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Financial Markets Review – First-Quarter 2019

Diversion - Inversion - Reversion

The Federal Reserve diverted from its path of interest rate hikes, leading to lower long-term interest rates and an inverted Treasury yield curve. After its March 20 meeting, the Fed announced that it expects no rate increases in 2019, a change in policy from the two hikes it had forecast in December 2018.

The yield curve is the relationship between short-term and long-term interest rates, usually measured by comparing the yield for three-month U.S. Treasury Bills with 10-year Treasury Notes. Normally, long rates are higher than short-term rates due to the risk of loaning money for longer periods of time. The exception is an "inverted" curve, when short-term rates are higher than long-term rates. After the Fed announcement, the three-month bill and 10-year notes closed the week at yields of 2.46% and 2.44%, respectively.

An inverted yield curve has been highly predictive of recessions. It has correctly signaled all nine recessions since 1955, with only one false positive in the 1960s (the inversion was followed by an economic slowdown, but not a recession, which is defined as two consecutive quarters of negative economic growth).

It was the first time the yield curve inverted since 2007. Bonds rallied and stocks initially sold off on the Fed diversion news, posting their worst day since January. But stocks had nearly uninterrupted gains in the first quarter of 2019, reversing the late December 2018 sell-off that pushed the Standard & Poor's 500-Stock index down 19.8%, just short of a bear-market drop of 20%.

Market barometers moved ahead each month, with the best January since 1987. Through the beginning of March, the Dow Jones Industrial average had a nine-week consecutive advance, while the NASDAQ Composite index a week later ended a 10-week streak to the upside.

At quarter end, stocks rose across the board by double digits, rebounding from similar negative returns in the fourth quarter of 2018. The Dow Jones jumped 11.2%, the Standard & Poor's 500-Stock index (total return) swelled 13.7%, and the NASDAQ surged 16.5%. For the S&P 500, it was the best first quarter since 1998 and best quarter since 2009. International stocks joined in the rally, gaining low double-digits for the quarter.

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Central banks around the globe remained accommodative as concerns continued about an economic slowdown. Central bankers lowered forecasts for economic growth, employment, and inflation. With lower interest rates, bonds saw across-the-board gains. The riskiest sectors had the biggest moves as U.S. Corporate High Yield leapt 7.3% and International Emerging Markets tacked on 5.4%.

After remaining nearly flat until March, at quarter end, the yield on the 10-year U.S. Treasury note was 2.41%, down 27 basis points from the start of 2019. The three-month-bill/ten-year-note spread slid to plus one basis point from 22 at the start of the year. Notably, the yields for two and five-year notes closed the quarter at 2.27% and 2.24%, respectively, below the three-month bill rate of 2.40%.

Below are rates of return for selected market indices for the first quarter of 2019, full-year 2018, and the three, five, and 10-year compound annual returns as of December 31, 2018.

	<u>1Q:2019</u>	<u>2018</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>
<u>Equity (Stock) Indices</u>					
Domestic					
Russell 1000 - Large Cap	14.00%	-4.78%	9.09%	8.21%	13.28%
Russell Midcap	16.54%	-9.06%	7.04%	6.26%	14.03%
Russell 2000 - Small Cap	14.58%	-11.01%	7.36%	4.41%	11.97%
Real Estate (FTSE NAREIT Equity REITs)	16.33%	-4.62%	2.89%	7.90%	12.12%
Commodity (S&P Global LargeMidCap)	12.38%	-8.93%	12.43%	-1.29%	4.83%
International					
MSCI EAFE Developed Large Cap	10.13%	-13.36%	3.38%	1.00%	6.81%
MSCI EAFE Developed Small Cap	10.76%	-17.58%	4.11%	3.42%	10.88%
MSCI Emerging Markets	9.95%	-14.25%	9.65%	2.03%	8.39%
Global - MSCI All Country IMI	12.44%	-9.61%	7.06%	4.72%	10.32%
<u>Fixed-Income (Bond) Indices</u>					
Bloomberg Barclays					
Global Aggregate - Unhedged	2.20%	-1.20%	2.70%	1.08%	2.74%
Global Aggregate - Hedged	2.99%	1.76%	2.91%	3.34%	NA
U.S. Aggregate	2.94%	0.01%	2.06%	2.52%	3.48%
U.S. Treasury TIPs	3.19%	-1.26%	2.11%	1.69%	4.37%
U.S. Corporate High Yield	7.26%	-2.08%	7.23%	3.83%	10.72%
Municipal	2.90%	1.28%	2.30%	3.82%	5.16%
International Emerging Markets	5.43%	-2.46%	5.05%	4.23%	9.05%

Source: ftserussell.com, reit.com, us.spindices.com, msci.com, bloombergindices.com