AEPG WEALTH STRATEGIES

INVESTMENT COMMENTARY
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Fed Pause and Trade Optimism Boost Markets… Overbought or More to Come?

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- **U.S. stocks record strongest January returns in 30 years, as S&P 500 gains 7.9%**
- **Optimism has risen on a trade deal with China, but there is still a long way to go on the tougher issues.**
- **Low bar on Q4 corporate earnings season has helped companies with both positive and negative earnings surprises.**
- **Big beat for January payrolls as the U.S. adds 304,000 jobs in January.**

What Piqued Our Interest

What a difference a month makes. As we near the midpoint of February, the markets have behaved much like they did in the beginning of last year. Investor appetite for risk has increased and volatility has recessed, as higher returning sectors such as small cap stocks, emerging markets, and junk bonds have all resumed leadership versus their higher-quality counterparts. This V-shaped recovery really doesn't surprise us, as we believed that last quarter's selloff was overdone and due for a reversal. While we remain very skeptical about the growth of the global economy as 2019 progresses, right now we believe the market is once again in tune with the fundamentals in the U.S.

So, what's been driving this rebound in risk taking behavior? For one, ***there has been a dramatic shift in the probability of further rate hikes by the Fed as the chart below depicts.***

As recently as October 1, 2018, which was right around the last peak of the market, there was a roughly equal probability (~32%) of either one or two more rate hikes by the end of 2019. In fact, there was also the same probability of three rate hikes (~15%) as opposed to none. Fast forward to today, and the futures are currently pricing in a 91% probability that the short-term rate will remain the same throughout 2019. The market is even pricing in a slight probability that we could see a 0.25% rate cut, although as of now the odds are small. These probability changes have been largely predicated by comments from Fed Chief Powell, as he is now turned more dovish and is preaching patience in future rate hikes, a far cry from last Fall when he proclaimed that the rate was "far away from neutral".

There have been other positive headlines affecting the market as well. Optimism that the U.S. and China can reach an agreement on a trade deal has risen, after the two countries held high-level meetings in search of common ground. The Wall Street Journal reported that China has offered modest concessions including more purchases of

Probability of Where Fed Funds Rate will be by Year End 2019*

	0.25% Lower	Current Rate (2.25-2.5%)	0.25% Higher	0.50% Higher	0.75% Higher	>1.0% Higher
Probability on 10/1/2018	2.2%	15.0%	32.6%	31.1%	14.7%	3.8%
Probability on 2/4/2019	5.7%	91.2%	3.1%	0.0%	0.0%	0.0%

**Source: CME Group, as of 2/5/19*

U.S. farm and energy products and has promised to open up their capital markets for U.S. investment. However, enforcement of these issues has always been the problem, and the two sides remain far apart on stickier issues such as intellectual property theft and Chinese state subsidies. Regardless, the tone has improved somewhat as it appears both sides want to make a deal, and all eyes will be on President Trump and President Xi when they are set to meet later this month.

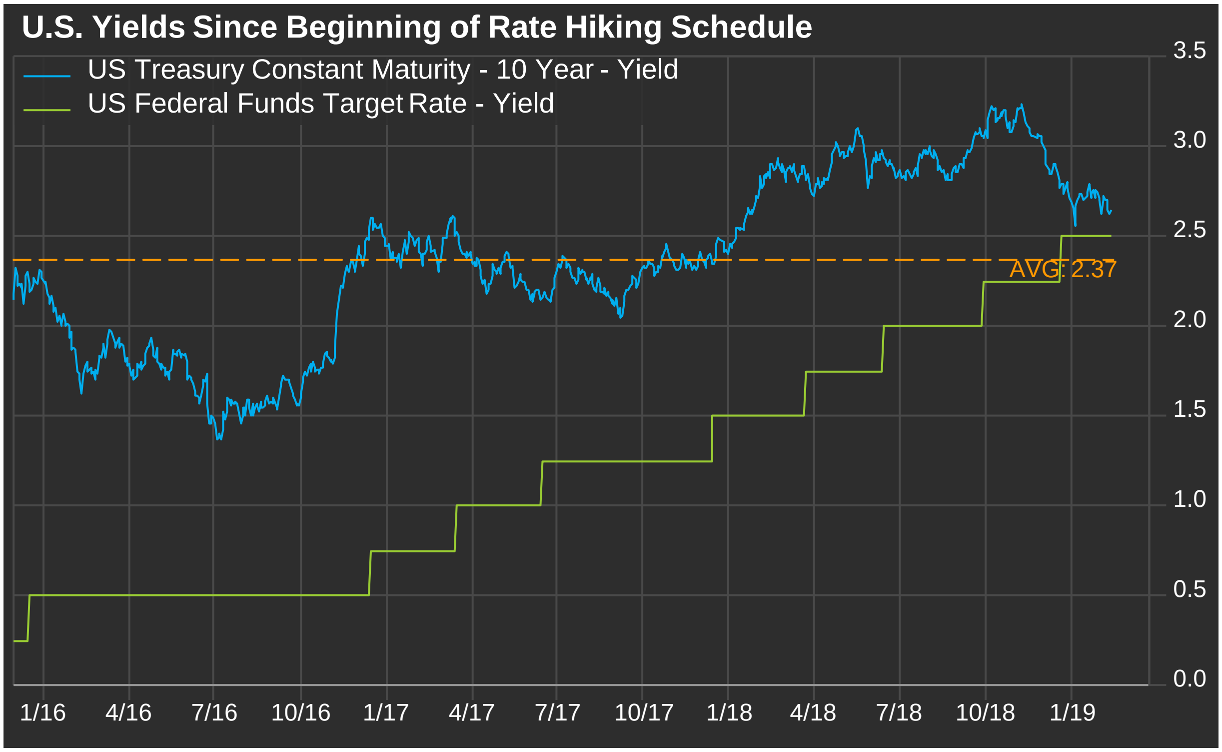
Furthermore, the U.S. created 304,000 jobs in January, which far exceeded the average analysts' expectations of about 165,000. The unemployment rate ticked up to 4%, however this was due to more people entering the workforce, as the participation rate edged higher to 63.2%, its highest level since 2013. In addition, wage growth continues to improve, as average hourly earnings rose by 3.4% which is the highest rate in nearly a decade. Meanwhile, corporate earnings season for Q4 is about half way over, and to date the results have been mixed. In aggregate, companies have reported worse than average earnings, but better than average revenues, based on 5-year numbers as reported by FactSet. In addition, analysts have lowered earnings estimates for companies in the S&P 500 by 4.1% and are now expecting a year-over-year decline in earnings in Q1 2019. Because the bar has been set so low, the market has been rewarding both companies with positive and negative earnings surprises. Companies that beat their Q4 earnings on average have climbed +2.3% (from two days before until two days after announcement) while companies that missed have also risen by +0.8%.

Market Review

Every major asset class posted gains in January which was a sharp reversal compared to the prior month. As measured by the S&P 500, stocks posted their strongest January returns since 1987 as the index climbed by almost 8% last month and is now up more than 16% from its low on December 24th. The broad large cap index is now about 7% off its high-water mark set last September, having retraced more than 61.8% of its losses, a popular Fibonacci sequence technical indicator which suggests that the previous downward trend could be broken. Amongst large cap stocks, growth stocks have performed slightly better than value stocks (8.97% vs. 7.72%), although the gap has narrowed considerably compared to recent years. Top performing sectors included economically sensitive sectors such as Industrials (+11.4%), Energy (+11.25%), and Real Estate (+10.77%). Moving down the cap scale, both mid and small cap stocks outperformed large stocks in January, posting 10.76% and 11.23% gains respectively. The small cap Russell 2000 index had fallen well into bear market territory, declining by 27% since early September, and has now made up for roughly half of those losses. Looking overseas, international stocks climbed in line with the U.S., and emerging markets performed marginally better. From a regional perspective, overall Latin America performed the best climbing 15.34% on average, compared to 6.98% for Europe and 5.11% for Asia-Pacific, according to FactSet market indices.

Index Name	1 Month	YTD	1 Year
S&P 500	7.97	7.97	-2.90
Russell 2000 (Small Cap)	11.23	11.23	-3.90
Russell 3000 (All Cap)	8.54	8.54	-2.80
MSCI AC World ex USA	7.56	7.56	-12.58
MSCI EAFE (Developed Intl)	6.57	6.57	-12.51
MSCI EM (Emerging Markets)	8.76	8.76	-14.24
Bloomberg Barclays US Aggregate Bond	1.06	1.06	2.25
Bloomberg Barclays US High Yield - Corporate	4.52	4.52	1.73
Bloomberg Barclays Municipal Bond	0.76	0.76	3.26
Bloomberg Barclays US Short Treasury	0.23	0.23	2.01
Bloomberg Commodity Index	5.45	5.45	-8.23
MSCI US REIT INDEX	11.72	11.72	9.85

Total Return Performance through January 31, 2019. Source: FactSet

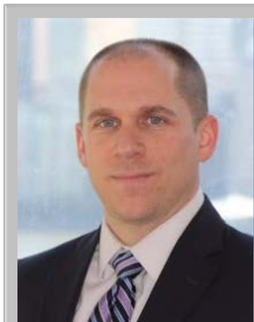


Turning towards fixed income, bond prices continue to creep higher as the 10-year yield on U.S. treasuries has fallen all the way from 3.24% to 2.65% as of mid-February. In fact, since December of 2015 when this rate hike schedule began, the 10-year yield is not far off its average yield of 2.37% and is well within one standard deviation from the mean. The U.S. Aggregate Bond Index moved higher by 1.06% in January, a continuation of the rally which began in December last year. In general, longer dated bonds performed better than shorter, and lower credit quality outperformed higher. The U.S Aggregate Investment Grade Credit Index gained 3.02% in January, and the High Yield (junk bond) index climbed by an impressive 4.52%. Needless to say, these indices are much more correlated to the equity markets and both posted negative returns in 2018.

AEPG Perspective

According to a popular technical indicator known as the Relative Strength Index (RSI), the S&P 500 in the short run may be due for a pause or a pullback. The RSI measures price momentum in up sessions versus down sessions over the past 14 days, and recently has approached "overbought" levels. This index of course is not fool-proof and can be less precise during strong trending markets such as the one we are in right now. The S&P 500 is also trading right back at its 200-day moving average, a level not reached since early December. This level could function as a sign of resistance, or if we break higher, could also create a new support floor. ***Our feeling is that the market will ultimately be driven by what happens with the ongoing China negotiations, but in the short run may continue to be driven by momentum and other technical factors.***

Investor sentiment has also dipped in recent weeks, which on one hand is negative but historically can also be considered a contrarian bullish indicator. The Bank of America February Global Fund Manager Survey highlighted that equity allocations were at their lowest mark since September 2016, and cash levels were at their highest since January 2009. We believe the higher allocation to cash (and cash proxies) may be appropriate, especially given the 2-2½ % yields one can get from money market funds and short-term treasuries. However, despite our somewhat pessimistic outlook towards the second half of 2019, we continue to believe that equities are the most attractive asset class for the time being. Notwithstanding the foregoing, our equity exposure has become more conservative with an emphasis on value, dividend payers, and lower volatility funds. It appears (for now at least) that another government shutdown is unlikely, and that should help sustain the current market rally. Unless the trade talks with China fall apart in the coming weeks, we will remain cautiously optimistic on the market for the next several months. Nevertheless, we believe that there may be problems brewing on the horizon and suggest de-risking strategies as we work our way through the year.



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