ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending December 31, 2018

Economic Activity

Inflation should be the last leg for the Federal Reserve (the "Fed") to push interest rates higher to their longer-term forecasts. It is not the last leg apparently, it is clearer after the fourth quarter that the Fed is more than just data dependent and they are sensitive to the global economy and the performance of the equity markets. They became a little softer in December on their outlook for the U.S. economy and even reduced their long-term interest rate outlook by 25 basis points for 2019. On the data-dependent side of the equation, the labor markets continue to be tight while inflation recently has slightly slowed down. The annual growth in the Consumer Price Index dipped back to 2.2% in November from 2.9% in July and the Fed's favorite inflation gauge, the PCE Deflator, moved from its recent high of 2.03% back to 1.88% in November.

The steady rise in interest rates has finally started to find its way into the housing market as some of the major metropolitan regions in the United States have experienced a decline in home values over the past three months—they were led by San Diego, San Francisco, and Dallas. Despite that decline, home prices were still up over the past year by 5.03% in the United States as a strong labor market, lower marginal tax rates, and real wage growth have supported the growth. The turnover in the housing market continues to be driven by existing home sales. New home sales fell to their slowest annualized pace in October since March 2016.

Interest Rates

The Federal Reserve (the "Fed") raised their target rate for the fourth time this year on December 19 to a range of 2.25 to 2.50. Despite that, yields on the U.S. Treasuries declined significantly in the fourth quarter. The yield on the ten-year and two-year U.S. Treasuries declined by 54 and 46 basis points from their highs in mid-fourth quarter. For a short time-frame, the yield on the 5-year U.S. Treasury was less than both the 3-year and 2-year Treasuries—not the typical "inverted yield curve" but still one that illustrates the lack of current confidence in the Federal Reserve and, to a lesser degree, the trade policy from President Trump's administration.

The fourth quarter was a very poor quarter for credit as investors piled into risk-free US Treasuries and government mortgage-backed securities. For the quarter, through December 30, high yield bonds lost 4.7% and investment grade bonds lost 0.43% while U.S. Treasuries gained 2.3% (source: Bloomberg Barclays). The media accentuated the amount of growing corporate bond debt in the United States that have an overwhelming/growing amount of debt. We are concerned from a macro perspective as this element weighs on the overall market, but we are less concerned as we analyze and research the positions and weightings that we hold in our client portfolios. Since late-September, data from both Lipper and the Investment Company Institute have shown that weekly flows into municipal funds have been negative through mid-December. Even though fund flows have been negative, the Bloomberg Barclays Municipal Bond Index has returned 1.25% year-to-date through December 30 and the yield on this index has declined during the fourth quarter by 17 basis points to 2.69% as prices have moved in the same direction as U.S. Treasuries—up.

Stock Market

In the fourth quarter all major U.S. equity markets declined more than 15% from the highs reached in the previous quarter. As of year-end, more than 65% of stocks in the S&P 500 are down more than 20% from their highs with the financial and technology stocks leading to the downside. For the quarter the S&P 500 was down 14% and the Russell 2000 down 21%. The tech heavy Nasdaq was down 18% with large cap technology companies of Apple, Google, and Facebook all down more than 20% from their highs. International markets continued to struggle with the MSCI EAFE (Developed International) down 13% and the MSCI emerging markets down 8%. Overseas markets continue to be impacted by ongoing Brexit negotiations, debt problems in Italy, and the lack of any positive economic news.

Third quarter earnings continued the trend seen in the first half of the year with another quarter of greater than 20% growth and at least 5% revenue growth. Expectations heading into the quarter were very high and most companies met those expectations, but several reported lackluster forward earnings guidance. There were some high-profile companies who guided to weaker results like Amazon who for the first-time forecasted sales guidance below 20% and Apple who acknowledged flat volume in iPhones sales will impact sales growth. A common theme for the quarter was corporate management highlighting less visibility, a stronger U.S. dollar, and rising raw material costs.

As the leadership within technology faltered high quality and defensive companies outperformed in the quarter with consumer staples, utilities, and healthcare leading the way. As the S&P 500 declined for the quarter and earnings grew 20% year over year, valuation became more reasonable with the P/E (price to earnings ratio) of 15 which is in line with historical averages. The interest rates increases from the Federal Reserve have drained liquidity from the economy while increasing volatility and reducing valuation (P/E) in the financial markets.

ABOUT THE INVESTMENT ADVISORS

1st Source Bank has been providing comprehensive financial planning and wealth management services since 1936 and currently manages over $3.5 billion in assets.

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