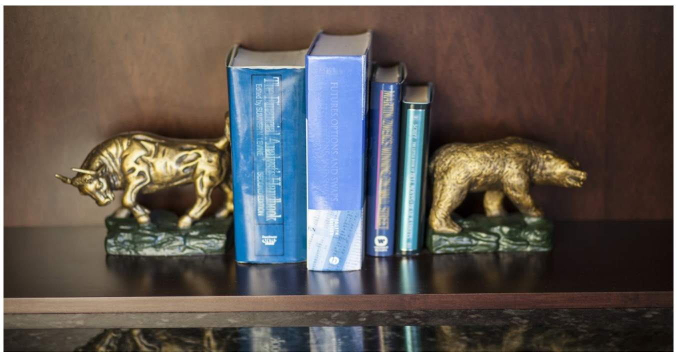
1988 · 30 YEARS · 2018
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2019: FIRST QUARTER **121ST EDITION**



"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

~ Warren Buffett

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Capital Markets Scoreboard

Equities					
Indices	**1Q19 Total Return (%)**	**2018 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	13.6	-4.4	16.5	3.3	1.9
DJIA	11.8	-3.5	15.4	3.8	2.2
NASDAQ	16.8	-2.8	22.0	4.3	1.1
Russell 1000 Growth	16.1	-1.5	20.4	7.3	1.2
Russell 1000 Value	11.9	-8.3	13.9	2.0	2.5
Russell 2000	14.6	-11.0	21.0	2.1	1.3
International*					
MSCI EAFE	10.1	-13.4	13.3	1.6	3.1
MSCI Emerging Markets	10.0	-14.2	12.0	1.7	2.3
MSCI United Kingdom	11.9	-14.1	12.5	1.7	4.0
MSCI France	10.8	-11.9	13.6	1.6	3.1
MSCI Germany	7.0	-21.6	12.1	1.5	3.1
MSCI Japan	6.8	-12.6	12.5	1.3	2.3

Fixed Income		
Indices**	**1Q19 Total Return (%)**	**2018 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	1.2	1.6
U.S. Corp - Gov (3-5 Years)	2.2	1.1
U.S. Corp - Gov (10+ Years)	6.2	-4.1
U.S. Treasuries Master	2.2	0.8
U.S. Corporates Master	5.0	-2.2
U.S. Municipals Master	2.9	1.1
U.S. High Yield Master	7.4	-2.3
International*		
Developed Markets Sov Bond	1.6	-0.3

Commodities		
Resource	**1Q19 Total Return (%)**	**2018 Total Return (%)**
Precious Metals		
Gold	1.1	-2.1
Silver	-2.4	-8.3
Industrial Metals		
Copper	11.7	-19.9
Aluminum	1.6	-16.6
Energy		
Brent Crude Oil	33.7	-24.2
WTI Crude Oil	33.3	-25.3
Natural Gas	-9.5	-0.4

Key Rates				
Rates	**3/31/2019**	**12/31/2018**	**3/31/2018**	**12/31/2017**
U.S. Target Fed Funds Rate	2.50	2.50	1.75	1.50
2-Year U.S. Treasury	2.27	2.48	2.27	1.89
10-Year U.S. Treasury	2.41	2.69	2.74	2.40
30-Year U.S. Treasury	2.81	3.02	2.97	2.74
10-Year German Bund	-0.07	0.24	0.50	0.43
10-Year Japanese Bond	-0.09	-0.01	0.04	0.05
30-Year Fixed Mortgage	4.27	4.64	4.44	3.95

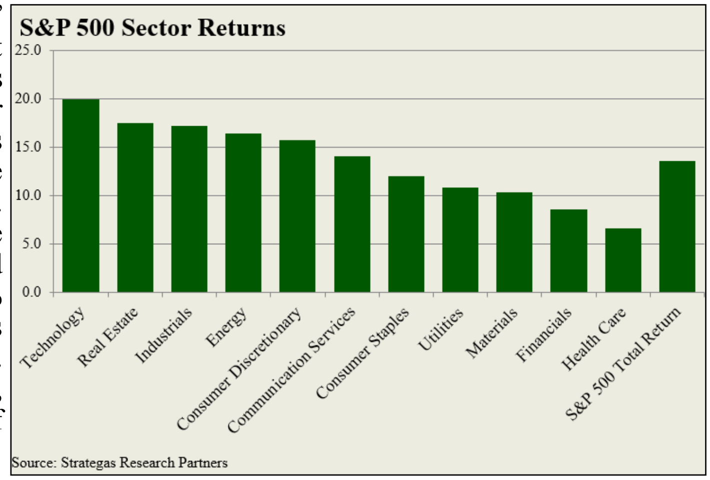
Currencies				
Indices/ Exchange Rates	**3/31/2019**	**12/31/2018**	**3/31/2018**	**12/31/2017**
ICE U.S. Dollar Index	97.28	96.17	90.15	92.12
USD per EUR	1.12	1.14	1.23	1.20
USD per GBP	1.30	1.27	1.40	1.35
JPY per USD	110.69	109.72	106.35	112.65
CAD per USD	1.34	1.37	1.29	1.25

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

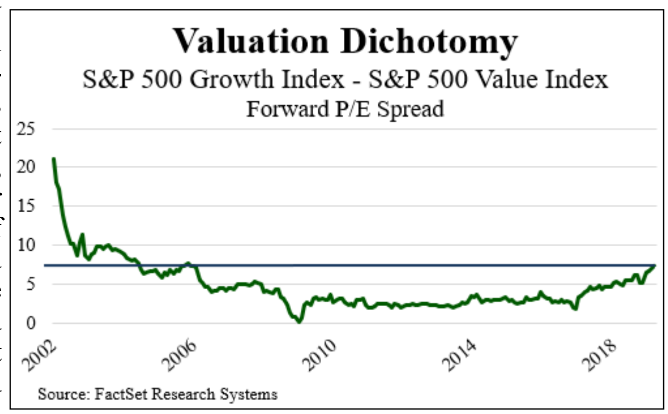
- Equity Markets began 2019 with a "v-bottom" recovery from their sizeable declines in last year's fourth quarter. The Standard & Poor's 500 (S&P 500) index closed the first quarter with a total return (price appreciation plus dividends) of 13.65%. All 11 sectors in the index posted positive returns for the quarter. Technology led the way, up 19.9%. On the other end of the spectrum, Financials and Utilities posted returns of 8.6% and 6.6% respectively. They were the only two sectors to post single-digit returns for the quarter. From its recent low on December 24, 2018, the S&P 500 produced a total return of 21.23% through March 31.



- Smaller-company stocks fared even better than their large-cap counterparts in the first quarter, with the Russell 2000 Index returning 14.58%. International markets trailed domestic indices, but still provided strong returns – the MSCI Europe, Australasia, and Far East (EAFE) Index and MSCI Emerging Markets Index returned 10.13% and 9.95% respectively when denominated in U.S. dollars. When denominated in local currencies, international developed and emerging markets returned 10.73% and 9.86% respectively.

- Earnings have historically been a primary driver of stock prices, yet the S&P 500 opened the year with its best quarterly return since the second quarter of 2009 in the face of an expected decline in first quarter earnings. As the quarter closed, analysts were projecting a first quarter earnings decline of 4.2%, due in part to tough year-over-year (Y/Y) comparisons caused by the corporate tax cut boost in 2018. A first-quarter earnings decline would mark the first Y/Y earnings decline since the second quarter of 2016. While revenue growth is expected to be positive for calendar year 2019 at nearly 5%, it will still represent a slowdown from the nearly 9% growth experienced last year.

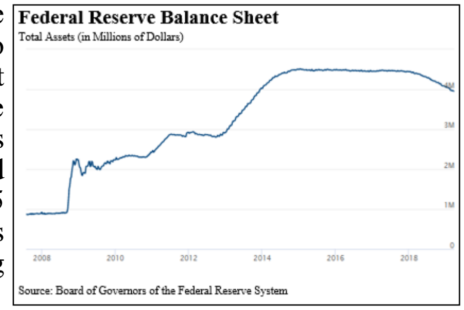
- The S&P 500 ended the quarter with many valuation measures slightly higher than historical averages. For example, the S&P 500 price-to-earnings (P/E) ratio of 16.7x forward earnings was above its 16.1x historical average. Interest rate and bond yield-inclusive valuation models, however, indicate the S&P 500 closed the quarter undervalued. The most interesting aspect of valuations is the dichotomy between growth and value stocks. In the last week of the quarter, the forward P/E ratio of growth stocks (20.6x) and value stocks (13.3x) reached its widest discrepancy since March 2006. Earnings and revenue growth in the stock market have been difficult to find, and investors have become increasingly willing to pay a premium for them.



- The first-quarter rebound in equity prices occurred despite subdued participation from individual investors. With growth prospects in short supply as the current bull market continues beyond the 10-year mark, corporations still ripe with cash after the most recent tax reform have used that excess cash to fund large-scale share buybacks, driving stock prices higher even in the face of light investor participation. Share buybacks are often the subject of negativity in the press and political arenas. Some believe they create capacity constraints and should be reinvested more meaningfully. They also increase a company's earnings per share (EPS) without any change in underlying earnings. However, share buybacks serve to return cash to shareholders, giving them added capacity to reinvest in other companies with better growth prospects.

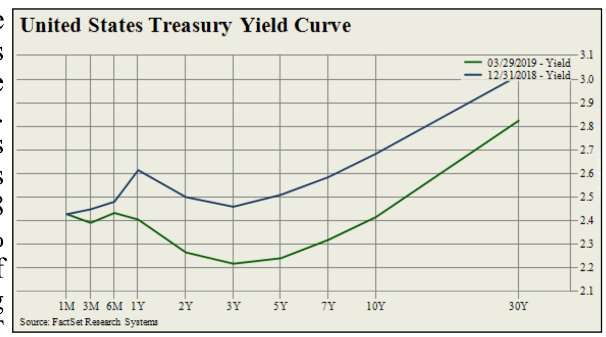
- Interest rates decreased and credit spreads (the yield differential between government and corporate bonds) tightened in the first quarter, creating a favorable environment for risk-taking in the fixed income markets. As measured by BofA-ML indices, U.S. Treasuries (USTs) in aggregate returned 2.2% for the quarter while investment-grade bonds returned 5.0%. High-yield bonds, which lost 4.6% in the fourth quarter of 2018, produced a first quarter return of 7.4%. Interest rate-sensitive long-term corporate and government bonds with over 10 years until maturity gained 6.2% while their shorter-term counterparts with one to three years until maturity gained 1.2%.

- After projecting two 2019 interest rate increases last December, the Federal Reserve (Fed) changed course aggressively in March by no longer predicting further increases this year. The Fed also noted it would look to suspend the unwinding of its balance sheet sometime in 2019 after signaling in December it would continue reducing its balance sheet by $50 billion per month indefinitely. The Fed balance sheet reached a peak of over $4.5 trillion in January 2015 due to quantitative easing (QE) and is now below $4 trillion. This compares to just $870 billion in August 2007, so there is still a long path to get back to "normal".



- In March, the global amount of negative-yielding debt increased above $10 trillion for the first time since 2016. 10-year government bonds in both Germany and Japan resumed yielding below 0% during the quarter. In November 2018, the spread between 10-year German bunds and USTs reached its highest level since 1987 and has remained elevated since. This environment puts downward pressure on UST yields as well, since foreign investors can purchase USTs, then pay to hedge away currency risk and effectively capture a higher risk-free return than when purchasing their own government's bonds.

- More segments of the yield curve "inverted" during the first quarter, causing alarm bells surrounding this traditionally bearish indicator to go off. The yield curve is the spectrum of UST yields across various maturities. Generally, this curve will be upward sloping, as investors will seek compensation for the risk that comes with investing in longer-term bonds. After ending 2018 at 2.69%, the 10-year UST yield dropped below 2.40% in March, lower than the current fed funds rate of 2.50%. The 2-year UST yield sank as well, reaching 2.22%. With yields on both the 2-year and 10-year UST below the fed funds rate, ultra short-term bonds could continue providing a yield advantage if the Fed does not cut interest rates. While curve inversions have preceded each of the last seven recessions, they have also offered two false-positives, and subsequent stock market downturns have been mixed in timing and magnitude.



- High-yield (junk) bonds provided their strongest quarterly return since the third quarter of 2009 off the Fed's dovish signaling and the 2018 sell-off (high-yield bonds finished the year with a -2.3% total return). Issuers of high-yield bonds are particularly sensitive to increases in interest rates, as they have higher levels of debt relative to assets or equity. They also have proportionally higher levels of floating rate debt than their investment-grade counterparts, and these instruments are generally linked to short-term interest rates. Although high-yield spreads finished the quarter above levels seen through the first three quarters of 2018, they remain below 5-, 10-, and 30-year averages.

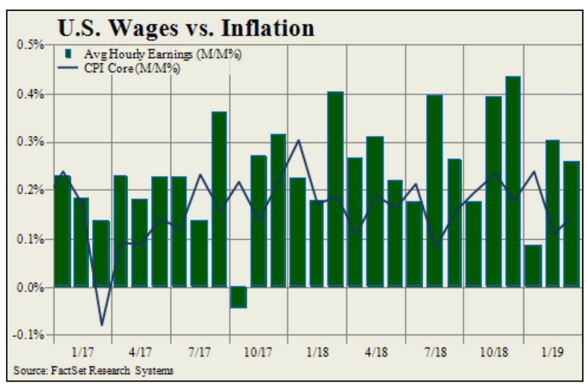
ECONOMICS

- On March 28, the Commerce Department reported that economic growth in the U.S. slowed to 2.2% in the fourth quarter of 2018 (adjusted for inflation and seasonality), down from an initial estimate of 2.6%. Most sectors of the economy were weaker relative to the prior quarter, including household spending, business investment, residential construction, and government infrastructure spending. For the year, Gross Domestic Product (GDP) grew by 2.9% compared to 2.2% for 2017.

- GDP growth for the first quarter of 2019 is expected to be below 2%, with many economists forecasting a gain of 1.5% or lower. Slow global growth will be a major headwind for the U.S. economy. Particularly worrisome is the Eurozone – its growth is predicted to be half that of the U.S. in 2019 and 2020. The January federal government shutdown is also expected to be a drag on growth, but that will only be temporary. Recently, the Atlanta Fed's closely-watched GDPNow model raised its estimate for 2019 GDP growth to 2.3% while the Conference Board forecasts U.S. GDP growth of 2.4% for the year.

- After reaching a 10-year high of $621 billion in December, the U.S. trade deficit surprisingly decreased to begin the year. Last year's widening was due primarily to a strong U.S. economy, strong dollar (which makes U.S. exports more expensive and foreign imports cheaper), and falling world trade growth relative to global GDP growth. Net goods imports continue to drive the deficit (-$891 billion in 2018), while the U.S. remains a net exporter of services (+$270 billion in 2018). Though services exports ticked up slightly, an $8.2 billion decline in goods imports was primarily responsible for the $8.8 billion narrowing of the trade deficit in January. Of this $8.8 billion, $5.5 billion was between the U.S. and China, which remains the largest net deficit to the U.S. ($419 billion in 2018).

- The Bureau of Labor Statistics (BLS) reported that nonfarm payroll employment increased by 196,000 in March, continuing the streak of 102 consecutive months of job growth, while the unemployment rate remained low at 3.8%. The number of new jobs in February was also revised upward from 20,000 in the initial report to 33,000. The March report was a welcome relief from the February report which caused unease about the economy and heightened fears of a possible recession. An average of 180,000 jobs were created per month in the first quarter, down from the 223,000 average in 2018. Most companies continue to hire but are finding it difficult due to a continued shortage of skilled labor.

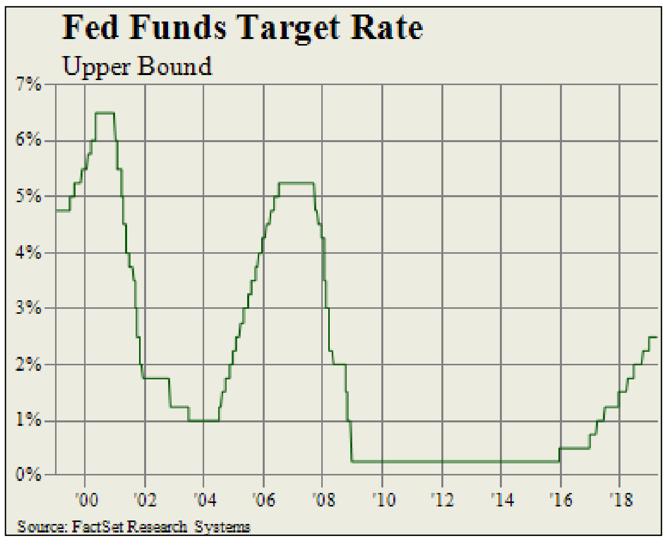


- Average hourly earnings increased 10 cents in February and another 4 cents in March to $27.70. Wages increased 3.2% over the year, outpacing inflation by 1.3% (real average hourly earnings). A surplus of job openings relative to unemployed workers (7.5 million versus 6.5 million) and productivity growth (up 1.9% in the fourth quarter of 2018) have contributed to wage growth. Initial jobless claims are at their lowest levels since 1969 even though today's working-age population is nearly three times larger. Manufacturing jobs increased for 19 consecutive months (the longest stretch since the 1990's) before shedding 6,000 jobs in March. For the first time since the 1970's, more jobs are being re-shored than offshored. While real consumer spending (after inflation) is expected to again increase by 2.6% in 2019, the overall trend in consumer confidence has been waning since the summer of 2018 which supports expectations for a moderation in economic growth.

The Fed Fought the Markets and the Markets Won

The Federal Reserve Bank (Fed) has a Congressional mandate to promote full employment and maintain price stability. While not a Congressional mandate, the Great Recession of 2007-2009 added another responsibility – to stabilize the financial system. The monetary tools the Fed uses to carry out these tasks are 1) raising or lowering short-term interest rates and 2) expanding or reducing the size of its balance sheet by buying or selling primarily government bonds. The latter tool was utilized for the first time during and after the financial crisis. The Fed's job is to anticipate where the economy will be in terms of employment, inflation, and the soundness of the financial system, and not where it is today. They attempt to offer guidance on their thinking about the future in policy statements, news conferences, research, and speeches. Investors are monitoring this very closely.

The Fed conducted the largest monetary experiment in modern history beginning during the financial crisis by lowering short-term interest rates to near zero (0.0-0.25%), and later dramatically increasing the size of its balance sheet via three quantitative easing (QE) programs. This involved purchasing massive amounts of government and mortgage bonds; the Fed's balance sheet went from $870 billion before the crisis to $4.5 trillion at its peak in January 2015. Central banks in the Eurozone, Japan, and U.K. took similar action. The results in the U.S. were historically low interest rates, subdued inflation, anemic economic growth of 2%, and inflated values of financial assets, especially stocks. Economists will debate for decades the effectiveness and merits of this aggressive monetary policy (particularly the QE programs), but most agree that it prevented the Great Recession from becoming another Great Depression.



Source: FactSet Research Systems

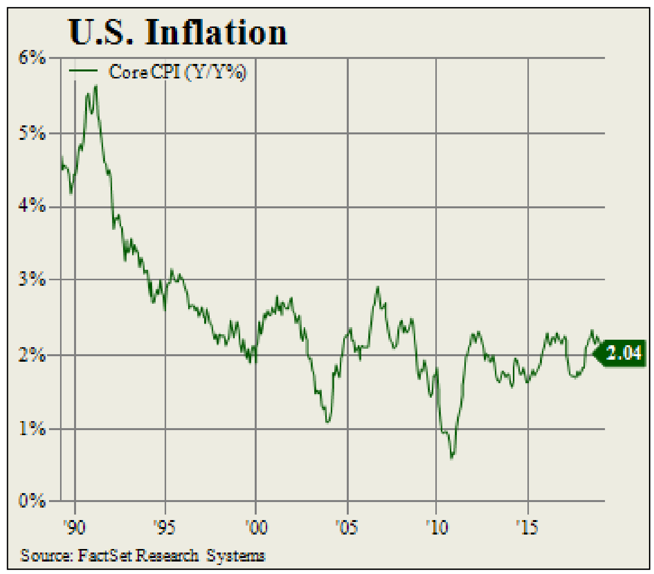
In 2015, the Fed began unwinding this monetary experiment to return monetary policy to a state of normalcy. Along the way, it has hiked short-term interest rates by 0.25% nine times: once in December 2015, again in December 2016, three more times in 2017, and four times in 2018, the latest in December. The Fed has also reduced its balance sheet by $500 billion starting in 2017, letting bonds mature without purchasing replacements.

The Fed's unwinding schedule has been dictated by forecasts based upon current data, economic models, past experience, and intuition. Investors look at the same data and form their own expectations as reflected in the marketplace. The Fed could analyze and use this financial market data and expectations in forming its monetary policy but has historically chosen to instead rely upon its own analysis. The Fed staff's record as an economic forecaster does not inspire much confidence. For several years after the end of the Great Recession, Fed forecasts projected exuberant economic growth along with higher inflation and interest rates that never materialized. The market's expectations were much lower. This was not a big issue until 2017 when the Fed began raising interest rates more aggressively and reducing its bond portfolio. It all came to a head in the fourth quarter of 2018.

The Fed raised rates in late September 2018 for the third time that year. At that time, projections called for one more hike in 2018, three more in 2019, and one or two in 2020. This did not go down well with the stock market – the S&P 500 hit an all-time high of 2,930.75 on September 20 and had nearly reached correction territory (a decline of 10% or more) by late October. President Trump was very vocal and critical about the Fed raising interest rates. By the time of the November Fed meeting, the S&P 500 had rebounded to a slight decline of near 4%, and despite market disagreement, the Fed announced it did not plan to deviate from its earlier forecasts. The S&P 500 continued in gradual decline until the end of November, and then things got interesting. The Fed raised interest rates for a fourth time in December and basically told the markets and President Trump to "take that and —". The Fed's hawkish message was that the economy is so strong and labor markets are so robust that they expected to raise interest rates two more times in 2019. The Fed also said that it would not alter its $50 billion a month balance sheet reduction, known as quantitative tightening (QT.)

The stock market did not react well to the news. It declined another 16% by December 24, with half of the drop coming after the Fed's December 19 rate hike decision. The result was the worst December stock market performance since 1931. The S&P 500 had declined 19.78% from its September 20 high to its Christmas Eve low of 2,351.10, just shy of the 20% decline required to be classified as a bear market.

The Fed took notice. In January 2019, Fed Chair Powell started talking about patience in raising interest rates and some flexibility in downsizing the Fed's balance sheet. It was a message the stock market wanted to hear – the S&P 500 had one of its best January performances on record, up 7.87%. At its March 2019 meeting, the Fed did not apologize but somewhat admitted that the markets were right. Projections moved to no interest rate increases in 2019 and perhaps one in 2020 depending on the economic data, and an end to balance sheet reduction in October 2019. The Fed and the markets finally seem to be on the same page in forecasts of future economic growth and the neutral interest rate, the rate that will not ignite inflation or cause unemployment to rise. This appears to be in the 2.50-2.75% range as opposed to the Fed's original forecast of 3.5%. The S&P 500 has appreciated 21.23% from its December low, experiencing one of its sharpest v-shaped moves in history after last year's near-bear market decline.



Subsequent economic data has confirmed the wisdom of the Fed accepting market forecasts. GDP growth for the fourth quarter of 2018 was revised down to 2.2% from 2.6% initially. Inflation by the Fed's preferred measure, the Personal Consumption Expenditures (PCE) Price Index, was up 1.37% in January from a year earlier, far below the Fed's inflation target of 2%. The big worry now is inversion in the yield curve; 3-month and 1-year interest rates are higher than 10-year UST yields. Raising short-term interest rates two or three more times would have magnified this situation as the 10-year UST yield is forecasting slower economic growth and lower inflation. The yield curve has inverted before the last seven U.S. recessions. The question now has shifted to whether the Fed will *cut* interest rates in 2019. The market has assessed that probability at greater than 50%, and the Trump Administration is also calling for a rate cut due to slowing global economic growth.

Perhaps the Fed staff should have read a book written by James Surowiecki titled, "The Wisdom of Crowds: Why the Many are Smarter than the Few and How Collective Wisdom Shapes Business, Economics, Societies and Nations." In other words, the consensus of large groups of people is better than an elite few at solving problems. Hopefully the Fed has seen the light and its recent U-turn will prolong the economic expansion, which is on pace to celebrate its 10-year anniversary in June, a new record. The bull market in stocks passed its 10-year anniversary on March 9, 2019, and the S&P 500 has appreciated nearly 320% (excluding dividends) from March 9, 2009 to the end of the first quarter of 2019. As of August 2018, it became the longest bull market in history, although not the largest in terms of appreciation. That title belongs to the 1990's bull market when the S&P 500 appreciated 417%. The S&P 500 first-quarter performance was the best since 2009 but closed the quarter 3.29% below the September 2018 high. Still, it will not take much to set a new S&P 500 record in 2019 and the U.S. economy should avoid a recession in the near future – that is, as long as the Fed decides not to put up a fight.