue to believe that a neutral asset allocation and an emphasis on companies backed by stable cash flows and strong balance sheets will best serve our clients in this environment.

We also continue to monitor the impacts of the economic environment on the Environmental, Social, and Governance risks of our holdings. The extremely low current level of unemployment has made it increasingly difficult for companies to find and attract new workers. Corporate reputations for workplace conditions, employee benefits, and corporate values may prove especially important in this environment. We believe that our selection of companies exhibiting best practices in these areas, as well as the achievements of our advocacy team in helping companies improve their ESG practices, will continue to provide value to our clients, to society, and to the planet.