Q1

2019

HIGH PEAKS
ASSET MANAGEMENT

QUARTERLY MARKET UPDATE

Welcome to the new quarterly commentary page of High Peaks Asset Management. At the conclusion of each quarter we will be posting a general overview of the markets and our take on what's to come. As you know we have previously supplied this commentary accompanying your quarterly consolidated statements, however in the interest of efficiency and the environment, we will now use this medium. Your quarterly consolidated statements are available upon request by either emailing our office at jdimaggio@ae.cadaretgrant.com or by giving us a call at (518)767-3287.

The equity markets came raging back in the first quarter of 2019 after the steep and abrupt sell off that ended 2018. The S&P ended the quarter up 13.07%, the Dow Jones Industrial Average up 11.15% and the NASDAQ up 16.49%. Much of this gain can be partially attributable to a recoup of losses in December when all of the major indexes sold off at least 8.5% in tandem. But there were other factors in play as well which spurred equity growth and made the first quarter of 2019 the best quarter for equities since 1998.

One major factor was the Federal Reserve Bank's stance on interest rates. It had been projected that the Fed would continue to raise rates through 2019 in an attempt to normalize the interest rate environment and better equip the Fed to handle economic weakness in the future. However, the Fed pivoted and suggested that they would cease raising rates and there is even market speculation that a rate cut may be on the horizon. When interest rates are lower, investors are less incentivized to invest in bonds and more so to invest in equities (stocks), this typically drives up stock prices. This may have been a major factor in the snap back in the equity markets we've seen in the first quarter.

On the fixed income (bond) side of the ledger, we saw bonds outperform in this quarter as well. The 10 year treasury interest rate, which is the benchmark for the bond investor, continued to come down from its recent high of 3.23% in early November and year-end close of 2.69%, to trade at 2.416% at the end of the quarter. This was a boon for bond prices as bond prices move inversely to bond yields. Investors saw their bond prices regain the slight losses from last year and then some.

This type of bond volatility is very unusual and may signal trouble ahead. In addition to the volatility we saw a glaring red flag for investors in the inversion of the yield curve, which is often a precursor to recession. This occurs when short term interest rates, in this case the 3 month treasury yield is higher than the 10 year treasury. In this quarter, this occurred on five straight trading days, and hasn't happened since 2007. This signals a lack of confidence in growth expectations and gives us cause for concern for the economy and equity investing.

The return to historically very high valuations in the stock market as measured by the Shiller PE ratio and recent bond volatility and yield curve inversion present indications that we should proceed with caution in equity investing. We continue to invest defensively in equities for our clients and prepare to be nimble in adjusting for a potential slowdown in the economy. We are late in the economic growth cycle so caution is warranted.

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The equity markets continued their upward trajectory in the 2nd quarter despite some troubling economic indicators, U.S.-China trade tensions and tariffs, and rising Middle-East uncertainty. The Standard and Poor's 500 Index climbed to new highs over the quarter and closed at 2,941.76 up 3.8%, Dow Jones Industrial Average closed at 26,599.96 up 2.59% and the NASDAQ Composite Index closed the quarter at 8006.24 up 3.6%.

The stock market outperformance shocked some investors as earnings for S&P 500 companies are expected to decline in the second and third quarters of this year. This in conjunction with the U.S.-China trade war ratcheting up affecting both importers of Chinese goods and exporters to China together, with global geo-political uncertainty, suggest that the markets may be "climbing a wall of worry".

While the equity markets climbed this wall of worry, the U.S. bond markets were seeing a dramatic reversal. Interest rates over the period measured by the benchmark 10 Year Treasury were slashed from 2.41% to 2.0% by the end of the current quarter. If you recall the 10 year yield had previously retreated to 2.14% from 2.69% during the first quarter. The continued slide in yields can be attributed to a change in Fed policy and outlook, as well as a flight to quality as many investors flee the perceived overvalued stock market in favor of the security of the bond markets.

As a result of this slide in interest rates, bond prices outperformed and many bond funds saw their best returns in years. Bond prices move adversely to interest rates, so a fall in interest rates is very favorable to bonds and bond mutual funds. The downside to this bond volatility is that it produced a phenomenon which we rarely see in government issued bond markets, where short term bond interest rates are higher than longer term bond interest rates of the same quality. This phenomenon is called an inverted yield curve and has often been a precursor to a recession.

The equity market cycle is now into its 10th year. Given coincident market conditions and factors we are concerned about the equity markets. Depending on our clients risk tolerance and positioning, we may be looking to take some risk off of the table.

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Q3

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QUARTERLY MARKET UPDATE

The third quarter saw a lot of volatility return to the equity markets while the bond markets rallied. All the major stock market indexes ended the 3-month period relatively unchanged with the S&P 500, Dow Jones and NASDAQ up 1.2%, up 1.2% and down .09% respectively. The quarter started out strong as the equity markets sored to new highs in July, as the Federal Reserve cut interest rates for the first time in 10 years. This enthusiasm was short lived as lower interest rate excitement gave way to recession fears and trade war concerns in August. August was the worst month of the year for stocks. September was better as another Fed rate cut helped stocks to recover and end the quarter even or slightly ahead.

If we look at the stock market gains for the year, we see them up about 19% for the year at quarter's end. However, if we look at them based on their value last year, on a year over year basis, we see them up only about 2.2%, this is a bit of a reality check. The market selloff at the end of last year is responsible for this disparity.

The big question on investor's minds is if this stock market recovery is sustainable through the end of the year and for how long. The equity markets have been riding the wave, creating the longest bull market in history. Lack of growth in the global economy, trade wars and tariffs, and the initiation of impeachment proceedings on the current administration are all cause to proceed with caution in this market. Our conservative approach to equity investing continues to be validated by these concerns and the recent market volatility.

Bond yields came crashing down over the quarter, with the benchmark 10 Year Treasury moving down from 2% to 1.675% to end the quarter. We have seen more volatility in the bond markets over the last 2 years than any period in recent history. This pull back in bond yields was stimulated by two Fed rate cuts of .25% over the period. We anticipate interest rates to continue to move a little lower going forward considering the Fed's pivot on Fed policy precipitated by pressure from the administration to keep interest rates low to fuel the economy. Other global central banks have been overly accommodative in an attempt to stimulate their economies, and apparently the Fed feels the need to "keep up with the Jones" although arguably our economy may not warrant such accommodation.

Lower yields translate to higher bond prices and better performance in bond mutual funds. Many of our clients have seen their bond mutual funds have abnormally robust returns. We will look to trim interest rate exposure in our client's bond investments in an effort to lock in these gains and to protect against rising interest rates in the future.

A reminder, account values are available by email or snail mail upon request. End of the year statements will be mailed with the end of the year commentary in January. As always feel free to contact the office with any questions or concerns. Thank you for your continued confidence and patronage.

Sincerely,
Joe and Bruce

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