LPL RESEARCH

MARKET INSIGHT MONTHLY

March Update | As of February 28, 2019

FEBRUARY 2019 IN REVIEW

ECONOMY:

SOUND ECONOMIC DATA IN FEBRUARY AMID GLOBAL UNCERTAINTY

U.S. economic data were sound in February, even as confidence fell amid uncertainty from global trade and political headwinds. The Conference Board's Leading Economic Index (LEI), an aggregate of ten leading indicators, declined 0.1% in January, but grew 3.5% year over year. While the LEI declined month over month, positive year-over-year momentum signaled low odds of recession in the coming year **[Figure 1].**

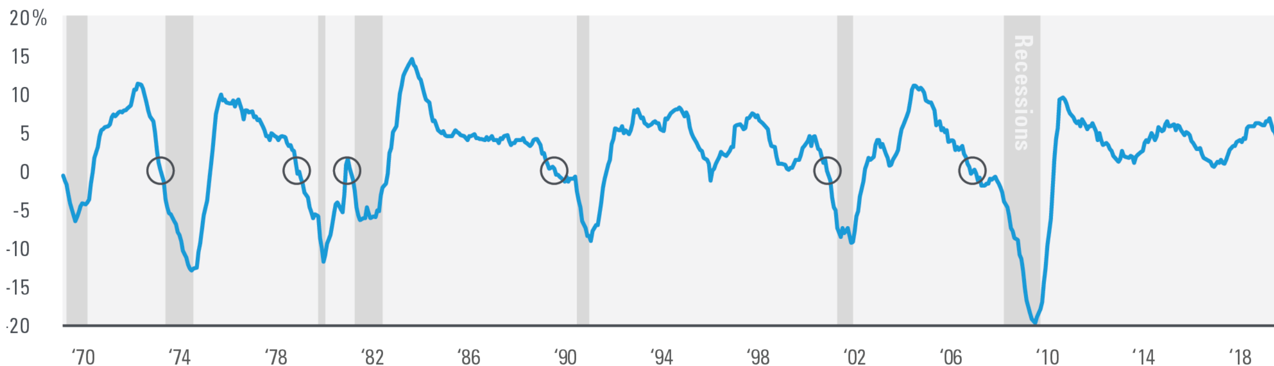
The delayed fourth quarter gross domestic product (GDP) report was an encouraging sign to investors that global uncertainty hadn't significantly derailed output. Fourth quarter GDP grew 2.6% from the prior quarter, higher than consensus estimates for a 2.2% gain. GDP grew 2.9% overall in 2018 and 3.1% year over year for the fourth quarter. Consumer spending contributed 1.9%, the biggest component of fourth quarter output growth, while business spending added 0.8%.

Labor market strength was another bright spot. Nonfarm payrolls rose in January, capping jobs' biggest two-month increase since July 2016. The participation rate also climbed to its highest point since 2013, indicating more participants were enticed by solid economic conditions to enter the workforce. The unemployment rate did tick up to 4% in January, but the increase came with caveats due to the government shutdown and higher participation.

Inflation data remained at manageable levels. Average hourly earnings rose 3.2% year over year, around the fastest pace of the cycle, but materially lower than the 4% growth that has preceded recessions historically. Pricing gauges also showed that inflationary pressures remain manageable. The core Consumer Price Index, which excludes food and energy, increased 2.2% year over year, while the core Producer Price Index climbed

1 LEADING INDICATORS TYPICALLY TURN NEGATIVE BEFORE RECESSIONS

Year-over-Year % Change in LEI*



Source: LPL Research, Conference Board 02/28/19

*The Conference Board Leading Economic Index

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2.8% year over year. Core personal consumption expenditures, the Federal Reserve's (Fed) preferred inflation gauge, rose 1.9% year over year, its eighth-straight month within 0.1% of policymakers' 2% target.

Manufacturing rebounded from a discouraging slide through the end of 2018. The Institute for Supply Management's (ISM) manufacturing Purchasing Managers Index (PMI), a gauge of U.S. manufacturing health, rose to 56.6 in January. Markit's PMI also ticked up to 54.9 in January, confirming the improvement in manufacturing activity. While recent manufacturing data are encouraging, we see the ongoing U.S.-China trade dispute as the primary obstacle to consumer and corporate health. Once trade risk subsides, we expect manufacturing activity to improve further as companies resume business investment.

Confidence continued to deteriorate though, fueling speculation of an economic slowdown. The Conference Board's Consumer Confidence Index slid for a third straight month in January, its biggest three-month decline since 2011, while NFIB's measure of business confidence fell for a fifth-straight month. Drops in consumer confidence have been late-cycle signals historically, as lower confidence could weigh on consumer spending, and consequently, on output [Figure 2]. Separately, a report delayed by the government shutdown showed retail sales fell the most in December on a monthly basis since 2009, boosting speculation that lower confidence could be cooling consumer activity.

Central Banks Take a Break

Major central banks around the world took a break, as the Fed, European Central Bank, and Bank of Japan did not have meetings scheduled in February. However, financial markets' expectations for policy were consistent during the month. Fed fund futures implied an 85% probability that rates will remain unchanged through the rest of 2019, and an 11% chance that rates will be cut before the end of the year.

2 CONFIDENCE SHIFTS COULD BE LATE-CYCLE RED FLAGS

Economic Cycle Trough	Economic Cycle Peak	Consumer Confidence Peak	Date of Max Confidence	Time from Peak Confidence to Start of Recession (Months)	Consumer Confidence at Start of Recession	Drop in Consumer Confidence from Peak to Start of Recession
03/1975	07/1981	110	04/1978	39	84	26
11/1982	07/1990	121	02/1989	17	102	19
03/1991	03/2001	145	01/2000	14	117	28
11/2001	12/ 2007	112	07/2007	5	91	21
06/2009	?	138	10/2018	?	?	?
Average (Before Current Cycle)		**122**		**19**	**99**	**23**

Source: LPL Research, Conference Board 02/07/19

Economic recessions noted are from the National Bureau of Economic Research, which defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

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GLOBAL EQUITIES

STRONGEST TWO-MONTH START FOR STOCKS SINCE 1991

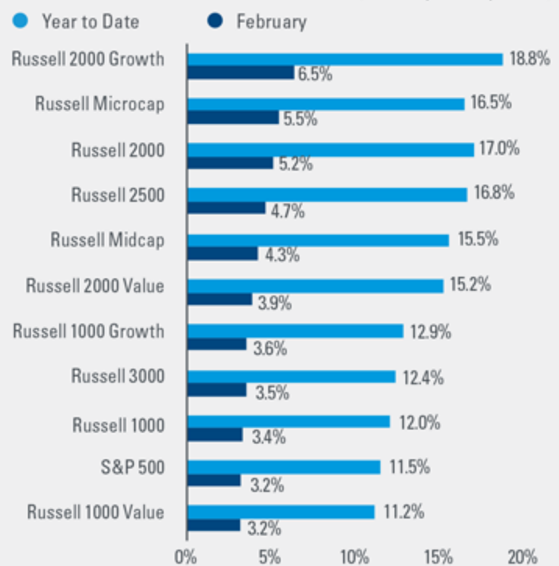
Stocks followed their best January in more than 30 years with more gains in February. The S&P 500 Index's 3.2% gain for the month brought its two-month return to 11.5%, its best start since 1991. The Dow Jones Industrial Average (Dow) and Nasdaq also delivered solid gains with advances of 4% and 3.6% on a total return basis (including dividends).

The drivers for January's stock market gains remained in place in February. First and foremost, U.S. trade negotiators made further progress in talks with China. A Fed on hold, the end of the government shutdown (though expected), and a strong jobs report in early February also helped buoy sentiment, offsetting a mixed earnings season, weak December retail sales data, and weaker growth in Europe.

U.S. and China negotiations continued to progress. Talks at the end of January and throughout February reportedly yielded progress on Chinese commitments to purchase U.S. goods, greater market access, intellectual property theft prevention, and eliminating forced technology transfers. Progress was sufficient for President Trump to remove the threat to impose tariffs on an additional $200 billion of Chinese goods if a deal were not reached by March 1. As March began, questions about enforcement of an eventual deal lingered, but confidence in an agreement remained high, and President Trump and President Xi are expected to meet in late March or shortly thereafter.

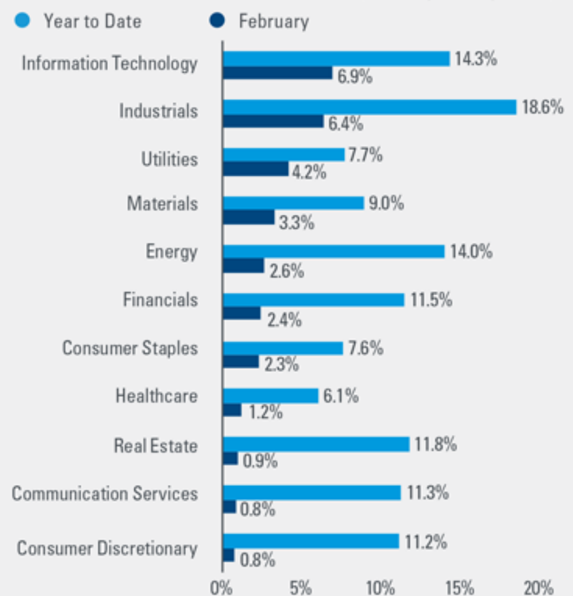
Fed communications during February reinforced the market's expectation that rates would likely remain unchanged throughout 2019, although resolution of trade tensions could catalyze enough economic growth and potentially bring a late-year hike. In his congressional testimony, Fed Chair Jerome Powell reiterated the Fed's favorable economic outlook while acknowledging challenges to growth, including an economic slowdown in major foreign economies, Brexit uncertainty, and U.S.-China trade relations.

DOMESTIC INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 02/28/19

S&P 500 SECTOR PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 02/28/19

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Stock investing involves risk, including loss of principal.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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Small caps outperformed their large cap counterparts for the second straight month, benefiting from relatively greater economic and market sensitivity. The Russell 2000 Index returned 5.2% during the month, above the 3.4% and 4.3% returns for the large cap Russell 1000 and Russell Midcap indexes.

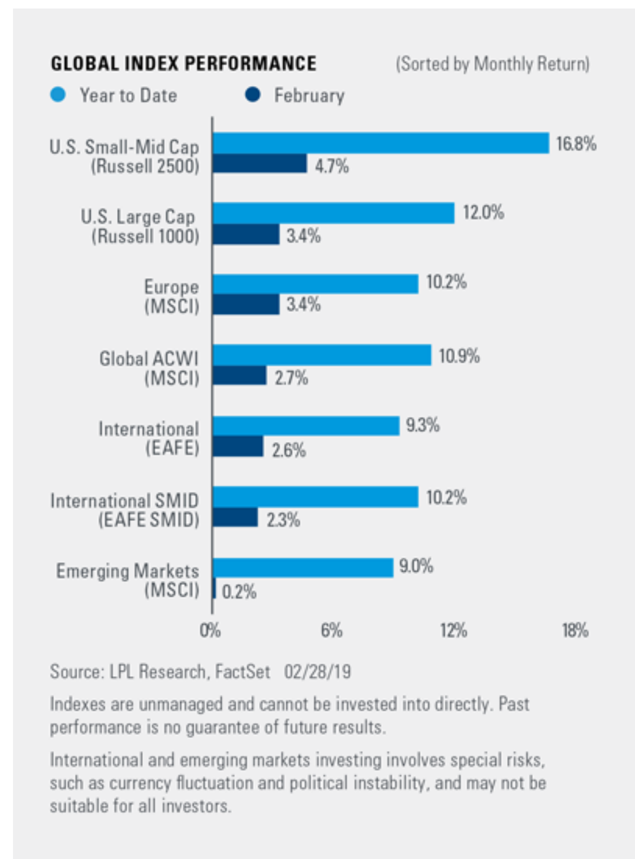
Growth outpaced value for the second straight month, as the Russell 1000 Growth Index returned 3.6%, slightly ahead of the 3.2% return for the Russell 1000 Value Index. Growth stocks have generally performed better during rising markets in recent years and have outperformed during most of the nearly 10-year old bull market. In February, the growth style benefited from outperformance of technology and industrials stocks, while the value style was weighed down by underperformance of the financials sector.

Technology topped the February sector leaderboard with a 6.9% return, followed closely by industrials, which returned 6.4%. Software strength propelled technology while industrials got a boost from the aerospace and defense and capital goods industry groups. The strong performance by these industries, which are among the most sensitive to trade with China, reflects the market's increasing optimism toward a deal. Sector laggards included consumer discretionary and communication services, with notable weakness in the media, retail, and telecom services industry groups.

International

Neither international developed market nor emerging market (EM) equities were able to keep up with U.S. equities during February. The MSCI EAFE Index returned 2.6% for the month, while the MSCI EM Index managed only a 0.2% gain. More evidence of weakening economic growth in Europe and Japan and a firm U.S. dollar weighed on developed international equity indexes. At the country level, markets in Hong Kong, Switzerland, and France performed best (based on MSCI country equity indexes). Japan and Germany lagged, with the latter narrowly avoiding recession during the fourth quarter of 2018. February's Brexit news was well received and propelled the U.K. equity market 3.4% higher during the month.

Progress on U.S.-China trade talks, prospects for fiscal stimulus, and the Fed's pause in hiking rates all should have helped support EM equities in February, as they did in January. However, the MSCI EM Index managed only a marginal gain. China wasn't the problem, as its equity market rallied 3.5%. Secondary EM countries such as Brazil, South Korea, and South Africa all suffered losses and dragged the overall index down. Although oil rallied, commodities markets were not strong enough broadly to offset EM headwinds.



Source: LPL Research, FactSet 02/28/19

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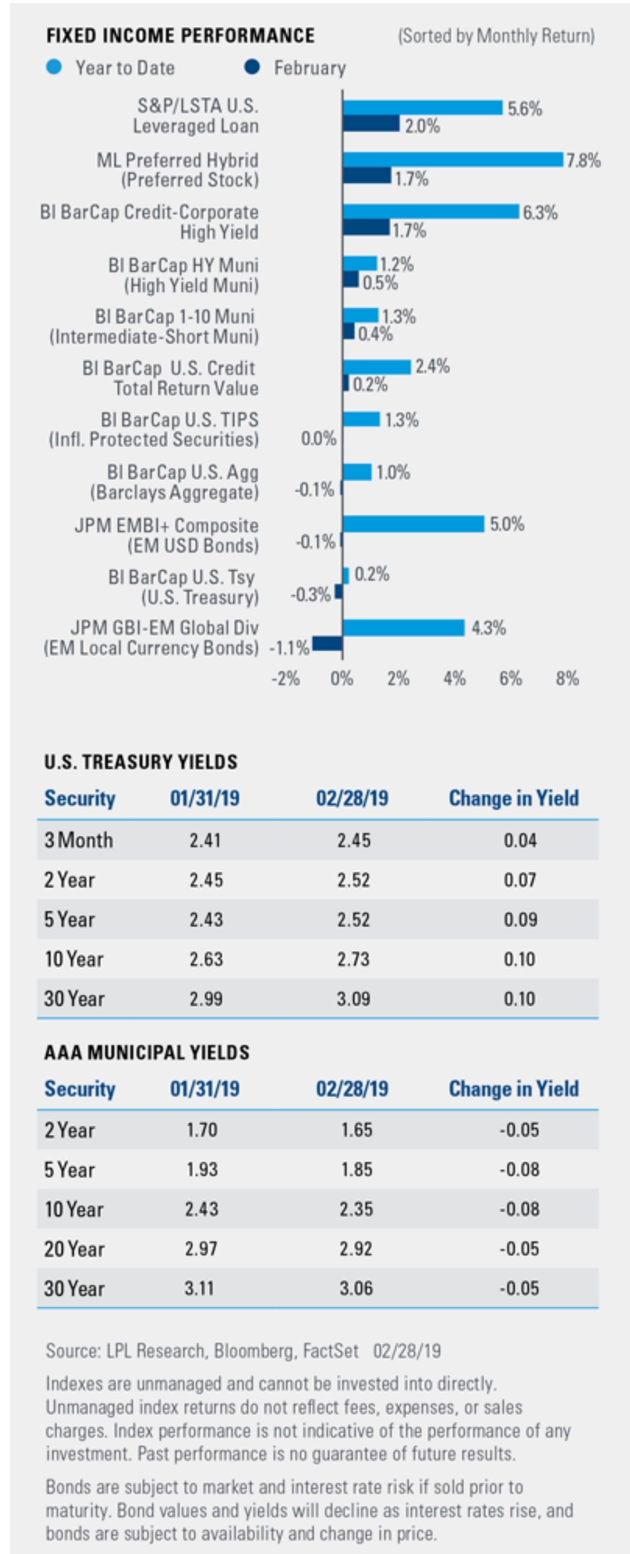
International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

FIXED INCOME

TREASURY YIELDS DROP FOR THIRD STRAIGHT MONTH

Treasury prices jumped, while yields dropped for a third straight month in January amid the Fed's decision to leave rates unchanged and commitment to patience in tightening policy any further. The 10-year Treasury yield slid 6 basis points (bps) to end the month at 2.63%, after falling to a 12-month low of 2.55% on January 3. The yield curve flattened further, as the spread between the 2-year and 10-year yields fell to 17 bps (.17%).

All nine fixed-income classes we track rose in January (as shown in the Fixed Income Performance Table). Lower-quality fixed income generally outperformed higher-quality bonds as investors' risk appetites resurged after a rocky end to 2018. High-yield corporate bonds rose 4.5%, the sector's best month since October 2011, while bank loans gained 3.6%. Investment-grade corporate bonds, represented by the Bloomberg Barclays U.S. Aggregate Credit Index, rose 2.2%, while the broad Bloomberg Barclays U.S. Aggregate Bond Index increased 1.1%. Mortgage-backed securities climbed 0.8%, and Treasury prices rose 0.5%. EM debt climbed 4.4% in its best month since July 2012.



U.S. TREASURY YIELDS

Security	01/31/19	02/28/19	Change in Yield
3 Month	2.41	2.45	0.04
2 Year	2.45	2.52	0.07
5 Year	2.43	2.52	0.09
10 Year	2.63	2.73	0.10
30 Year	2.99	3.09	0.10

AAA MUNICIPAL YIELDS

Security	01/31/19	02/28/19	Change in Yield
2 Year	1.70	1.65	-0.05
5 Year	1.93	1.85	-0.08
10 Year	2.43	2.35	-0.08
20 Year	2.97	2.92	-0.05
30 Year	3.11	3.06	-0.05

Source: LPL Research, Bloomberg, FactSet 02/28/19

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

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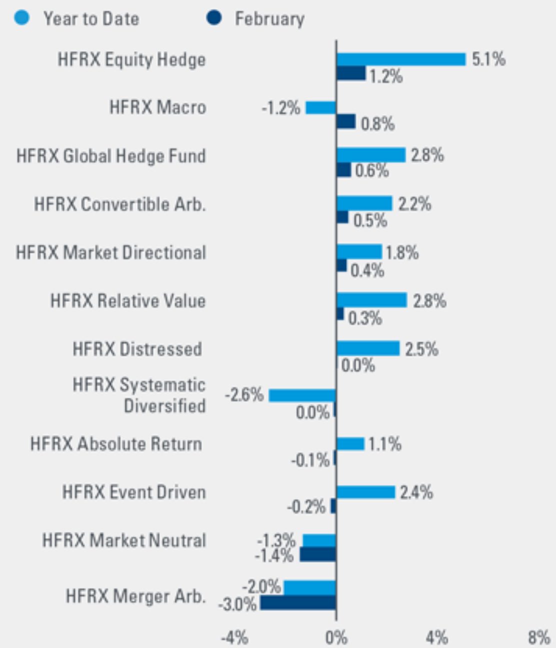
ALTERNATIVE INVESTMENTS

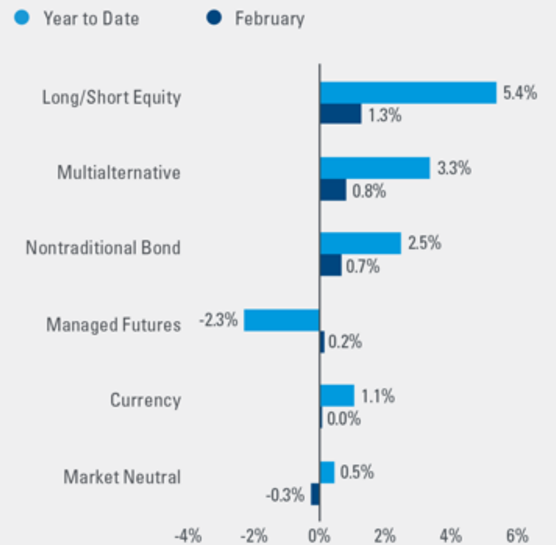
CONSTRUCTIVE START TO 2019

During January, long/short equity strategies performed in line with long-only benchmarks on a risk-adjusted basis, as the HFRX Equity Hedge gained 3.9% compared to the S&P 500 8% return. This represented an up-capture ratio of 48.6%, above the industry's beta of approximately 0.40, which indicates managers' added alpha. From a sector perspective, an overweight to industrials (11.4% during January) supported performance. The smaller performance gap between value (Russell 1000 Value Index, up 7.8%) and growth sectors (Russell 1000 Growth Index, up 9%) was also notable, as the recent outperformance of value by growth-related stocks has been a consistent headwind facing many strategies.

The HFRX Merger Arbitrage Index gained 1% during January. After receiving the proceeds of several large transactions at the end of 2018, managers have been slowly adding capital to new investments. Additionally, the U.S. government shutdown caused delays in the timetable of regulatory approvals, which has added additional uncertainty surrounding the pace of deal closings this year. Overall, the merger and acquisitions environment remains healthy; however, we're aware of the potential weakening impact of U.S. tax reform and ongoing trade conversations between the United States and China.

In the macro space, after a tremendous end to 2018, short equity exposure weighed on trend-following strategies, as the HFRX Systematic Diversified Index declined 2.6% during the month. Long bond exposure helped offset losses to a small extent, however, short equity exposure across most global indexes was difficult to overcome during such a broad-based rally. Relative value strategies continue to perform well on a risk-adjusted basis, as the HFRX Relative Value and HFRX Convertible Arbitrage Indexes gained 2.5% and 1.7%, respectively.





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Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

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REAL ASSETS:
BROAD-BASED STRENGTH

The liquid real asset categories we track were all solidly positive in January, reversing December's declines. Master limited partnerships (MLP) and U.S. real estate investment trusts (REITs) delivered the biggest gains, while commodities lagged with a more modest advance.

Master Limited Partnerships

MLPs broke a four-month losing streak with sharp January gains, as the Alerian MLP index returned 12.6% during the month and outpaced the broad equity markets. The sharp rebound in oil prices was the primary catalyst for the advance, while the end of tax loss selling, a more stable interest rate outlook, and attractive valuations also provided support.

REITs and Global Infrastructure

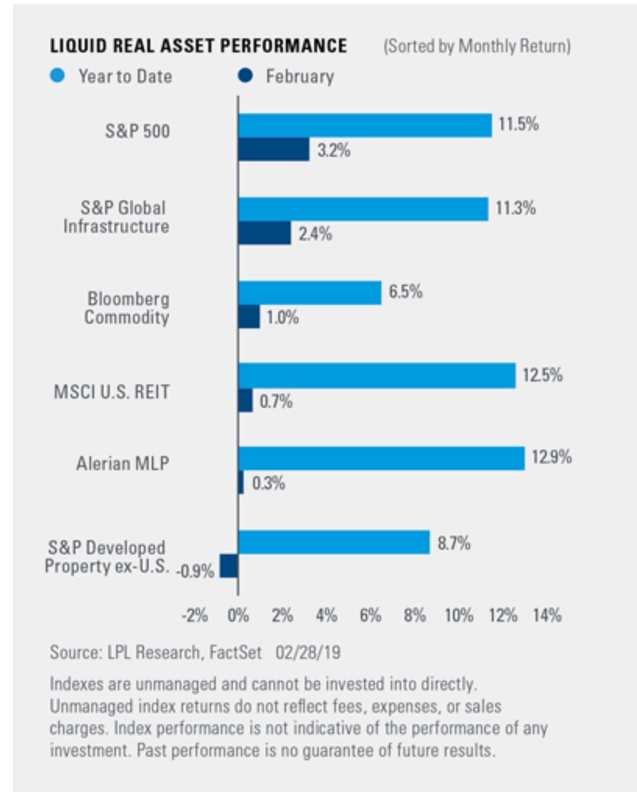
In January domestic REITs rallied nearly 12%, outpacing the S&P 500, after struggling throughout most of 2018. Cyclical real estate sectors outperformed the domestic REIT index, with the industrials and office segments both outperforming by several percentage points. Residential and retail both underperformed the MSCI U.S. REIT index for the month, with retail continuing to face fundamental headwinds as more department stores announced store closures in January. International real estate, measured by the S&P Developed Property ex U.S. index, outperformed broad U.S. and global equities but trailed domestic REITs for the month.

The S&P Global Infrastructure Index roughly matched the broad U.S. equity market in January with its 8.8% return, marginally outperforming the S&P 500 while trailing domestic REITs by 3%. The sector was able to offset a modest performance headwind from lagging European and Japanese equity markets.

Commodities

The Bloomberg Commodity Index rose 5.5% in January, rebounding from a disappointing end to 2018. Crude oil again dominated the price action of other commodities. OPEC production cuts, the Venezuelan uprising, optimism over a U.S.-China trade resolution, and increased global fiscal stimulus prospects all pushed oil prices up 18.5% during the month. The latter two catalysts also drove modest gains in industrial metals.

Precious metals continued their momentum higher, buoyed by residual volatility fears, rising inflation expectations, and an improving technical picture. Natural gas prices were the main detractor, down 4.3%, largely due to expectations of warmer February weather. Agriculture prices were flat to modestly positive, including soybeans, which have been one of the central elements in China trade negotiations.



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