ECONOMIC REVIEW

Steve Scranton, CFA
Chief Investment Officer & Economist

Although initial estimates of 1^{st} quarter GDP will not be released by the Bureau of Economic Analysis (BEA) until after we go to press, it is clear that the US economy decelerated further from the slower growth in the 4^{th} quarter. **The deceleration is not necessarily a true reflection of the health of the economy due to two one-time factors that hit in the 1st quarter:**

Government Shutdown

- By the administration's own estimate, GDP growth was reduced by approximately .50% due to the government shutdown. The ripple effect may well have caused a further reduction as both consumer and business sentiment fell during the shutdown. The psychological impact of volatile financial markets in the 4^{th} quarter combined with the government shutdown led both businesses and individuals to become more cautious in their spending.

Weather

- With flooding in the middle of the country and heavy snow in other parts of the country, spending was hurt. When you are focused on surviving the weather, you are not too focused on discretionary spending. The other side of that situation is that once the weather damage recedes, the recovery process starts. This leads to increased spending as people repair or replace the damage done from the weather.

There were also several other factors that slowed economic growth and will continue past the 1^{st} quarter:

Tariffs

- The ongoing trade tension between the US and China continues to hurt economic growth. Evidence is growing that the tariffs are hurting not only China but also US exporters and US companies that import all or part of their raw materials to make their products. The encouraging news is that the US and China are in active discussions to resolve their trade dispute.

Dollar Strength

- The dollar increased in value by approximately 7% versus major developed country currencies. As I have discussed in previous newsletters, a stronger dollar acts as a "market tariff" since US exporters face the challenge that their goods are now more expensive versus their foreign competitors, while US firms competing against foreign imports are challenged due to the cheaper cost of the imports. Unless US companies are willing to reduce their profitability, sales and production will decline as sales are lost to foreign competitors.

Interest Rates

- The cumulative impact of the Federal Reserve raising interest rates by 2.5% creates a drag for individuals and consumers. Every dollar needed to make interest payments means fewer dollars available for spending. One of the realities of the low interest rate environment of the last 10 years is that both individuals and businesses funded some of their spending by borrowing.

Now that the weak 1^{st} quarter is behind us, all eyes will focus on whether a rebound will occur in the 2^{nd} quarter.

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ALTERNATIVE STRATEGIES

Rick Cloutier, CFA
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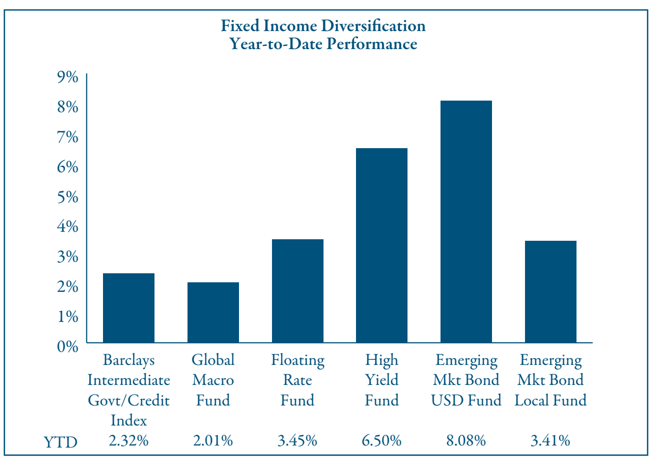
After the market's decline in the 4th quarter, the Fed ended the year with a more dovish tone and so far this year has continued with this lenient policy towards interest rates. This moderation, along with growing optimism on trade negotiations with China, **has led to the best quarter for stocks since the 3rd quarter of 2009,** repaying investors their 4th quarter losses. For the quarter, the S&P 500 soared 13.6%. Small cap stocks fared even better with the Russell 2000 jumping 14.6%. International stocks, while not climbing as high as the US markets, moved smartly higher as well. Developed markets rose 10.0% and emerging market stocks gained 9.9%.

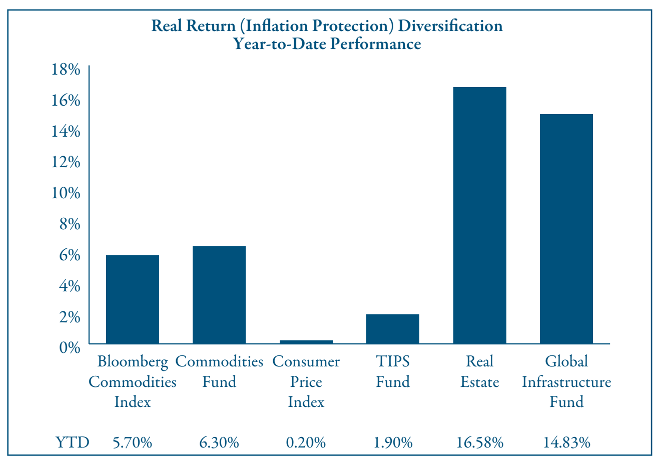
As a result of the Fed's more dovish stance on rates and slowing global growth, fixed income investments also performed well. The 10 year Treasury bond began the quarter yielding 2.68%, but by quarter's end was yielding 2.41%. Overall, bonds in aggregate were up just under 3%, municipals gained a little over 3% and high yield bonds returned 7.3%.

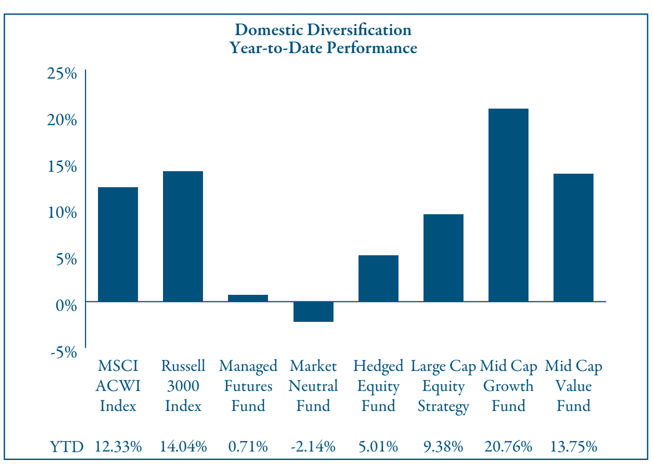
Real return alternative strategies had an equally impressive quarter. Real estate rose 17.2% and commodities, led by a big jump in oil prices, gained 6.3%. During the quarter, because of tight supplies and less pessimism on global growth, oil climbed 33% to close with West Texas Crude priced at $60.17/barrel.

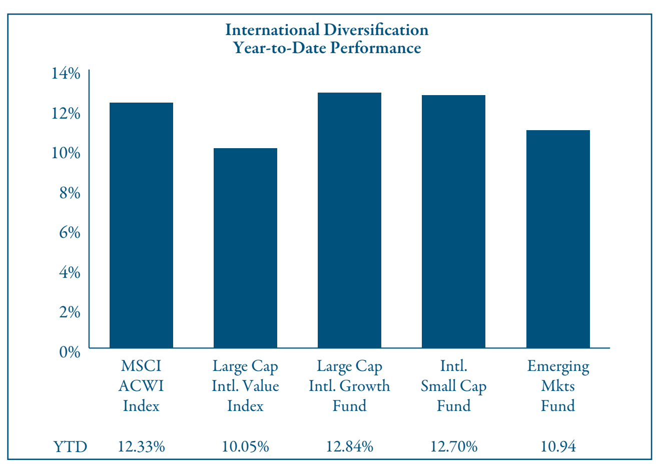
While our absolute return, or risk management, strategies provided downside protection during the 4th quarter's sell-off, they trailed equity returns this quarter due to the market's run-up and provided returns that were similar to the returns of short-term bonds.

With corporate growth slowing from last year's torrential pace, stocks have become more expensive. **The market's growth has been fueled by optimism over the potential of a trade deal with China.** As we have discussed in the past, there are many obstacles inhibiting the two sides from finding a solution to all the differences; however, there are incentives for both President Trump and China to resolve some of the issues and come to an agreement. **Although we believe the US economy will continue to expand in 2019, we are cautious about the current exuberance.**









DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

Like we said in our last commentary, what a difference one quarter can make! After the steep late 2018 sell-off, the 1^{st} quarter brought a spectacular rebound. A rally lifted the major indices (Dow Jones Industrial Average +11.8%, S&P 500 +13.6%, Nasdaq Composite +16.8%, and Russell 2000 +14.6%). The gains were broad based. All eleven sectors rose, with leadership powered by technology, +19.9%; real estate, +17.5%; and industrials, +17.2%. The lagging sectors were healthcare, +6.6% and financials, +8.6%. The 1^{st} quarter recuperation essentially got the market back to October levels — and helped prolong the bull market, which marked its 10^{th} anniversary on March 9^{th}.

The Federal Reserve (Fed) kicked off the rally when it shifted to a dovish tone about interest rate increases and the balance sheet wind-down. It acknowledged a weakening global economy (and potential effects to the US economy) and adopted a patient approach to future monetary policy actions. **The "pause" in rate increases reassured investors who had worried the Fed might raise rates too far and too fast in a slowing economic landscape.** Rising hopefulness for a trade deal between the US and China further buoyed sentiment during the quarter.

This led the market to reconsider whether it had overshot the sharp downward re-pricing of risk in the late 2018 sell-off. A "risk on" tone to behavior took hold, and by the end of the 1^{st} quarter the S&P 500's valuation was 16.8x forward 4-quarter estimates — up sharply from the low of 14.6x at the end of 2018. However, sentiment still seems less ebullient and more inclined toward anxiousness.

Uncertainty remains about slowing economic and corporate earnings growth, the still unresolved US-China trade war, and whether the Fed paused too late. Investors will be looking to economic data in the coming months for clues as to the state of the economy, here and abroad. Hope remains elevated for an agreement between the US and China. Against this backdrop, investors will be closely watching the upcoming earnings season. Earnings expectations for the 1^{st} quarter and 2019 have been reduced sharply. Have they been cut too much…or not enough?

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

The US Federal Reserve (Fed) finally got the message that staying on the previous course of monetary tightening was a mistake, especially in light of the US trade disputes and the ongoing tapering of asset purchases (quantitative tightening).

With the global economy continuing to weaken, especially Europe and China, and the US economy showing signs that it was not immune to these forces (as evidenced by the inverting yield curve), the Fed made a major change in the 1^{st} quarter by moving to a neutral monetary policy stance and announcing an end to its quantitative tightening by September 2019. Even though it is officially called a pause, since the Fed is still implying another rate hike in 2020, the market is actually pricing the next move to be a rate cut as soon as early next year.

The policy change was a major move and Fixed Income markets reacted accordingly. Treasury yields declined between 20 and 28 basis points. Other asset classes that would benefit from easier monetary conditions performed even better. **In a reversal from the 4^{th} quarter of 2018, the best performing Fixed Income sectors were those with the highest credit risk.** The lowest rated corporate bonds returned over 7% for the quarter.

Tax free municipal bonds also had a strong quarter. In addition to the tidal change by the Fed, there were two additional reasons for the strength. Municipal supply was down. Much of the drop in supply can be traced to the tax reform act of December 2017 which prohibited advance refundings of older, higher-coupon municipal bonds. Demand is also higher, particularly in the high tax states like New York and California as their citizens are seeking tax relief since the tax act imposed a $10,000 cap on federal deductions for state and local taxes (SALT).

There has been a clear reversal in the Fixed Income markets starting last November when the 10-year note was 83 basis points higher. **Expectation that the US economy will slow has been a prevalent theme among fixed income investors. The current pause at the Fed is very appropriate, and only time will tell if the Fed acted early enough.**

Washington Trust Bank
WEALTH MANAGEMENT & ADVISORY SERVICES

INTERNATIONAL REVIEW

Derrick Wilson
Portfolio Manager

The New Year got off to a strong start as global equity markets rallied in the 1st quarter, bouncing back from a rough ending to last year. China's Shanghai composite index led the way, returning 28% over this period. Despite slowing Chinese GDP leading to concerns over future growth, renewed optimism over ongoing US-China trade talks, as well as Chinese officials promising fiscal stimulus through planned tax cuts and support from monetary policy, helped to push the market higher. This sentiment carried over to Hong Kong with the Hang Seng index up over 12%. Japan rose at a slower pace as the Nikkei index was up almost 7%.

Turning to Europe, Italy is officially in a recession and Germany is on the cusp. Then there is the dark cloud still hanging over Great Britain and the European Union as the Brexit deadline of March 29 came and went with no resolution or agreed-upon terms other than an extended deadline of April 12 (with potential for longer at time of writing). Euro-area economic data continues to show the region is in an overall weakened state. The equity market rally did not escape Europe, however, as the Euro Stoxx index gained just over 13%.

Political turmoil erupted in Venezuela when National Assembly leader Juan Guaido took to the streets and claimed himself as the country's rightful leader in an attempt to displace President Nicolas Maduro from power. More than 50 countries, including the United States, supported Guaido as pressure continued to build on Maduro to step down. This battle is still ongoing with Maduro. Emerging market equities and currencies suffered some as this initially took place, but finished the quarter higher overall.

World central banks point to maintaining loose monetary policies. Bank of Japan Governor Haruhiko Kuroda said in a statement, the central bank would consider extra monetary easing if required. European Central Bank President Mario Draghi noted in a speech that an accommodative policy stance is still needed in the euro area and will offer more cheap loans to banks and keep interest rates at record lows for longer, reviving its Targeted Longer-Term Refinancing Operations (TLRO). These actions intend to keep the economies moving forward.

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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