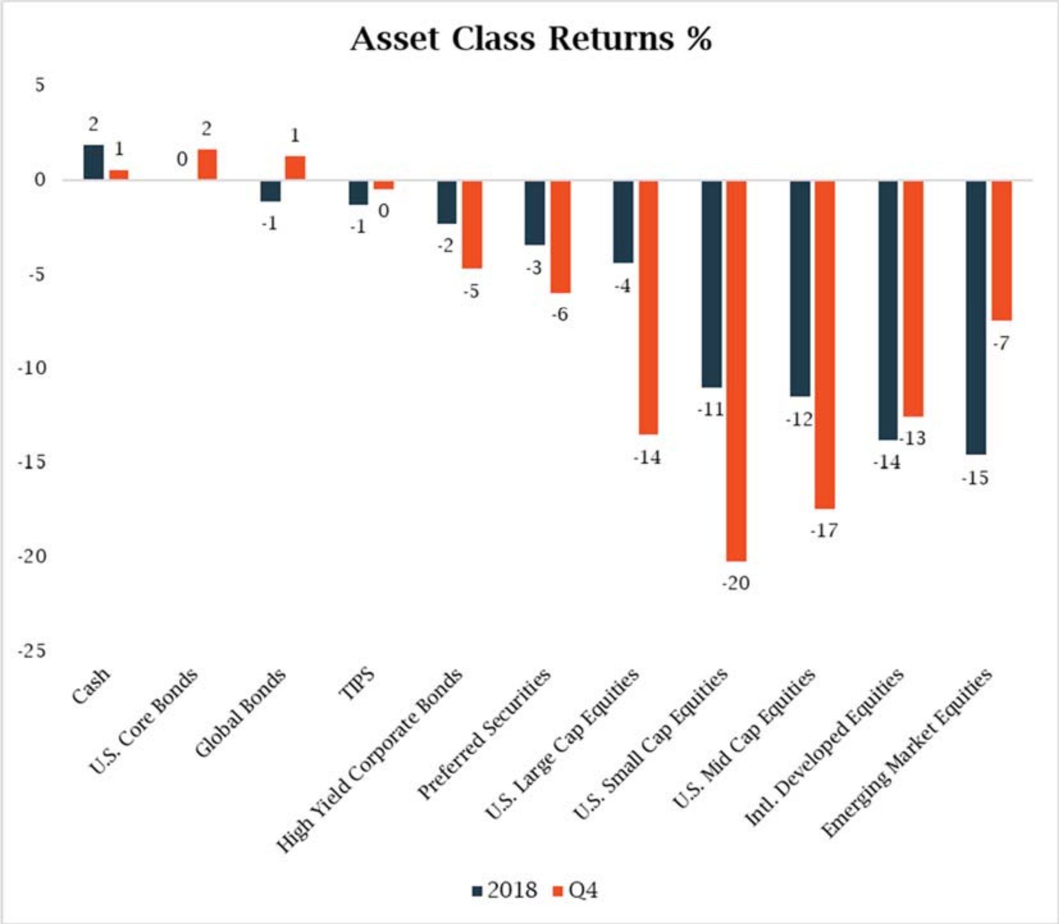
heritage
WEALTH ADVISORS

First Quarter 2019

Market Outlook & Portfolio Insights

First Quarter 2019 Market Outlook

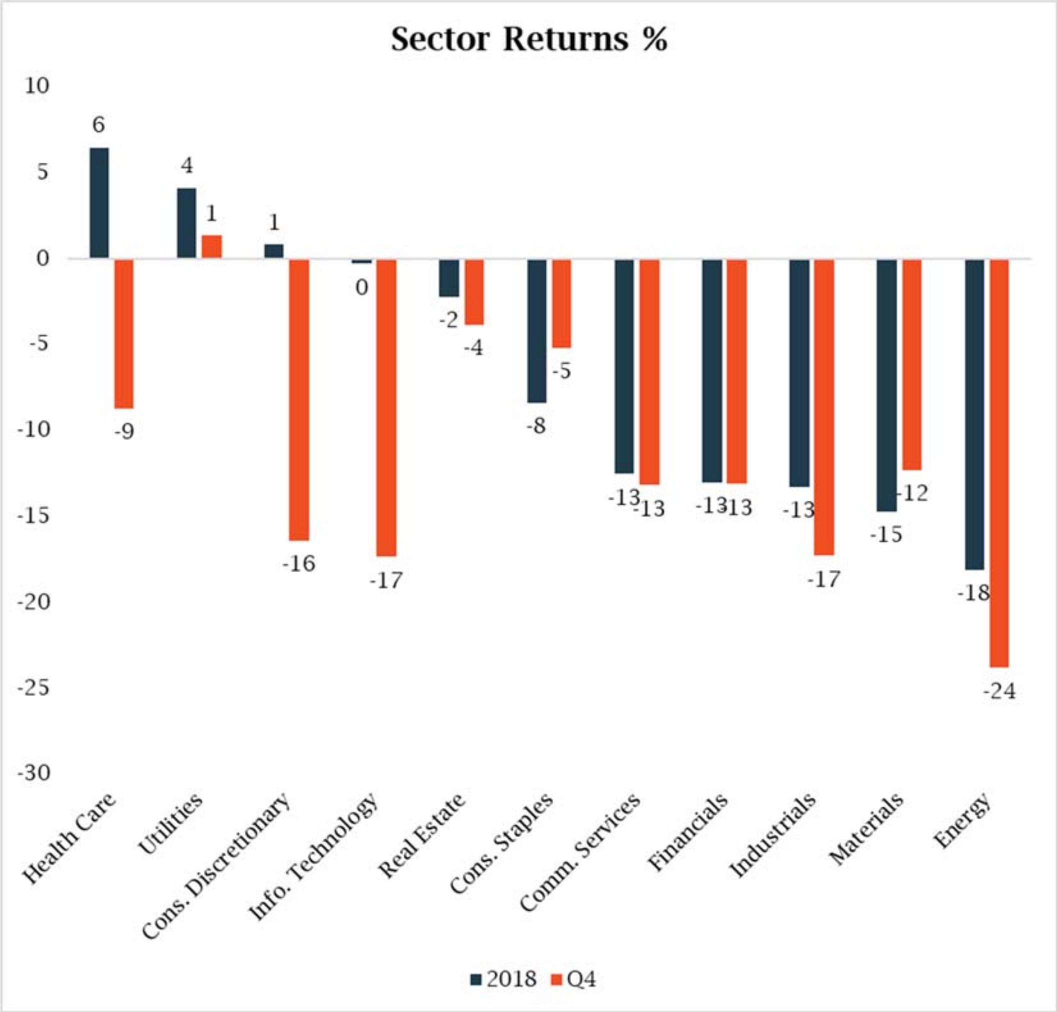
Both stocks and bonds generated poor returns in 2018, leaving investors with few places to hide.



Source: Morningstar

First Quarter 2019 Market Outlook

The breadth and severity of the equity sell-off during the fourth quarter resulted in negative returns across most sectors.



Source: Morningstar

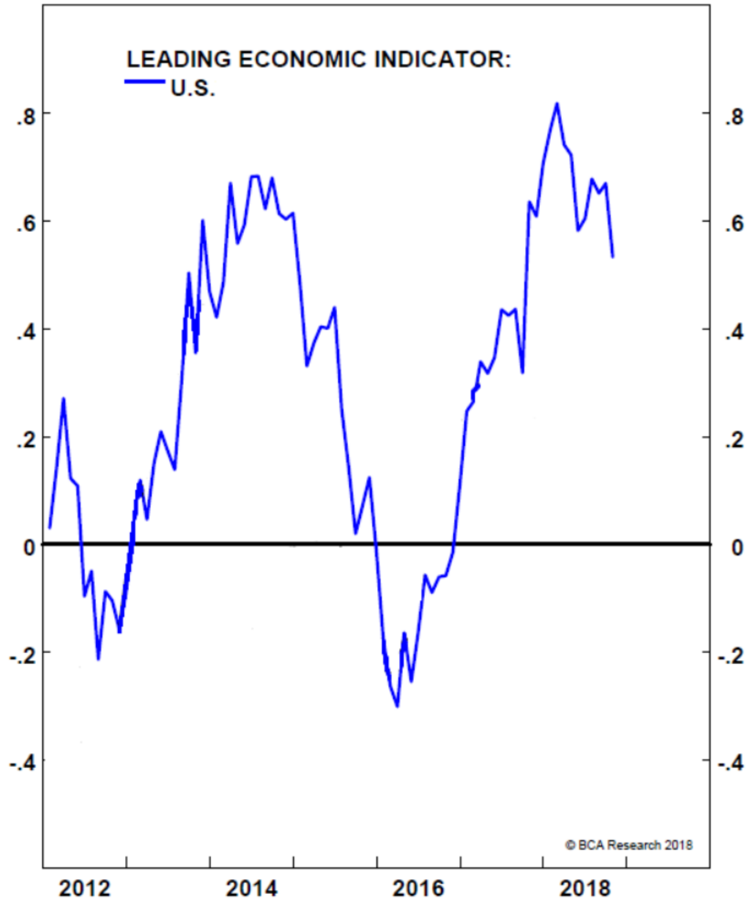
First Quarter 2019 Market Outlook

Catalysts for the Pullback:

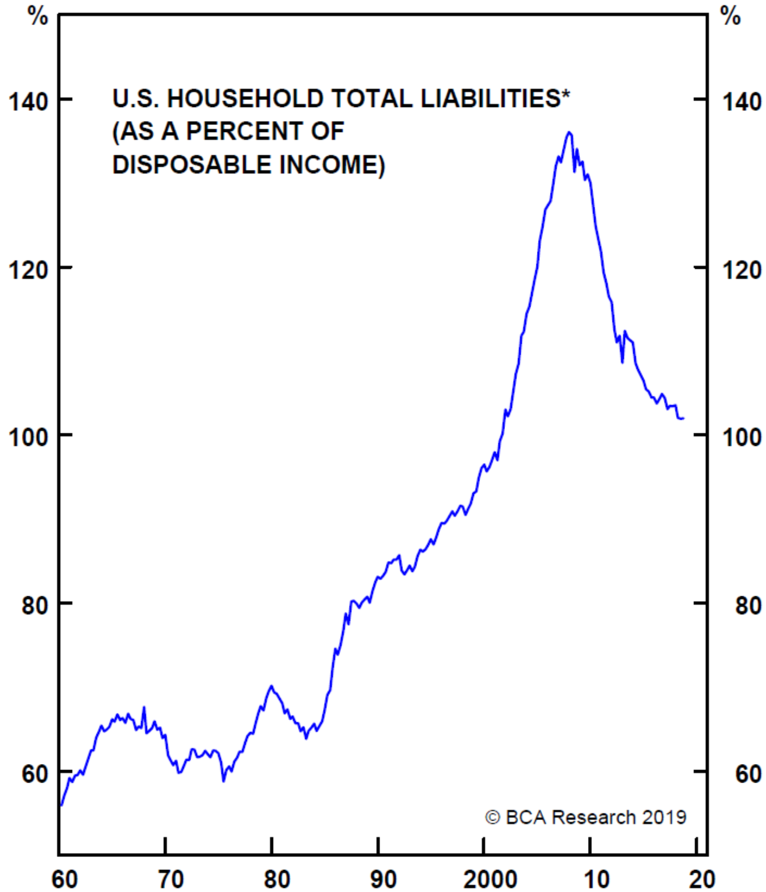
- Slowing economic growth
- Weaker corporate earnings guidance
- Continued normalization of monetary policy by the Federal Reserve
- Political uncertainty
- Trade uncertainty

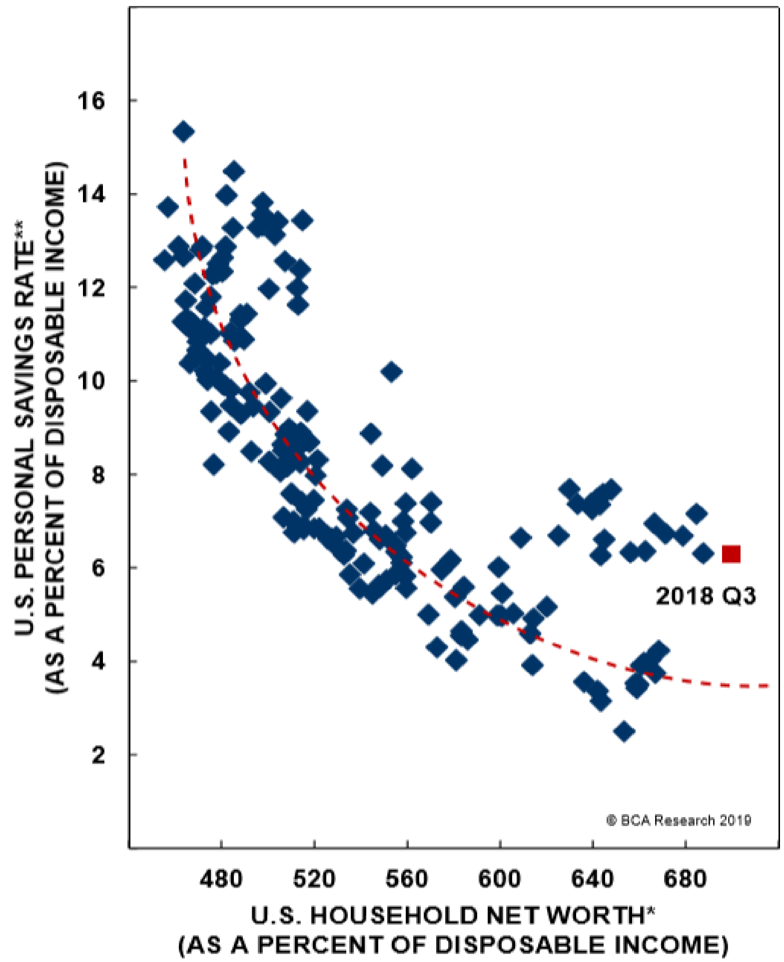
First Quarter 2019 Market Outlook

While the U.S. economy is decelerating from above-average levels of growth, underlying economic data continues to suggest positive growth.



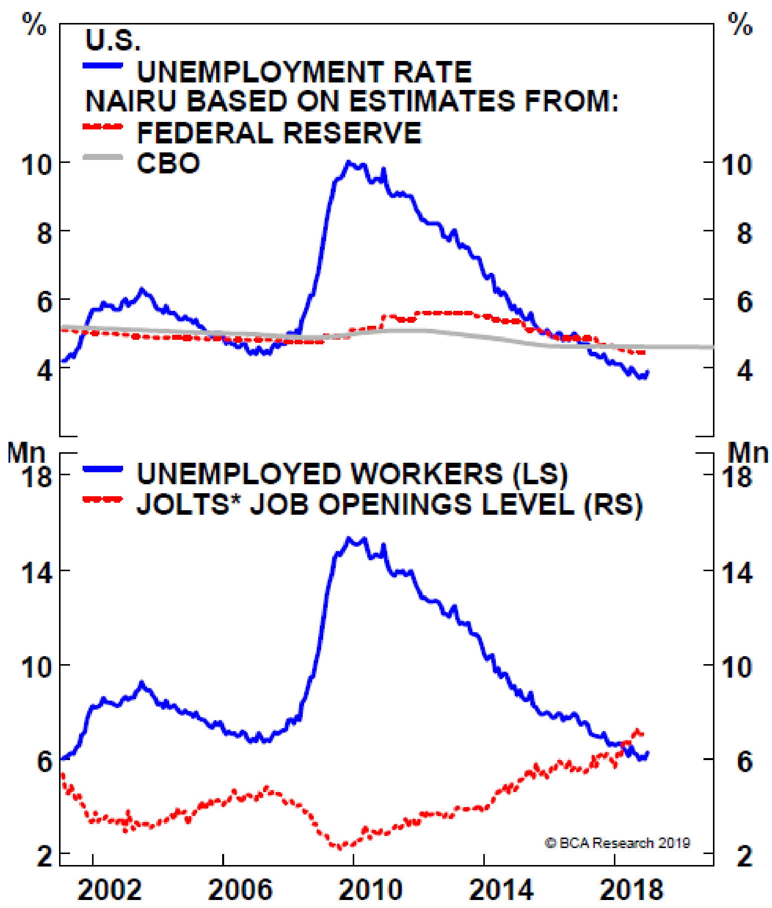
With respect to the consumer, leverage has declined meaningfully and an elevated savings rate has room to fall.

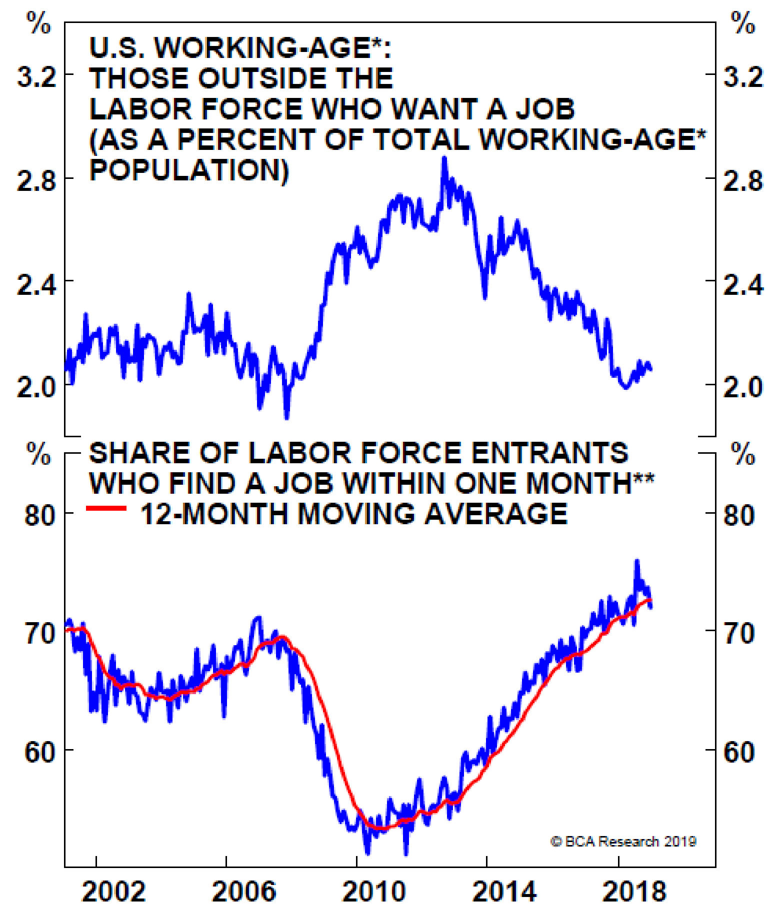




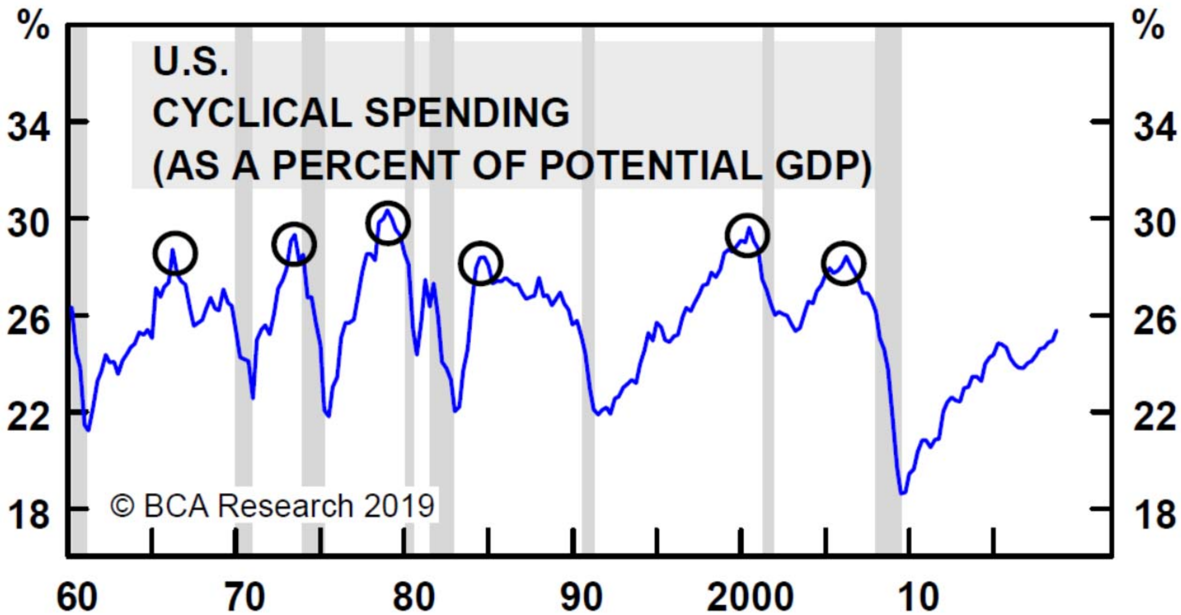
First Quarter 2019 Market Outlook

Employment trends remain healthy.





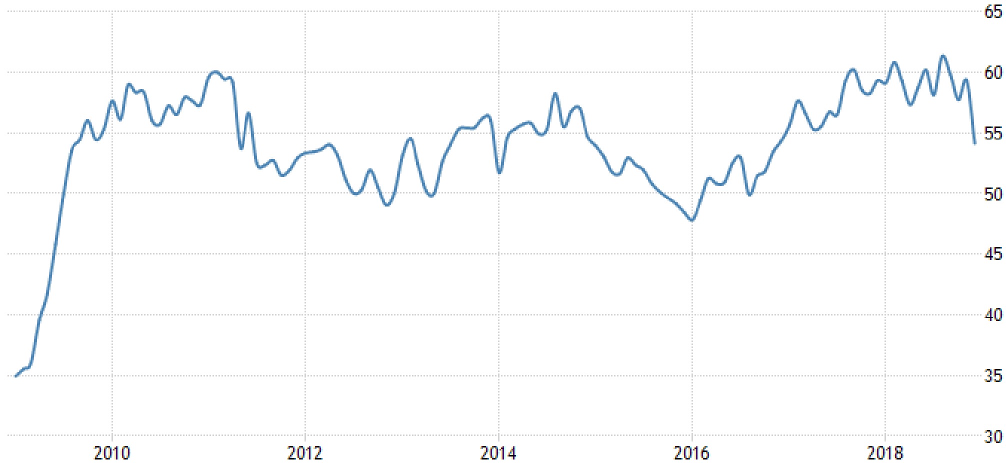
Cyclical spending resides at below-peak levels.



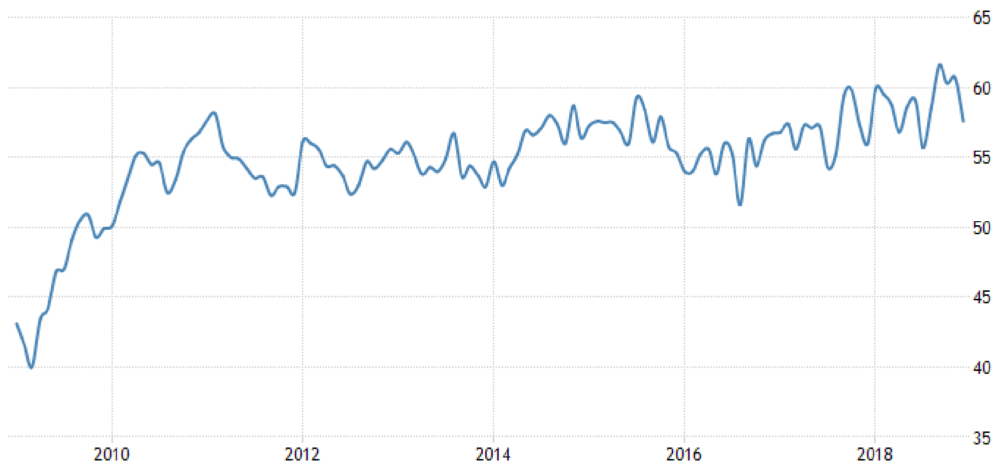
First Quarter 2019 Market Outlook

Although U.S. Manufacturing and Non-Manufacturing Indices have declined recently, they are coming off elevated levels and remain above 50, signifying continued expansion, albeit at a more moderate pace.

U.S. Manufacturing PMI

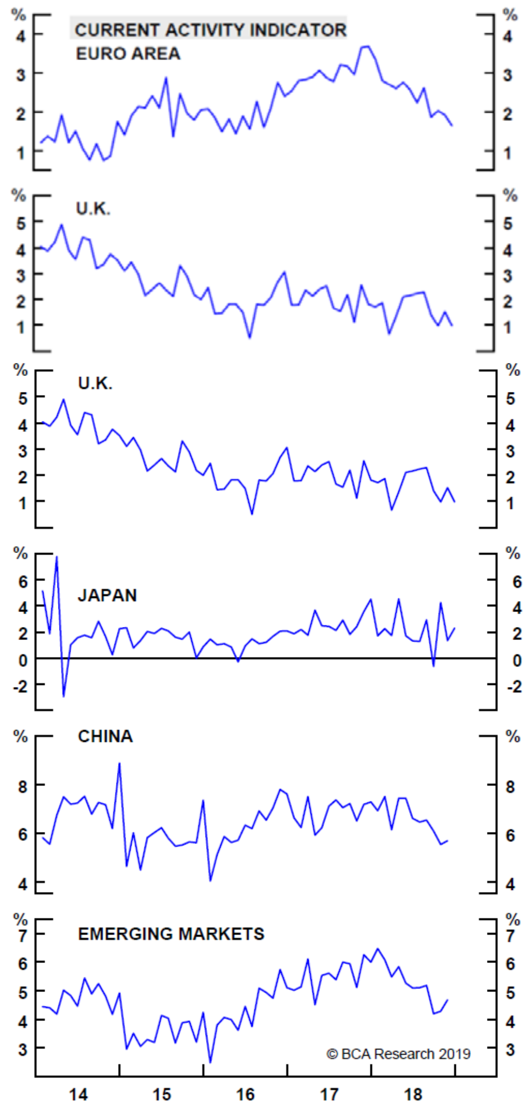


U.S. Non-Manufacturing PMI



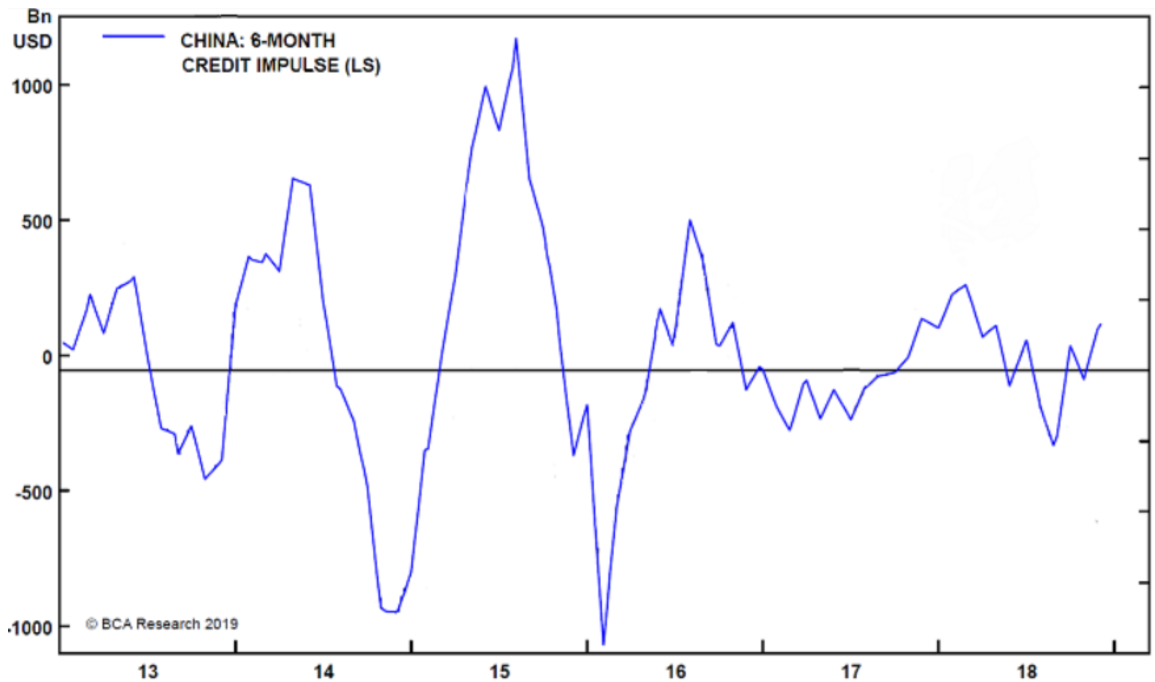
Source: Trading Economics

Overseas, economic activity is slowing.



First Quarter 2019 Market Outlook

While muted in comparison to past stimulus measures, China has taken multiple steps to jolt its economy and has driven a positive inflection point in credit impulse. A pickup in Chinese growth would be supportive for emerging markets and international developed markets alike.



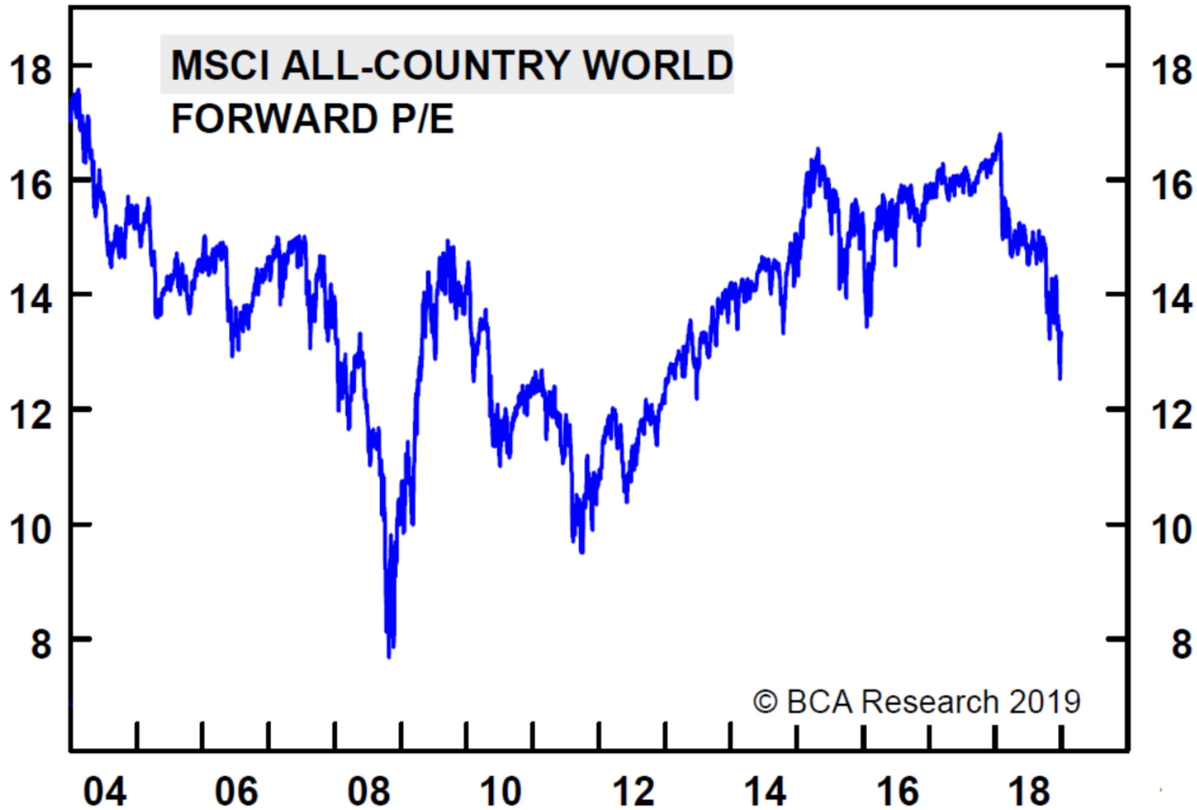
First Quarter 2019 Market Outlook

Negative investment sentiment reached extreme levels during the fourth quarter.

Source: CNN Business

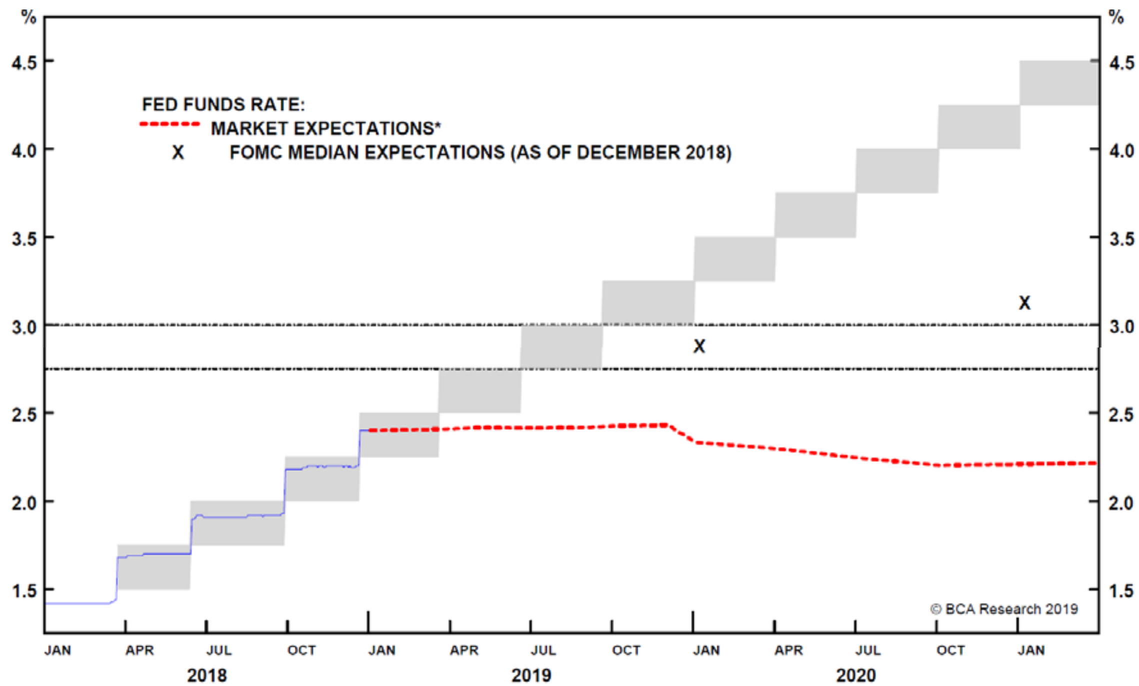
First Quarter 2019 Market Outlook

The magnitude and breadth of the equity sell-off resulted in a meaningful compression in valuations across the globe. At these levels, markets appear to be discounting a deeper slowdown than is suggested by underlying economic data.



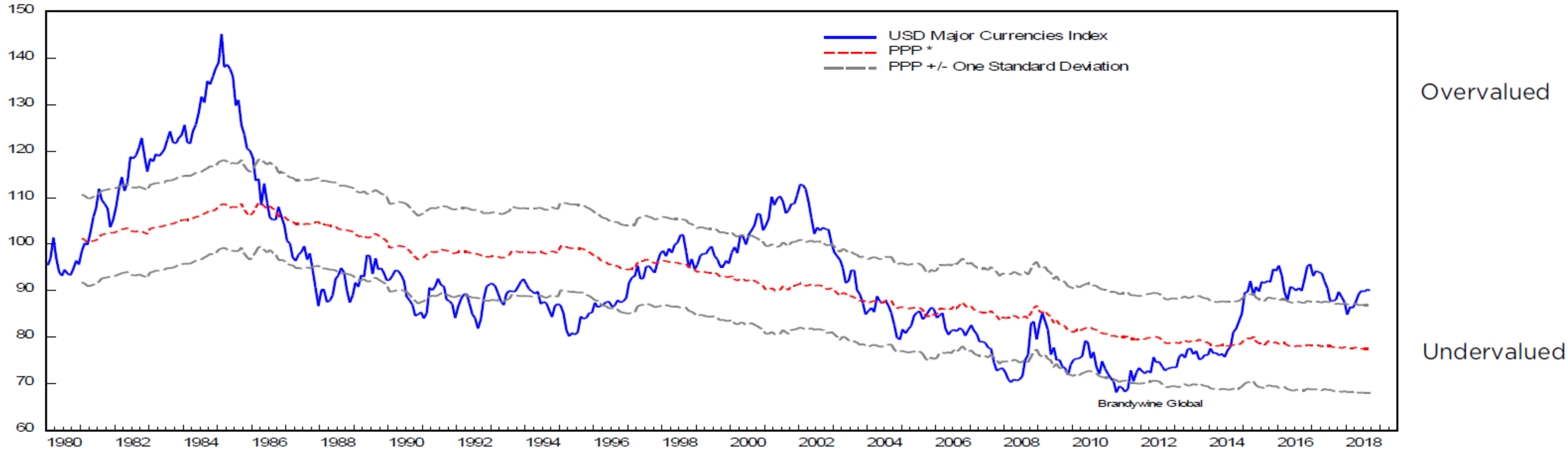
First Quarter 2019 Market Outlook

A further slowing of economic growth coupled with benign inflation would likely lead a data dependent Fed to pause on further rate hikes. Markets appear to be pricing in a Fed rate cut in the second half of 2019.



First Quarter 2019 Market Outlook

The convergence of growth rates between the U.S. and international economies coupled with U.S. Dollar Purchasing Power Parity at extended levels should push the U.S. Dollar lower. A weakening Dollar would be a net positive for emerging markets.



*Based on GDP Weighted PPI of 6 Countries: Euroland, Japan, UK, Canada, Switzerland, Sweden

Heritage: Recent Tactical Shifts

June 2018: Increased exposure to U.S. equities relative to international equities. Specifically, sold out of international small cap and emerging market equities and reduced exposure to global equities. Deployed proceeds into U.S. large and mid cap equities along with a regional bank ETF.
Rationale: The U.S. economy is growing faster than many other regions of the world, which should result in the outperformance of domestic equities relative to international equities in the coming quarters. We believe that regional banks stand to benefit meaningfully from a stronger U.S. economy, rising interest rates, and deregulation -- all themes that should remain pervasive.

August 2018: Invested in bank loans and reduced exposure to global bonds.
Rationale: Bank loans should drive incremental income in a rising rate environment and reduce the duration (i.e. interest rate sensitivity) of client portfolios. Our favored global bond strategy, BrandywineGLOBAL's Global Opportunities Bond Fund, seeks to maximize total return through strategic investments in countries, currencies, and sectors. With meaningful allocations to non-U.S. developed and emerging markets, the Fund is positioned to take advantage of global growth. It benefited from synchronized global expansion last year, returning 12.7%. However, we believe that relative economic strength is shifting towards the U.S. Therefore, a smaller position in global bonds seems prudent.

September 2018: Shifted index position in domestic large-cap stocks from the iShares Core S&P 500 ETF (ticker: IVV) which tracks the market capitalization-weighted S&P 500 Index to the Invesco S&P 500 Equal Weight ETF (ticker: RSP) which tracks the equal-weight S&P 500 Index.
Rationale: Over the course of the last five years, we have increasingly utilized a combination of the S&P 500 Index fund coupled with the Heritage Concentrated Leaders portfolio (our internally-managed U.S. large-cap stock portfolio) to gain broad exposure to U.S. large-cap stocks. While we remain constructive on U.S. equity markets, we are becoming increasingly troubled by the concentration of market capitalization and performance in a narrow group of sectors and individual stocks.

December 2018: Sold out of bank loans and reduced exposure to U.S. energy master limited partnerships ("MLPs"), deploying the proceeds in U.S. equities and raising cash. Additionally, removed currency hedge on international equity exposure. Holding excess cash with the expectation of ultimately investing in emerging market equities.
Rationale: The combination of stable economic underpinnings, a data dependent Federal Reserve, attractive valuation levels, and oversold market technical indicators continue to argue for maintaining long term exposure to equities. The decline in equities coupled with relatively tight credit spreads suggest that risk is likely to be better rewarded in stocks than lower quality credit investments. While our outlook on MLPs remains constructive, the ability to shift into higher quality businesses at comparable valuations is compelling. We expect a modestly weaker U.S dollar over the intermediate term.

Heritage: Summary Market Views

Monetary Policy — **Less Accommodating**

The Federal Reserve raised interest rates four times in 2018 and reduced the size of its balance sheet. The economy has been slowing but remains on solid footing, and recent inflation readings have been benign. The Fed has signaled two more hikes in 2019 but with short-term rates reaching the lower end of the neutral rate, it has also indicated willingness to be patient and flexible in its policy decisions. A critical question is whether the Fed will be able to “normalize” rates without inducing a recession.

Fiscal Policy — **Accommodating**

The lower corporate tax rate and deregulation boosted corporate earnings in 2018. The impact of fiscal policy on the economy will likely be smaller in 2019 but should remain positive. It is still unclear whether the incremental fiscal stimulus will boost long term economic growth.

Economic Fundamentals — **Neutral**

Expectations for annualized U.S. real GDP growth in 4Q18 currently reside at 2.6%, down from 3.5% registered in 3Q18 but above the average pace of 2% during this recovery. While economic growth has slowed, a recession does not appear to be an immediate risk. The picture is less favorable in internationals markets. Weaker activity in China has been a headwind to global growth, particularly in other emerging markets, developed Europe, and Japan which relative to the U.S. rely more heavily on the world’s second-largest economy for demand. Tariffs and a stronger U.S. dollar have also weighed on global growth.

Market Sentiment — **Negative**

Weaker corporate earnings guidance, interest rate policy uncertainty, political uncertainty, and trade wars have been driving increased market volatility. The CNN Fear and Greed index, the CBOE equity put/call ratio, investor sentiment, and technical indicators have reached extreme levels. Some high quality, global franchise businesses are down 30% – 40% from recent highs, creating potential buying opportunities.

U.S. Equities — **Positive**

The S&P 500 is trading at 14.3x forward earnings, below the long-term average multiple. The Russell 2000 is trading at 17.7x forward earnings, also below the historic average. Earnings growth forecasts have been revised lower but are nonetheless healthy in the mid single-digit range. Current valuation levels appear to be discounting more than the recent reset in growth expectations. Within the U.S., we favor large cap over small cap and value over growth.

International Equities — **Neutral**

The MSCI EAFE is trading at 11.9x, below the long-term average, given the slowdown in underlying economic and earnings growth. EM stocks are trading at 10.6x, also below the historic average. Within international markets, we favor developed markets over emerging markets. However, with valuation multiples contracting, EM stocks are becoming increasingly attractive.

Bond Yields & Credit — **Negative**

The yield on the 10-year U.S. Treasury Note breached 3.2%, a seven-year high, before falling back to 2.7% by year end amid heightened market volatility. With the yield curve flat, value lies at the short end of the curve. Global bonds serve as an expanded opportunity set to add income through country and credit selection. High yield spreads have been rising but remain meaningfully below historic average and do not appear to be appropriately compensating investors for risk.

Commodities — **Neutral**

Slower global economic growth combined with the Trump Administration’s more laxed position on Iran oil-export sanctions transformed the threat of price spike into a price rout. OPEC’s recent production cuts should stabilize the markets short-term. Global economic growth and supply side discipline should remain the drivers to prices long term.

U.S. Dollar — **Neutral**

The U.S. dollar appears to be extended. The divergence in growth rates across the world has narrowed, suggesting future dollar weakness. However, in the event of a recession, expect continued dollar strength as investors rotate into safe-haven assets.

Disclosure

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Definitions:

U.S. Large Cap Equities: U.S. Large Cap Equities are represented by the S&P 500 Index.

U.S. Mid Cap Equities: U.S. Mid Cap Equities are represented by the S&P Midcap 400 Index.

U.S. Small Cap Equities: U.S. Small Cap Equities are represented by the Russell 2000 Index.

International Developed Equities: International Developed Equities are represented by the MSCI EAFE Index.

Emerging Market Equities: Emerging Market Equities are represented by the MSCI EM Index.

U.S. Core Bonds: U.S. Core Bonds are represented by the BBgBarc U.S. Agg Bond Index.

TIPS: TIPS are represented by the BBgBarc U.S. Treasury U.S. TIPS TR USF Index.

Global Bonds: Global Bonds are represented by the ICE BofAML Gbl Brd Mkt TR USD Index

High Yield Corporate Bonds: High Yield Corporate Bonds are represented by the ICE BofAML U.S. HY Constrained Index.

Preferred Securities: Preferred Securities are represented by the ICE BofAML Adjustable Rate Pref TR USD Index.