COHO PARTNERS, LTD.
Economic Commentary

First Quarter 2019

"Last thing I remember, I was
Running for the door
I had to find the passage back
To the place I was before
"Relax," said the night man
"We are programmed to receive
You can check out any time you like
But you can never leave!"."

--***Hotel California,*** **The Eagles**

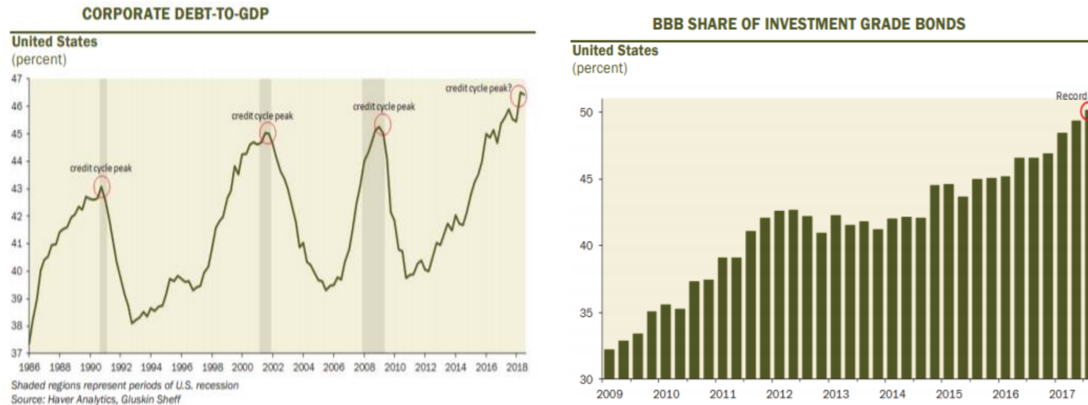
In 2017, then Federal Reserve Chair Janet Yellen proclaimed that removing the easy accommodation of low interest rates and peeling back Quantitative Easing (QE) would be like "watching paint dry". While our view has been that we would desire to have policy revert to more normal, market-determined interest rates and divorce Fed interest rate policy from the markets, we remained of the position that both markets and the economy had become tethered to these low rates and their removal would be challenging. In our prior commentary we quoted Dr. David Kelly of JP Morgan as saying, "Asset bubbles have been a far greater source of economic disruption over the past 25 years than any increase in inflation". and noted that the early January backtracking in comments from current Fed Chair Jerome Powell was "chalking one up for the stock market".

Commencing in late 2015, the Federal Reserve has been slowly attempting to "normalize" interest rate policy by both increasing the Federal Funds rate (the rate that banks charge each other for overnight lending) and shrinking the bond holdings on their balance sheet from levels that had been initiated for a post-crisis environment. In late March, Chairman Powell indicated the process may be all but done with officials foreseeing no more rate increases in 2019 and the end of the process of shrinking the balance sheet by September.

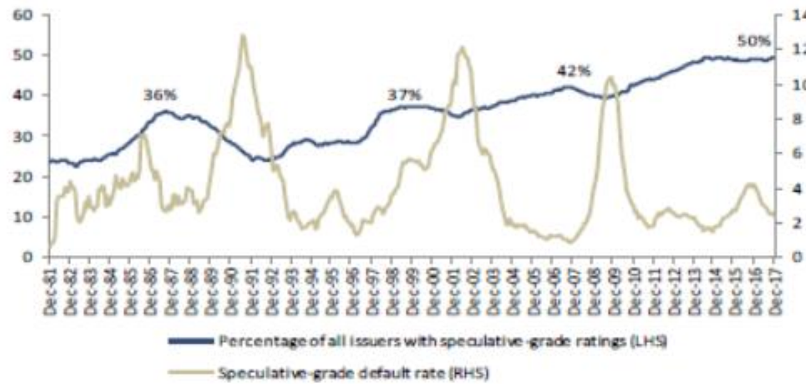
By virtually any historical metric, monetary policy will remain stimulative with the Fed Funds rate remaining between 2.25% and 2.50% while the balance sheet will still stand around $3.5T by September. This contrasts with a Fed Funds rate near 5% and a balance sheet just over $800B pre-crisis. Our concern remains high regarding the lack of ammunition available to monetary authorities to address the next economic downturn. So, what happened to cause this dramatic pivot?

Dallas Fed President Robert Kaplan may have highlighted the primary dangers of modern monetary policy in a speech in early March. Kaplan noted exactly what we have been focused upon when he said, "An elevated level of corporate debt, along with the high level of US government debt, is likely to mean that the US economy is much more interest rate sensitive than it has been historically." So, near zero interest rates since the financial crisis alongside multiple rounds of QE encouraged businesses to borrow and now these high levels of corporate debt are why the Fed cannot hike rates now? Evidently, The Eagles were Fed watchers.

The high levels of corporate debt may be where much of the leverage in this cycle has taken place. The cycle commenced with the share of BBB corporate bonds outstanding at about 30% of the total investment grade market. This is now at a record level of over 50% with $7T of this coming due in the next five years (see chart below right from Gluskin Sheff). This will now compete with the massive amount of new Treasury borrowings to finance the expanding deficit and may also impact capital spending plans as decelerating corporate cash flows from slowing profit growth need to fund these interest payments with a rising wage expense backdrop.



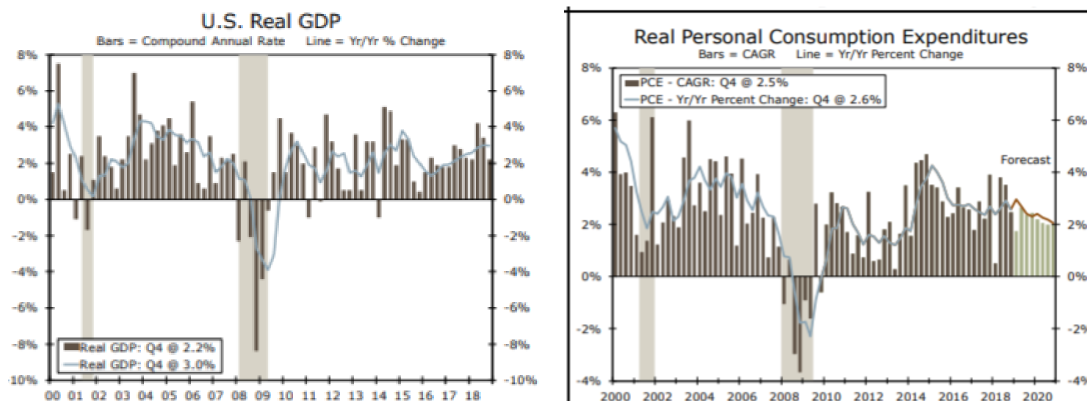
Additionally, this extreme level of lower quality debt currently has only a 2% default rate that often elevates to double digit levels during economic downturns (see chart below from Autonomous Research). We feel the start of such a freeze in the credit markets during 4Q of 2018 highlighted to Chairman Powell the high likelihood that a spillover from the credit markets into the real economy could occur.



UNITED STATES:

The final revision of 4Q GDP for 2018 shows the United States grew at a full year rate of 2.9% with 4Q/4Q growth coming in at 3.0% (see charts on the following page from Wells Fargo). The slowing in the fourth quarter to an annualized rate of 2.2% indicates that the rate of economic growth in the United States has downshifted a bit from earlier in the year, and we expect this to continue.

At the end of the year, we noted broad weakness in retail sales (December was the lowest reading since the recession) and personal spending that caused consumer spending to increase only 2.5%. This was lower than the initial 2.8% estimate and down markedly from the 3.6% pace during the middle part of the year.

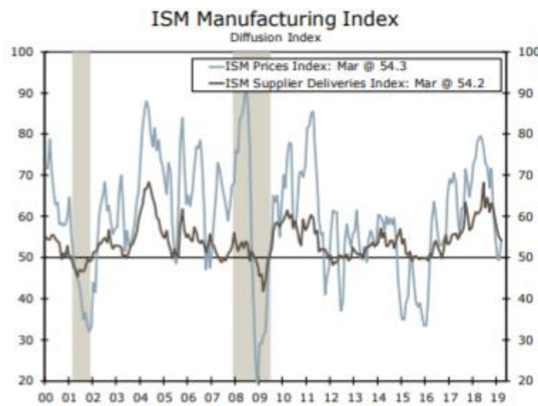


Real consumer spending (adjusted for inflation) was boosted earlier in the year from the personal tax cuts that were part of the Tax Cuts and Jobs Act (TCJA) of December 2017. Although the real income-boosting effects of the tax cuts may have already started to fade, income growth should remain solid due to the continuing strength in the labor market. Not only has employment growth remained strong, but wages are now rising at a decent clip.

Though reduced in the final revision, business fixed investment (BFI) spending, which grew only 2.5% in 3Q 2018, rebounded to a growth rate of 5.4% in 4Q. The interesting and potentially very long-term positive was the +6.6% increase in equipment and software spending and the tremendous +10.7% increase in spending on intellectual property products. These combined added +0.7% to the annualized 4Q GDP and, if continued, may have very positive longer-term productivity benefits. To us this is key as labor force growth from current levels of unemployment of around 4% are estimated to only add +0.5% to GDP growth. Productivity is up 1.3% y/y, still way below historical trends, and is the one area that can add to trend growth. It is worth noting that these areas are not included in the capital expenditure proxy that emerges from the durable goods report which remains disappointingly soft.

Residential investment (housing components) remains weak and has now contracted in the last four quarters though early signs in 1Q may show an arresting of these declines. Another area of forward-looking concern is that inventory levels have increased strongly during the last two quarters without the commensurate sell through. This does not augur well for future builds and may detract from 1Q and 2Q readings for growth.

Another area of recent slowing in the domestic economy is manufacturing. Though rebounding modestly to a level of 55.3 in March, The Institute of Supply Management (ISM) manufacturing index slipped in February to 54.2, a number that, while still in expansion, reflected the slowest pace of factory sector activity since 2016 (see chart on following page from Wells Fargo). Industrial production rose a modest 0.1% in February. This followed a decline in January, which was entirely due to weakness in manufacturing. This core weakness remained in February, as manufacturing output fell 0.4%. In fact, despite approaching the longest economic expansion on record, the industrial production index sits only modestly higher than the level of November 2007. The Fed is no doubt watching the recent softening in manufacturing where even with the March rebound, export orders remain at their lowest levels in two and a half years. At the very least, this release reaffirms their patient stance on further policy tightening.

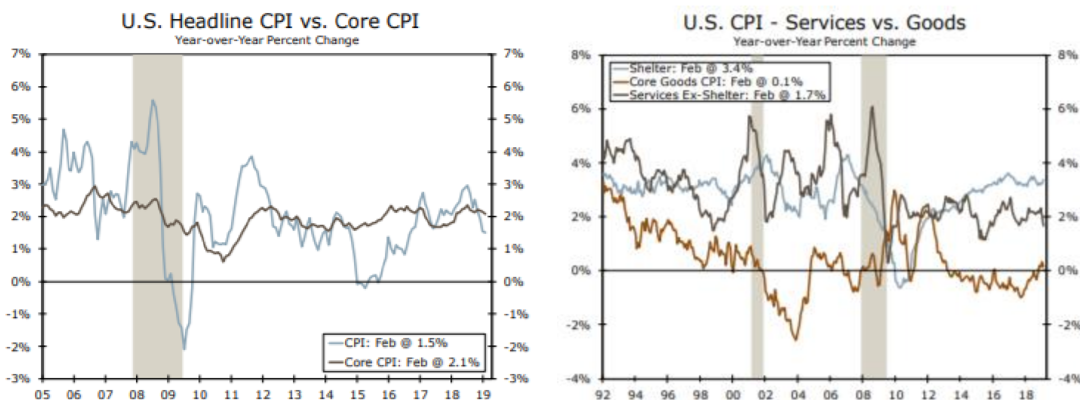


Following that weak spending data at the end of 2018, it is increasingly likely that the economic slowdown has continued into the 1Q period. With lower base effects in the important areas related to the consumer, it appears we may have a further slowing in consumption in the current quarter to below 2%. Though the Janaury retail sales numbers rebounded somewhat, December retail spending was revised even lower than the initial estimate. We are not sure the cause of this slowdown but two areas come to mind. The powerful market selloff in the final quarter of the year appears to have spooked consumers as household net worth (which declined $3.4T in 4Q 2018) is highly correlated to spending.

Additonally, we feel the elimination of all but $10,000 of the State & Local income tax deduction (SALT) may be having a direct and indirect impact. Due partly to this rollback, not only are residents in these high tax states seeing after tax incomes contract but also suffering through the largest declines in real estate prices.
This mostly impacts New York, New Jersey, Connecticut, California, Massachusetts and Illinois. The GDP of these 6 states are 1/3 of the entire US economy with California the equivalent of the 5th largest economy in the world. With the industrial side of the economy slowing, the U.S. consumer (70% of U.S. GDP and over 20% of global GDP) has been the rock that has held up growth and may be slowing.

INFLATION:

Consumer price inflation continues to moderate from headline accelerations seen from early 2017 through the middle of last year. In the most recent reading in February, the closely watched Consumer Price Index (CPI) slipped to 1.5% on a year-ago basis due to lower energy prices over the past year. Core inflation that excludes food & energy slowed but is still running at a 2.1% annualized pace (chart below left from Wells Fargo) over the past year and has now exceeded the stated FOMC goal of 2% inflation for 12 consecutive months.



While labor costs have been heating up (average hourly earnings growth hit a new cycle high in February) the

pass-through to consumer price inflation remains modest. Stronger productivity growth over the past year has kept unit labor costs in check, while historically high profit margins leave companies some scope to absorb higher labor costs.

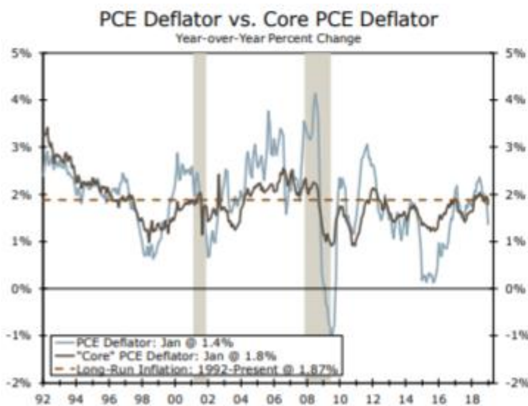
As the righthand chart on the prior page from Wells Fargo indicates, there continues to be a wide dichotomy between service and goods inflation. Goods inflation represents approximately 38% of the calculation of the core CPI and for most of the last seven years has basically been flat. Where inflation is most pronounced is in the services component, more specifically “shelter”. The “shelter” portion of the calculation alone represents about 42% of the total and over the last year has increased around 3.4% thus contributing approximately 1.43% of the 2.1% rate of price increase. Ex-housing, inflation is about 0.7%y/y. As we have stated for much of the last few years, inflation is fairly dormant.

THE FEDERAL RESERVE:

The lack of wage and price pressures in the economy continue to perplex the members of the Federal Reserve and it is somewhat ironic that this seeming defeat of inflation would not too long ago have been hailed as a major victory for the Central Banks. No longer. While prices of food, services and gas do continue to rise, overall inflation by current definitions remain quite tepid and has for much of this century.

Perhaps it is the “definitions” that need to be addressed. While Fed members would clearly like to see rising wages to increase consumer standards of living and some increases in discretionary consumer goods prices so companies may maintain purchasing power, inflationary pressures have clearly manifested in areas not measured in traditional inflation indices.

As shown on the chart below left from Wells Fargo, the core PCE (Personal Consumption Expenditures) has stayed near or below the 2% stated goal of the Federal Reserve since the late 1990s. Recently, this occurs despite wages finally starting to grow. However, by another gauge, there has been inflationary pressure elsewhere, specifically in the prices of financial assets such as stocks, bonds and real estate. This is picked up more accurately in a separate measure from the New York Federal Reserve called the Underlying Inflation Gauge (UIG). As shown in the chart below right, these measures, which incorporate real economic activity along with financial asset values, suggest inflation has been running towards 3% and may have compelled the Fed to raise rates much earlier than they ended up doing.



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

EMPLOYMENT & WAGES:

Following powerful job gains in 2018 averaging 223K per month, we anticipated a modest slowing of hiring in the current year alongside continued but moderating wage gains. Decelerating economic growth and the tight state of the labor market makes it more difficult for firms to fill vacant positions as finding qualified labor continues to be the most-cited concern among small businesses. Job openings near record highs reflects this.

While the 1Q hiring is still at a strong level, job growth has slowed to an underlying trend of 180K per month. Solid productivity gains ending 2018 were a key component of our view that wage gains would be able to follow without a correlated impact on inflation. That has seemingly not been the case through the first quarter of the year.

While annual wage growth for March is down to 3.2% from the post-recession peak of 3.5% in December, the six-month annualized trend has slipped to 3.0% with the three-month trend now at 2.5%. A potentially more informative way to view earnings is an aggregate proxy for inflation-adjusted weekly earnings shown below. This is calculated by using real average hourly earnings and multiplying this by average weekly hours worked and the total of people employed in the labor force.

The peak for this expansion was in February 2015 when aggregate real income exceeded 5.0% as inflation was low and the year-over-year trend in payroll growth peaked near 2.6%. Payroll growth is now down to 1.0% over the most recent 12-month period and this measure is now 3.6%y/y. Though this is down from the recent January level near 4.4%, it remains near the higher end of its cycle range. Still, the year-over-year deceleration noted in the number of people in the work force is a critical reason why most economists anticipate the trend rate of GDP growth will return to the more sustainable 2% level and may also underscore why consumer spending has moderated as well.

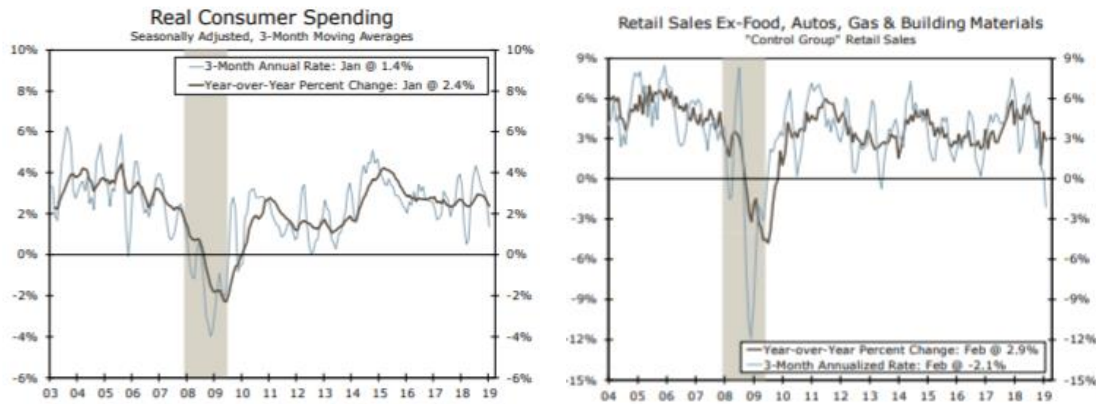
CONSUMER:

While the final revision of 4Q GDP showed that consumer spending grew at a more modest but still solid pace of 2.5% for the quarter (down from a 3.6% average reading for 2Q and 3Q), there was a marked slowing at the end of the period that continued through the first quarter. There have certainly been some headwinds for consumers. Markets have been volatile, the government shutdown added to uncertainty and there is some evidence that tax refunds were initially behind schedule. While weakening economic data have elevated talk of a potential recession, the largest area of potential concern would be the consumer. As almost 70% of our calculation of GDP is consumer spending, a retrenchment would materially weigh on economic growth.

Retail sales figures comprise the largest component of total consumer spending and have been exceptionally volatile over the last three months. The retail sales figures ex-food, autos, gas, and building materials is referred to as the "control group" as it feeds directly into the personal consumption expenditures in the GDP report. It is

the most important figure to note in the release. While February retail sales in the control group fell -0.2%m/m, the revision to January was to a +1.7%, the largest one-month increase in 17 years. However, this does nothing to negate the -2.3% drop in December, the worst single decline since 2000!

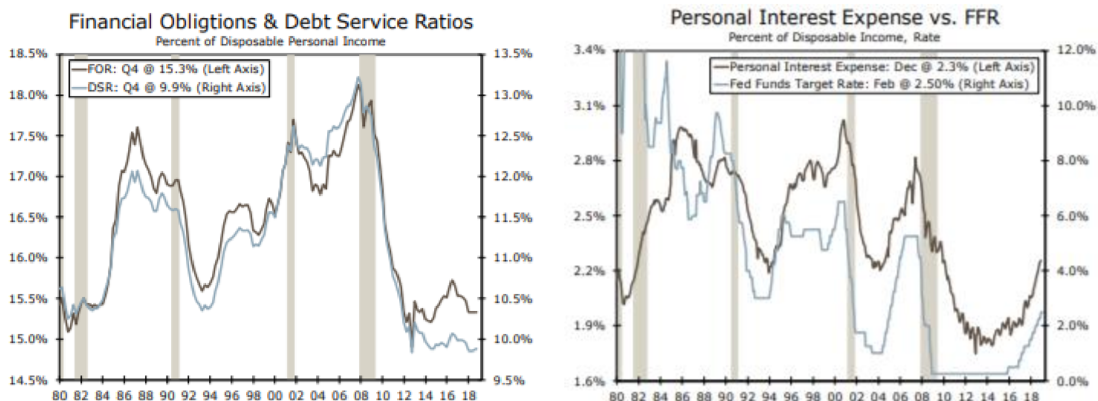
The chart below left from Wells Fargo shows the most recent consumption data through January and shows a slowing from a 2.4% year-over-year rate to a 3-month annualized rate of 1.4%. The more contemporaneous data available from the control group of retail sales is as of the end of February. The chart below right from Wells Fargo now depicts the nominal increase in year-over-year sales at 2.9%, one of the lower readings of the last three years. The control group reading, however, has plummeted to -2.1% on a 3-month a/r basis, a rate rarely seen outside of a recession.



Despite rising absolute debt levels (higher than the 2008 peak) and talk of rising delinquency rates on credit card and auto loans, we feel the consumer to still be in fine shape on the income statement with rising real earnings noted in the prior section alongside manageable debt levels, especially the servicing of that debt.

Total household debt-to-income levels are currently around 86% as of the most recent 4Q 2018 data. This is down from the peak of about 115% before the financial crisis and back to levels of around 2003. Though absolute debt levels are important to note, it is debt servicing levels that have a greater impact on the consumer's health.

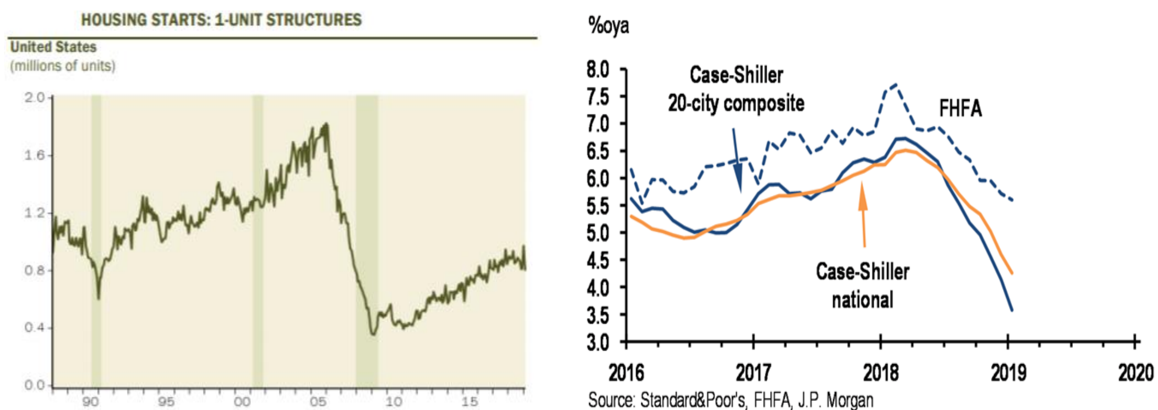
The Federal Reserve measures the Household Debt Service Ratio and the Financial Obligations Ratio which estimate debt payments to disposable personal income. As the chart from Wells Fargo below left shows, both of these ratios have been sitting near historic lows since 2012. While dramatically rising interest rates might change this calculus, we do not believe that to be an intermediate concern. Indeed, in the Wells Fargo chart below right we can see that despite nine increases in the Fed Funds rate over the last 3 plus years, the level of personal interest expense is still at lower levels than the troughs of other econimic expansions. If the consumer were to continue to curtail spending, it does not appear to be due to debt or wage concerns.



HOUSING & AUTOS:

We are optimistically noticing the green shoots in recent housing data where momentum has shifted from steadily deteriorating late last year to improving modestly early this year. No doubt the dramatic pivot in Federal Reserve interest rate policy and the resulting turnaround in financial conditions are primarily responsible for this shift, which is so far limited to increased buyer traffic and increases in mortgage applications for those looking to purchase a home.

Builders entered 2018 with optimistic expectations in response to lower mortgage rates and this may have been reflected in the early data on new housing starts for January. However, there has been little follow-through, and February starts dropped back to levels of May 2017 with the three-month trend below that of the past year (see chart from Gluskin Sheff below left). However, this has increased inventory levels which are now combining with slowing home price growth to create better opportunities for new home buyers. The Case-Shiller home price index (chart below right) has now moderated for 10 consecutive months and the year-over-year price gains are down to 3.6% from the 6.7% reached as recently as March of last year.



First time home buyers have been the consistently missing ingredient holding back the housing market. Millennials suffered economic losses versus prior generations as many graduated directly into a recession with far higher levels of debt (mostly student loans) forcing many to delay marriage, childbearing and even home-buying. We believe that these delays are less a function of changing preferences and more of economic circumstances which may be improving.

We are currently entering the critical spring home-buying season where about 40% of a full year's sales occur according to data from the National Association of Realtors (NAR). With scarce inventories no longer forcing elevated prices and sellers more realistically marking down their homes for sale, we are becoming more optimistic that the slowdown we have been projecting in the housing market over the last year may be arrested. Still, it is too early to project anything more than modest contributions to overall economic growth as years of home price gains exceeding wage growth continue to challenge affordability. House price gains should continue to slow to bring this more into an equilibrium level.

Auto dealers entered 2019 with a much heavier inventory of unsold vehicles pressuring them to cut factory output (evident in manufacturing output data). Inventories were up almost 3% from levels of early 2018 while sales were -2.3% for the full year according to data from WardsAuto.

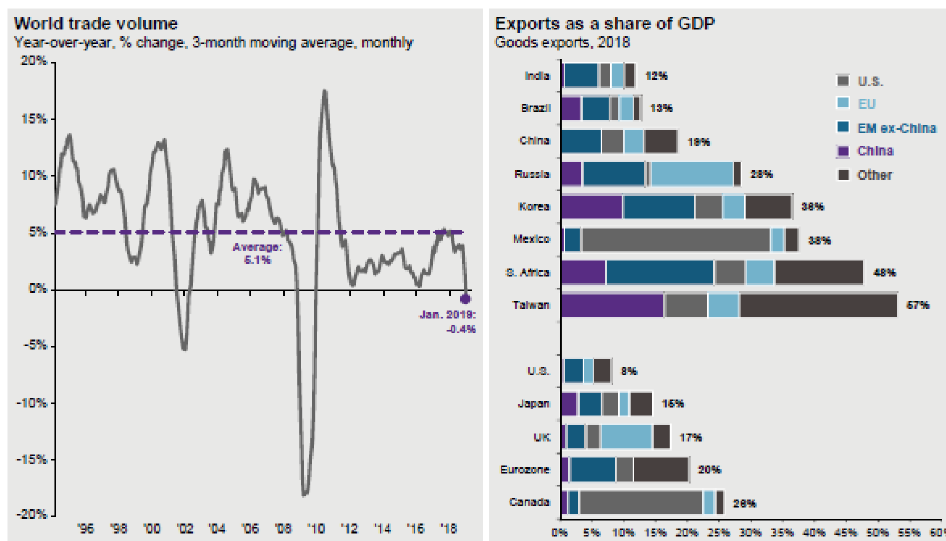
Retiring CEO of AutoNation, Mike Jackson, recently shared his views that it is getting harder to sell cars and that this signals the auto industry is about to enter a period of decline. He is expecting 2019 sales around 16.8M units which continues the slow decline from the peak level of 17.6M cars achieved in 2016. Indeed, it has long been our view that we have passed peak auto sales. The most recent data for 1Q 2019 show about 16.9M light vehicle

sales at an annualized rate, the slowest quarterly reading since 2014. (see chart below).

The data on car incentives certainly back up Mr. Jackson's argument as the slowdown in auto sales has corresponded with an increase in the average size of financing now at $31,722. For comparison, in 2016 the average size of financing on a new vehicle was less than $26,000. Commensurately, the average monthly payment continues to rise to new records and stands currently at $545/month even though the average loan duration has extended to over 70 months. An additional headwind is rising finance rates. According to Edmunds, the annual percentage rate on new financed vehicles in March rose to 6.33%. This compares with 5.66% last year and 4.44% five years ago. Auto production will continue to be a modest drag on overall growth for much of 2019.

INTERNATIONAL:

The chart below courtesy of JP Morgan depicts the main concerns for a global economy that has been impacted by trade tensions, tariffs and political uncertainty to a far greater level than had been anticipated. Through January, world trade volume (below left) has now fallen from an average annual increase of 5% to a contraction in just over a year. The chart below on the right shows the uneven impact that such trade wars have. The U.S. only derives 8% of our GDP from exports. By contrast Japan is 15%, China is 19% and the Eurozone is 20%. The larger European Union is nearly 47%.



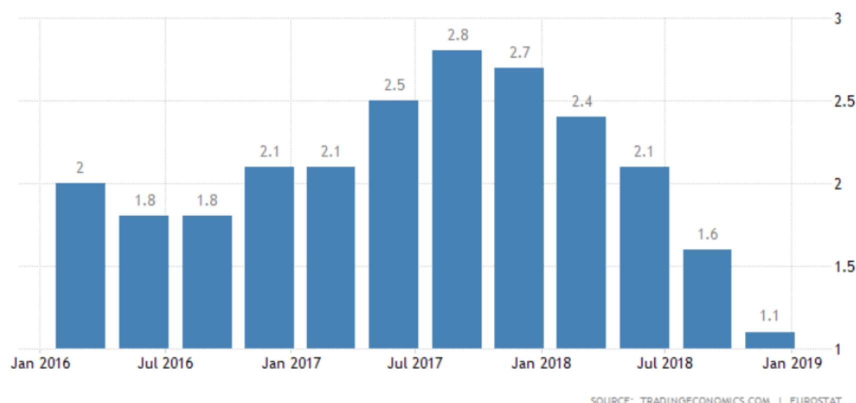
Declining trade has been clouding growth prospects outside of the U.S. leading the Organization for Economic Cooperation & Development (OECD) to downgrade 2019 global growth forecast to 3.3% with Europe suffering the largest cut. Europe is now expected to grow only 1% this year from a prior estimate of 1.8% (down from 2.7% in

2017) with Germany now down to 0.7% growth and Italy in contraction. The U.K. expectation has been lowered to 0.8%. All of these have been cut considerably from prior estimates.

Despite being revised lower to 2.2%, U.S. 4Q GDP growth held up relatively well when contrasted with widespread signs of slower growth across the globe. Major economies in Europe, North America and Asia registered only marginally positive growth while China continued its gradual slowdown. The good news, if there is any, is that this slowdown has moved many foreign central banks to revert to a more dovish stance. The European Central Bank (ECB) has signaled that policy rates may now be on hold through all of 2019 (if not forever), and, also, announced a new round of long-term loans. The Bank of Canada (BoC) said that the timing of future rate hikes had become more uncertain, while central banks in Australia and New Zealand have explicitly acknowledged in recent months that the next move in policy interest rates could be up or down. This was followed by major, targeted stimulus from the People's Bank of China (PBoC).

EUROZONE:

Europe continued to slow throughout 2018 finishing the 4Q period with just a 0.9% a/r of GDP bringing the full year to 1.1%. This continues the year-over-year decline in the growth rate of the Eurozone (EZ) which peaked at a 2.8%a/r in 3Q 2017 (see chart below).



Growth appears to have deteriorated further in 1Q indicating that the quarter may come in around an annualized rate of 0.5% potentially escalating fears of a recession. The March manufacturing PMI declined further into contraction at 47.6, the lowest level since 2013 (see chart from Wells Fargo below). Factory orders in the Eurozone have declined in nine of the past 13 months, while manufacturing output fell roughly 4% year-over-year in the three months through February. Germany, the largest country in the EZ and 4th largest economy in the world, with its industrial sector more dependent on China and trade has suffered more with growth basically flat over the last two quarters. In March its manufacturing PMI plunged to 44.1 and we would not be surprised if 1Q growth contracted.

The labor market remains strong with solid wage growth and low inflation likely underpinning consumers in the Eurozone. This may remain a key element of the narrative of a resilient services sector. The March unemployment rate fell one tenth to 4.9% as expected, a new low since reunification. On March 7th, the ECB slashed the inflation forecast to 1.2% from 1.6% clearly showing that the extreme monetary policy employed to generate higher inflation have been anything but a success and have left the ECB without the most effective tools to address economic challenges that may be coming its way. Over the balance of the year, however, we feel that stabilization in the Chinese economy via recent stimulus will have positive implications for Europe beginning in the second half of the year.

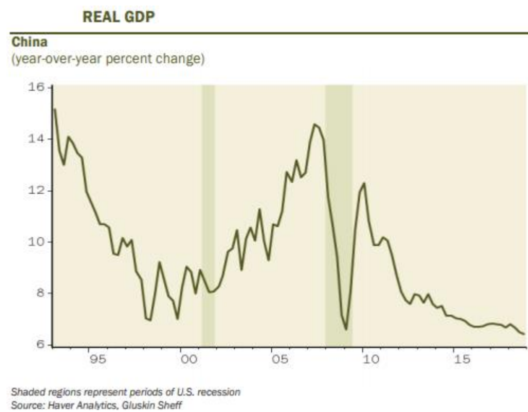
UK:

Postulating on Brexit is challenging as the options available to Theresa May and Parliament along with the policy and procedural failures change almost daily. As of this writing, the European Union leaders are scheduled to attend an emergency summit on April 10th to vote on delay to June 30th following four more failed votes on April 1st. There is no guarantee of any of this coming to pass amid decreasing confidence in a credible plan for Brexit. We are still of the mind that a second referendum may be in order, but we have already written three sentences more than our confidence should allow.

What we do see is that economic data continues to come in a little better than feared likely due to the continued stockpiling by firms in preparation for the worst outcome-a no-Brexit deal. GDP data continues to be resilient (see chart from Wells Fargo below) while the 55.1 March manufacturing PMI jumped to the highest level in over a year led, of course, by a huge increase in inventory building. However, the services PMI not subject to hoarding fell to 48.9 indicating an elevated risk of the economy stalling in the current quarter. With the uncertainty surrounding the process of the exit from the European Union, we continue to remain cautious on economic growth.

CHINA:

With growth slowing dramatically throughout 2018, China is currently facing its most difficult economic environment in years. Though economists forecast 6.2% growth this year (consistent with what the PBoC targets), that is a continued decline from the 6.6% level of this past year (see chart on top of following page) that was already the slowest in almost three decades. Chinese economic growth was slowing well before the trade dispute with the United States ramped up in 2018, but the escalation of trade tensions and the enactment of several rounds of tariffs have likely contributed to a further slowdown. China's $13 trillion economy (second in size only to the U.S.) accounts for almost a third of global growth each year and is a critical driver of global job creation and improved living standards via lower costs of production. With the U.S. near the longest expansion in our history and continued worries about growth in Europe, economic growth in China becomes even more important.



The fire-hose stimulus that followed the global financial crisis successfully prevented China from suffering through the Great Recession like the U.S. The consequence is that China's economy loaded up on debt, and its ability to service repayments depends on rapid growth to generate the profits and tax revenues needed. Back in mid-2016, China's economic policy switched from stimulus to restraint in response to concerns about a rapid buildup of unregulated shadow-bank lending, as well as President Xi Jinping's focus on reducing China's massive debt pile and cleaning up toxic air pollution.

The restrictions on lending may have unintentionally led to a liquidity crunch that impacted heavily the small, privately owned companies that account for about 60% of overall GDP growth and 90% of job creation while benefitting state-owned enterprises with access to bank loans. In recognizing these problems, the PBoC will now deploy targeted monetary instruments to spur banks to boost lending toward smaller businesses and announced an estimated $298B of tax cuts estimated to add as much as +0.6% to overall GDP. China continues to balance the need and desire for growth with the enormous amount of debt accumulated over the past 10 years in addition to debt being taken on to stimulate current growth. We know what that is like.

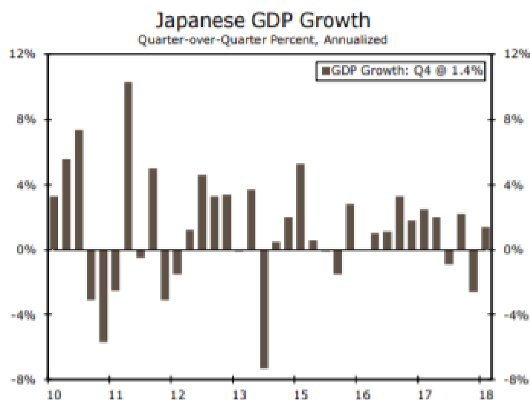
This shift in policy should be sufficient to address these credit issues and arrest the weakening trend. Recent data points on the Chinese economy are showing further signs of recovery and the recent PMI (Purchasing Managers Index of manufacturing) readings have moved to expansion for the first time in seven months. A critical assumption underlying this improved viewpoint remains a constructive outcome on the U.S.-China trade negotiations. With both sides desiring a positive outcome, we feel the contention will be alleviated soon. However, major reforms addressing more critical issues such as intellectual property theft may remain a work in progress.

JAPAN:

It has been a long-documented concern of Japan that it represents a very closed and demographically aging society. Since 2012 its working age population has declined by over 4.7 million. Despite this, policies that formed one of the major tenets of Prime Minister Shinzo Abe's three-pronged approach (referred to as "Abenomics) have focused successfully on increasing overall labor force participation and this has risen sharply during this period by more than any other advanced economy.

Abe has targeted women, increased immigration and even the elderly in a model that may be followed by many other economies that are now facing challenging demographic issues. Labor force participation among women has long been a cultural handicap and addressing this has seen female participation in the labor force increase to 69%, a level which is now far higher than the average of developed countries according to the OECD. Abe has also addressed immigration and has more than doubled the number of foreign workers in the labor force during this period.

The two-year period from 2016-2017 now appears to have been the anomaly for the Japanese economy as it expanded for eight consecutive quarters. The economy experienced a more volatile 2018 with two quarters of gains following two quarters of contraction. GDP slowed to a full year-over-year increase of 1.4% in 4Q (see chart below from Wells Fargo) which only partially offset the -2.6% 3Q decline. This softness has continued into the new year with most economic releases indicating a further slowdown.



Due mainly to the reforms noted above, job growth continues to be strong. In fact, the labor market continues to tighten further with the unemployment rate falling to 2.3% in February, a near quarter century low. However, this is still not feeding into consistent wage growth and consumer spending (as evidenced by weak retail sales in February) remains soft. A secular lack of confidence in the economy and the increases in labor force participation continue to work against the objective of wage increases. Businesses hesitate to pass on wage gains to employees and, in turn, employees save rather than spend. With the proposed consumption tax set to increase from 8% to 10% in October of 2019, we look for overall growth to moderate further below 1% for the full year.

MARKETS:

The dramatic change in the tenor of the market can be clearly attributed to the 180 degree change of the Federal Reserve that had promised two rate hikes in 2019 as recently as December. The markets are now pricing in a greater likelihood of a rate cut this year. The moves by the PBOC to aggressively ease monetary policy combined with additional fiscal stimulus in the form of tax cuts, led risk on markets to return powerfully in the opening quarter. Renewed dovish tilts by major central banks increased confidence that monetary authorities will engineer a soft economic landing and help prop up corporate earnings. This is a complete about face from the fears of the prior quarter and appears to have ameliorated any market concerns of an imminent recession.

The broader market averages recovered virtually all of the losses experienced in 4Q 2018 with the 13.6% first quarter gain by the S&P 500 the best start to a new year since 1998. Growth companies represented by the Russell 1000 Growth Index continued to outperform The Russell 1000 Value index returning 16.1% during the quarter versus a still strong 11.9% for value stocks. Though weaker in March, small cap companies in the Russell 2000 index returned nearly 14.6%.

Though markets outside of the United States continued to trail the returns of our domestic markets as their economies and geopolitical concerns remain more precarious, the influence of China and its stimulative actions arrested prior weakness. For the full quarter the MSCI Emerging Market Index returned over 9.9% with the Chinese market reverting to a 10-month high. Developed markets as represented by the MSCI EAFE index enjoyed a similar 10.0% gain.

Despite concerns expressed regarding the corporate bond markets, the overall reemergence of risk appetites led a nearly 7.3% return in the lower quality high yield bond market. The moderation of interest rates during the

quarter shepherded positive returns across the fixed income markets with the Barclays Aggregate index returning almost 3%.

Absent the influence of monetary policy, continued global trade tensions and slowing domestic and international growth should continue to exert downward pressure on corporate revenue growth that is slowing towards 4% for the year. Though margins remain high, headwinds of rising labor costs will pressure bottom line profits. More challenging, however, will be that earnings are now set to anniversary the peak of 2018 growth that enjoyed a major step-up partially due to the Tax Cuts and Jobs Act of 2017 as corporate tax rates were slashed to a statutory level of 21%. With the bar set high following 20% full year EPS growth for the S&P 500 in 2018, financial data firm FactSet estimates that 1Q earnings per share (EPS) growth for the S&P 500 will be negative. It currently shows full year 2019 EPS as flat to a modest single-digit gain.

Though global central banks have reversed the process of withdrawing policy accommodation that threatened markets in late 2018, trade and tariff issues and rising geopolitical tensions remain. We continue to expect higher levels of market volatility as economic and earnings growth slow. At Coho Partners our focus remains on downside protection. We seek to provide this from the construction of a differentiated portfolio populated with high quality companies possessing resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations. With financial markets by most metrics at elevated levels, we feel this philosophy is very well suited to address the challenges facing investors.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA

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