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First Quarter 2019 Review & Outlook

by Whitney Brown

INVESTMENT OUTLOOK

- Stocks surge in the first quarter.
- Advance is broad based.
- Federal Reserve actions drive selloff and rebound.
- Market advance may be leading recovery in global economy.

Stocks have shown conviction in retaking the ground abruptly lost in the final quarter of last year. Major U.S. market indexes all logged double-digit gains for the first quarter of this year. The tech-heavy NASDAQ led the way with a 16.5% gain. The small cap Russell 2000 followed with a 14.2% increase. On the international side, a big move in Chinese stocks pushed the MCSI Emerging Markets Index ahead of the developed markets MSCI EAFE Index. Commodities boomed with a recovery in crude oil prices, and even bonds rallied as longer term yields dropped on global growth worries.

The strength of the equity market rebound from the December 24th low has been remarkable, and the extent to which it has been matched by very broad participation from a wide range of equity market cap sizes, styles, and regions is rare in market history. Experienced market watchers have learned over the years to expect, after a major market decline, a process of "backing and filling" where the market goes through one or more cycles of rally and decline to retest the selloff low point. In recent weeks, the market has taken a brief pause or two on the way up but has shown no inclination to move lower on a sustained basis. Purely objective measures of the supply and demand for stocks are now very positive and imply a sustainable market uptrend for the months ahead.

Apart from other issues such as U.S.-China trade friction and waning economic growth, Federal Reserve policy was a major driver of market action throughout the October-to-March bust and bounce. More specifically, market anticipation of Fed policy along with the Fed's communication of it has had an outsized impact. The market reacted poorly in early October when Chairman Powell stated the Fed had much further to go with rate hikes before reaching a neutral level. A market already wary of slowing global growth and nervous about U.S.-China trade was alarmed by the Fed's apparent single-minded focus on "normalizing" rates and shrinking its balance sheet. Weeks of volatility followed. By early December a partial inversion of the yield curve signaled that markets were already factoring in slower long-term growth, yet the Fed went ahead with another quarter-point rate hike in mid-December, appearing unconcerned about the markets. Stocks swooned.

By early January Fed officials made an about-face and were actively touting a "patient" stance. In their meeting at the end of January, language referencing patience and low inflation were included in the policy statement. With the policy change, markets have breathed a sigh of relief that the Fed is no longer fighting inflation that doesn't exist, and instead may have accepted the reality of a permanent "new normal" economy characterized by weak inflation, slower growth, and lower interest rates.

Looking ahead to midyear and beyond, we must consider whether or not the market has already accounted for the eventual recovery in the global economy and a reacceleration of U.S. growth. Historically, stocks lead the economy by at least several months or more. If we see a significant pull back in the coming weeks, then we could expect weaker economic data before the start of a new leg up in the market. Recent U.S. data has shown some moderation in manufacturing and other areas, but little chance of recession. Europe and Japan are weak. There are hopeful signs of economic revival coming from emerging markets, and the latest manufacturing data from China was surprisingly good. Barring a failure of the U.S. and China to come to terms on trade, the market has probably made the right call.

Market Measures	1st QTR 2019	
S & P 500 (price)	13.1%	
Dow Jones Industrial Average	11.1%	
NASDAQ Composite	16.5%	
Russell 2000	14.2%	
MSCI EAFE	9.0%	
Barclays Capital Inter Gov't/Credit Bond Index		
	3/31/19	3/29/18
10-Year U.S. Treasury Bond Yield	2.41%	2.74%
Three-month U.S. Treasury Bill Yield	2.39%	1.71%

The Role of Bonds in a Balanced Portfolio by Watt Dixon

Bonds are often thought of as a boring, stodgy type of investment, especially when compared to common stocks. Stocks are always in the news while bonds seem to take a background role. With interest rates in a long-term downtrend since 1981, it is no wonder that stocks grab most of the investment headlines. While interest rates are constantly changing, the role of bonds does not. Bond prices move in the opposite direction of interest rates. This basic tenet of bond investing is important to keep in mind. However, if one is holding bonds until maturity, price fluctuation in bonds is not as relevant. Stocks generally offer superior returns over time, but bonds do a play an important role in most investors' portfolios.

Most portfolios can benefit from some bond exposure for diversification and income purposes. Bonds are debt instruments, meaning bonds pay investors a set interest rate. At times when the stock market is going down, bonds are still making interest payments. While stocks may be losing value during a bear market, steady interest payments from the bond portion of your portfolio will help mitigate your losses. From a diversification perspective, different asset types do not move in the same direction at the same time. Over the past 10 years the S&P 500 stock index and the Barclays Aggregate U.S. Bond Index have not moved in lockstep. In fact, their correlation has been close to zero. Also, as interest rates trend upwards, stocks will sometimes suffer. This is because rising rates make bonds more attractive to investors and also make borrowing money more expensive, making it more costly for companies to invest in growth opportunities.

Preservation of principal is another attribute many investors seek in bonds. Short-term Treasury Bonds offer excellent stability in most economic conditions. U.S. Treasury Bonds, such as T-Bills, have low levels of interest rate risk and credit risk. Corporate bonds do offer higher yields but are more subject to price fluctuations due to moves in interest rates. There is also more credit risk in corporate bonds. Inflationary concerns have not grabbed much attention lately; however, inflation can eat away at many types of investments. Treasury Inflation Protected Securities (TIPS) pay a fixed rate like regular treasuries, but also the principal value is adjusted to the rate of inflation. If we see inflation beginning to heat up, these types of bonds could help offset inflationary pressures.

Investing in bonds helps smooth out the ups and downs of stocks while providing a steady stream of "fixed income." At DHFB, we favor holding bonds until maturity. Attempting to trade bonds on interest rate moves is a very tough and often times painful bond strategy. Buying good quality issues with intermediate term maturities (2-7 years), has proven to be an effective bond strategy.

The Value of an Investment Advisor by Jim Hall

In a previous *Investment Outlook* we reviewed the advantages and value of working with a Registered Investment Advisor (RIA). Since inception, our firm has maintained the RIA designation and as such, we have a duty at all times to place our clients' interests above our own. No decision is ever made from the standpoint of "What's in it for me?"

Going hand-in-hand with the RIA designation but sometimes over-looked and perhaps under-utilized is the broader role of being your financial advisor. By meeting to discuss financial goals, needs, risk tolerances, and investment timeframes, we can craft a personal investment strategy to help you achieve your objectives. We consider potential tax considerations and implications as we contemplate investment buying or selling decisions.

Further, we can provide a calming influence when market euphoria or gloom becomes the central focus of investment commentators. During December's sharp sell-off, after listening to the various business analysts and commentators discuss how much the market was dropping, it was easy to believe a "crash" was imminent. We fielded many calls asking our opinion of the future direction and our opinion of converting completely to cash. That sort of decision must be carefully weighed as many clients have enjoyed very significant growth over the previous years and an emotional decision to "sell everything" could trigger some very sizable taxable gains. As we've seen during this recently-ended first quarter, the market rebounded just as sharply and is now nearing new highs again.

Legacy planning is another area that is often ignored or deferred until a later date. Although the topic can be uncomfortable to contemplate, failing to consider and plan can carry some very significant consequences and sometimes lead to the payment of unnecessary taxes. As financial advisors, we are in a position to help consider the documents needed to achieve client wishes and facilitate introductions to estate-planning attorneys to draft new documents or review older documents.

A key to our process involves periodic meetings. We use them to make sure the original goals and objectives are still in place and to update any new information. If it has been a while since your last review, we would welcome an opportunity to meet again.

Tax Cuts & Jobs Act—Impact on the Municipal Bond Market **by Stebbins Hubard**

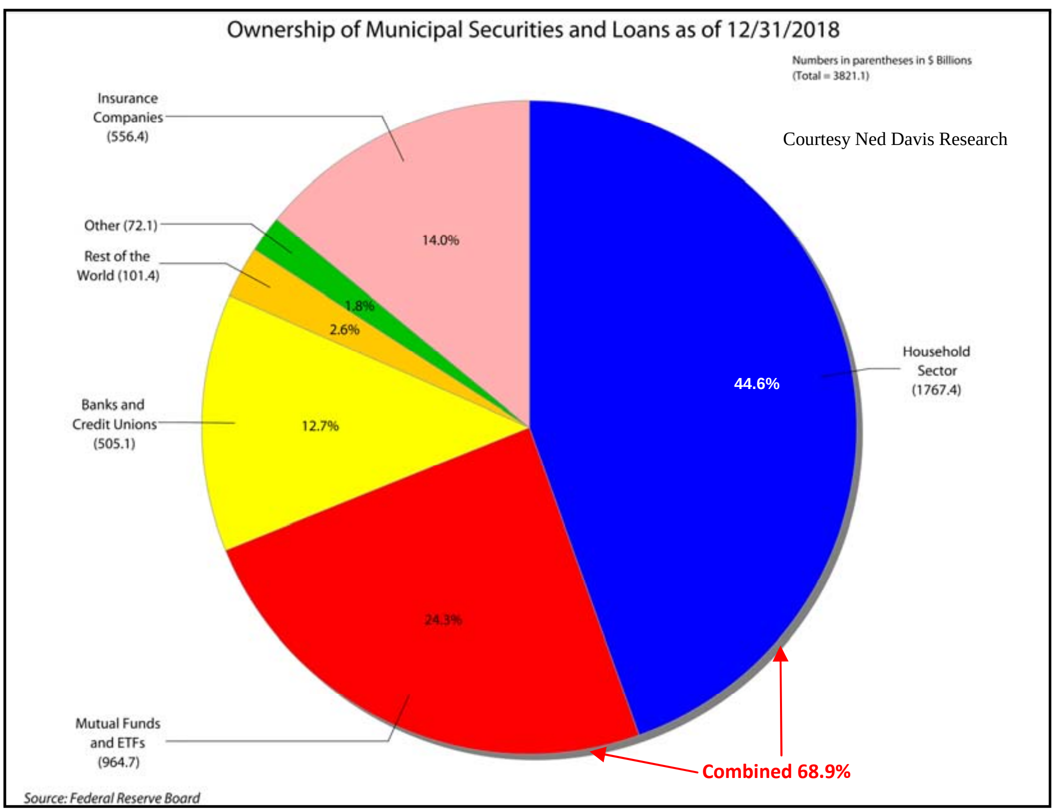
Municipal bonds pay interest income that is exempt from federal income taxes as well as state and local income taxes (if the bond is issued in your home state). With the passage of the Tax Cuts & Jobs Act (the Act) in December 2017, many worried it would negatively affect the market for tax-free municipal bonds. The top individual rate was reduced from 39.6% to 37% (plus the 3.8% Medicare surtax). This modest decrease was not enough to affect the attractiveness of tax-free versus taxable income for individuals. Also, the Act capped or took away many tax exemptions.

Because there are now fewer tax-exempt investment alternatives, demand for municipal bonds for individuals actually has increased. Some of the deductions that have changed include the cap on state and local tax (SALT) exemptions, the increased standard deduction reducing the benefits of charitable deductions for some, and the reduced cap for mortgages qualifying for full exemptions. The cap on SALT deductions has supported the municipal bond market, especially for investors in higher-tax states. Individuals hold approximately 69% (see chart) of the $3.8 trillion municipal bond market through direct (Household) and indirect (ETFs and Mutual Funds) ownership.

The Act reduced the top corporate tax rate from 35% to 21%. This has made lower interest rate municipal bonds less attractive for corporate investors relative to other taxable investments. Historically, banks and insurance companies have bought a lot of municipal bonds, making up 27% (down from 29% at the end of 2017) of the market. Since the passage of the Act, bank and insurance company municipal bond holdings have fallen every quarter.

The biggest effect that the Act had on the municipal bond supply in 2018 was through the elimination of Advanced-Refunding bonds (a valuable cost-saving tool for municipalities), allowing governments to refinance debt earlier, thus letting them take advantage of lower interest rates years sooner. Losing this benefit has cut refinancing activity by an estimated 20%. Overall, estimated total municipal bond issuance was around $338 billion in 2018 - down about $100 billion from 2017, the first decline in 4 years.

Overall, the Act contains pluses and minuses, but the end result is not too dramatic for the municipal bond market long term. Individual demand has stayed strong since the tax exemption remains and should become stronger because there will be fewer alternative ways to receive tax deductions. Corporate demand has declined, but the amount of the reduction is still uncertain. Supply was lower during 2018 due to the elimination of advanced-refunding bonds and heavy supply during the final months of 2017. Eventually, supply should return to its normal levels as outstanding bonds mature or reach their call dates, but that will be over the long term. The relative value of the municipal bond market remains strong.



Impact of the Tax Cuts and Jobs Act on Virginia Taxpayers by Ted Feinour

The Tax Cuts and Jobs Act which was signed into law on December 22, 2017 impacted Virginia's tax system significantly. The new law increased the federal standard deduction to almost twice its current value and eliminated or scaled back several itemized deductions. At the federal level, this resulted in causing more taxpayers to choose the standard deduction instead of itemizing.

The new law increased the standard deduction for federal returns to $12,000 for single filers and $24,000 for joint filers. Virginia allows a standard deduction of $3,000 for single filers and $6,000 for joint filers. The Virginia legislature first established the standard deduction in 1989 but did not index it for inflation. Virginia's standard deduction was therefore approximately half the value of the federal deduction but now is only one-fourth of the value. Virginia law requires a taxpayer claiming the standard deduction on his federal return to also claim the state standard deduction. Federal tax consequences usually determine a person's choice to itemize or claim the standard deduction, so by encouraging federal taxpayers to claim the standard deduction, the new tax act will cause more state taxpayers to do the same.

The fact that the state standard deduction is disproportionately smaller than the federal standard deduction will have two main effects until the Virginia legislature changes the tax laws. The first is that the state tax burden for taxpayers who previously itemized will now increase since they claim the smaller Virginia state standard deduction. Second, this will result in state revenues increasing. This means that a large number of Virginia residents will likely be surprised to see their state refunds reduced.