HAVERFORD

2019 SPRING OUTLOOK

"Some people see the glass half full. Others see it half empty. I see a glass that's twice as big as it needs to be."

—George Carlin

The financial markets have gone for a wild ride. The S&P 500 experienced its worst December performance since the 1930s, yet the rebound during the first two months of 2019 ranks among the best starts to any year. The market's gyrations almost always exaggerate the underlying fundamentals of businesses and the economy. This time around was no different—the market clearly overreacted during the final months of 2018 and has since bounced back on improved sentiment and a brighter outlook for 2019. There are two key reasons for the improvement: members of the Federal Open Market Committee (FOMC) have turned increasingly dovish on interest rates, while a de-escalation of China trade tensions appears inevitable. Both topics are consistent with our *2019 Outlook*. We still expect the FOMC to hike rates only once this year, and we remain optimistic on the outcome of trade negotiations.

With the market rebounding sharply off its Christmas Eve lows, it may be tempting to take gains and sit out the rest of the year. The "glass is half empty" argument reads something like this:

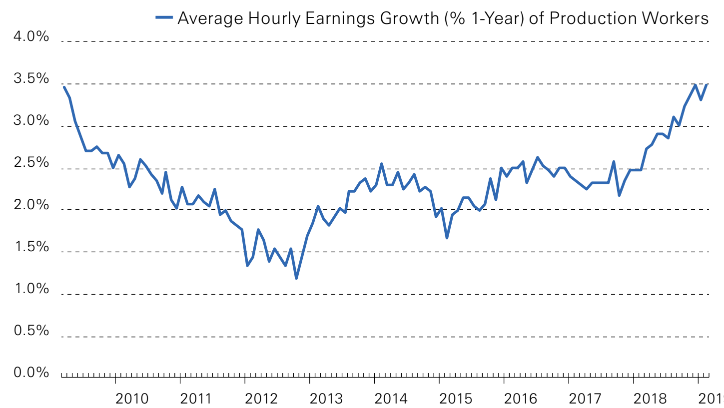
> Meaningful macro/political events could still turn out negative by year's end. Chief among them are the extremely vexing Brexit negotiations, the U.S. political landscape, and impending debt ceiling negotiations. We have no idea how Brexit will finally be resolved—no one does—and we expect the debt ceiling to be a knock-down, drag-out fight that will ultimately conclude with an increase. These issues—and others that have yet to be identified—will cause concern. We also can't ignore the slowing of global growth. Economic data has weakened, both at home and abroad. Leading indicators are weakening and global Purchasing Manager Indexes (surveys of business activity) are flirting with levels just above recessionary.

Despite these concerns, we believe the U.S. economy will remain resilient, global economies have bottomed, and stocks can add to their year-to-date returns. We view the glass as half full. Here's why.

The U.S. economy is still strong and growing.

The economy has slowed from the peak growth rates of the second quarter of 2018, but it is still growing. The employment picture remains robust. Job seekers who used to be on the sidelines are coming back into the market. The economy is adding more jobs than almost any model could have predicted at this point in the economic expansion, yet the unemployment rate has remained steady and inflation is in check. Wage growth has picked up slightly and the benefit is accruing to workers in lower paying jobs. Target CEO Brian Cornell recently said, "We are in a very stable consumer environment." Confidence remains strong, and we continue to expect that the economy will grow about 2.5% this year. A recession has never occurred with the real federal funds rate near zero, and we don't expect rates to rise much this year. The entirety of this data points to an economic "soft-landing" as a real possibility. As long as the U.S. economy continues to grow, we believe the ripple effects of trade tensions on China, Europe, and the rest of the world can be transitory.

Wage growth is improving but not elevated enough to fuel inflation fears



Source: FactSet Research Systems

Jerome Powell and the FOMC corrected course.

The areas of the economy flashing warning signs are sectors that are interest-rate sensitive, including housing and autos. During the preceding two years, the FOMC pushed rates higher until the markets called foul. Taking policy makers at their word, we believe the economy and the markets will now enjoy a welcome reprieve from rising rates. Raising rates was justified, but it is prudent to give consumers time to acclimate to the higher levels, such as a conventional 30-year mortgage near 5%. With time, we think these sectors of the economy can orchestrate a comeback and breathe new life into the economic expansion.

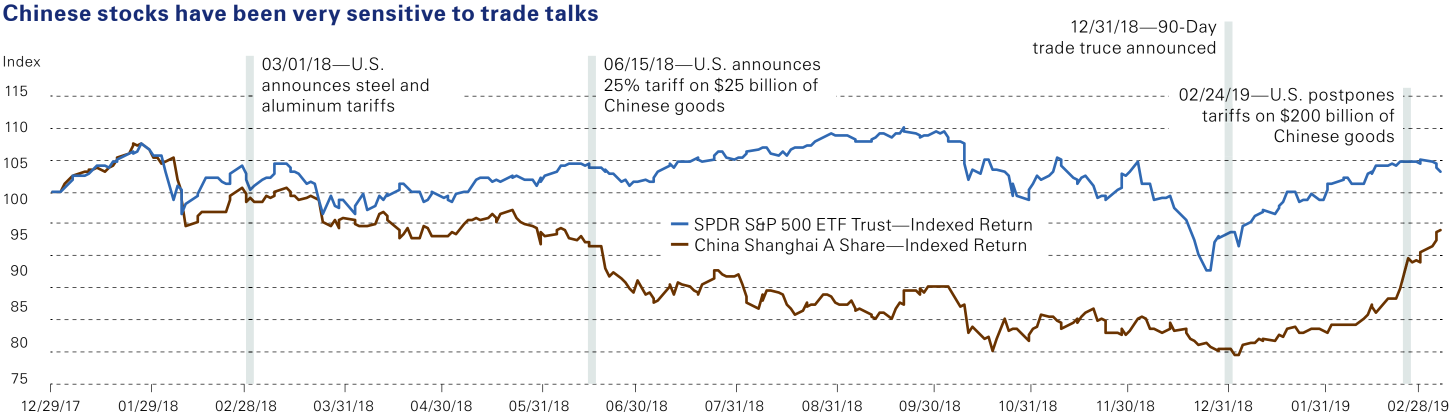
This course correction included the Fed's view of the balance sheet.

Following the Great Recession, the Federal Reserve implemented an additional form of monetary stimulus, known as Quantitative Easing (QE), by increasing the size of the Federal Reserve's balance sheet. In addition to raising rates, the Fed is now in the process of reducing its balance sheet assets, which is a form of monetary tightening. QE was unprecedented and put the Fed in uncharted waters. Reducing the balance sheet is no different, and there is no precedent to draw on when forecasting its effects. To describe balance sheet reduction, Jerome Powell used the unfortunate terminology of "autopilot." That implies it is a standard task that can be entrusted to a computer model. It is not. The further the balance sheet is reduced, the more meaningful the quantitative tightening could become. This fact has now been acknowledged by Jerome Powell, and we anticipate that in late March the FOMC will provide more guidance on this issue.

The de-escalation of trade tensions will provide economic stimulus.

On February 24, the Trump administration delayed a tariff increase on $200 billion in Chinese goods, citing progress in trade negotiations. On March 3, *The New York Times* reported that the United States and China appear close to striking a deal that will roll back tariffs, and there is speculation that Presidents Trump and Xi will formalize that deal in late March. Markets have responded positively to such news. The Chinese stock market, up over 24% so far in 2019, has reacted most notably to the trade negotiations. We believe stocks have not fully priced in how accretive a roll back in tariffs would be. Strategas Research Partners estimates that removing tariffs will provide a $65 billion "tax cut" to the U.S. economy. A deal with China is probably the most effective stimulus the administration could provide to the economy in 2019. It will likely propel capital spending higher and increase corporate earnings. Higher capital expenditures can turn around lagging economic indicators, and higher earnings growth should make stocks more attractive.

Chinese stocks have been very sensitive to trade talks

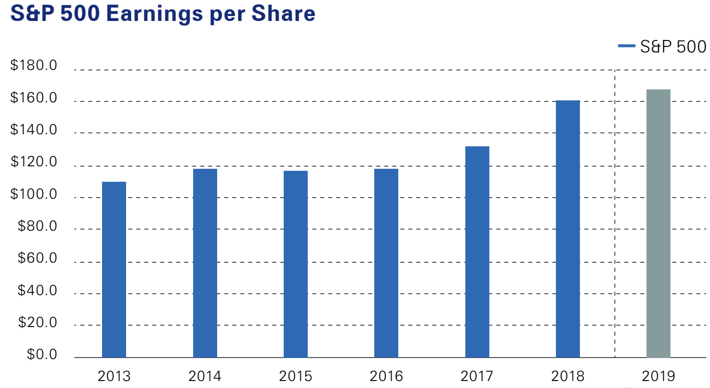


Source: FactSet Research Systems

Earnings expectations have come down, way down.

Aggregate expectations for 2019 S&P 500 earnings fell from $179 to $169 during the fourth quarter of 2018. We believe expectations have bottomed. Corporate earnings estimates usually fall throughout the year as reality rarely exceeds expectations. It could be different this year (dangerous words, we know). Our view on economic growth and the outcome of trade negotiations, combined with the sharp reduction in estimates during a period of unjustified pessimism, informs our optimistic outlook for the remainder of the year. Even at $169, annual earnings growth will be positive and approximately 4% higher than 2018. Looking beyond earnings, corporate management teams remain optimistic about cash flow projections and business prospects as evidenced by dividend announcements. The median dividend-paying company raised their payout 10.7% in 2018, and we believe dividend growth will remain robust in 2019.

S&P 500 Earnings per Share

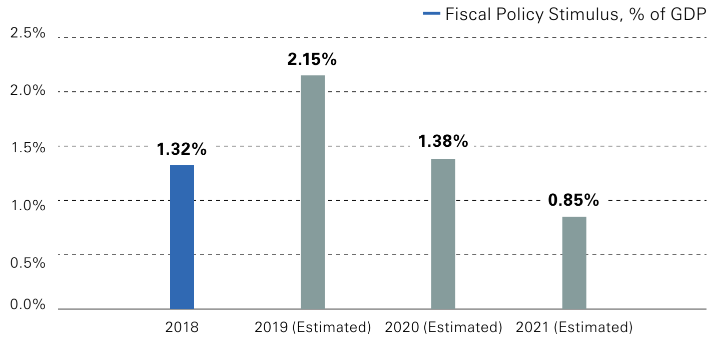


Source: FactSet Research Systems, Standard & Poor's Financial Services

Investors are often rewarded by viewing the glass as half full.

We have reviewed five reasons that give us confidence that the bull market, which celebrates its 10th anniversary this month, can continue. There are more reasons, including positive market internals (i.e., market breadth), the washout in sentiment, and an increase in fiscal stimulus over 2018. By many measures, the market is still "unloved." For every positive rationale we have exposed, a rational observer can point out warning signs or reasons to be negative. The negatives may be valid, but in the long-run they have a way of working themselves out, neutralized by economic growth and prosperity. Investors are often well-rewarded for viewing the glass as half full.

Fiscal Policy Stimulus, 2018–2021



Source: Strategas Research Partners

Investment Implications

In response to the ever-changing investment landscape, Haverford has made some active portfolio decisions. The most meaningful decision has been not to drastically turn over the equities we hold. We have purchased shares of beaten-up stocks but have not meaningfully altered the portfolios' sector allocation. In globally diversified portfolios, we have reduced our exposure to European equities in favor of Emerging and U.S. equities. The risk/reward profile (economic growth, valuations, currency, political) of Europe continues to worsen in our view. We continue to recommend tax-exempt municipal bonds for tax-paying clients in the top two federal brackets. The muni market is supported by improving finances, a favorable supply/demand equation, and the probability that there will be no further tax cuts. We favor shorter duration corporate and government bonds for tax-exempt clients. Due to the flat yield curve, investors can attain yields that exceed expected inflation without incurring much interest rate risk. We find little to like about the volatility of long-term bonds such as the 30-year Treasury, which provide only slightly more than a 3% yield.

All data as of March 7, 2019, unless otherwise noted.

With the right people, the right solutions, and the right client experience, let us show you the difference Haverford *Quality Investing*® can make. Please contact your Haverford Relationship Manager or, if you have yet to meet with us, call our offices to arrange a time that is right for you. Either way, we're looking forward to getting to know you.

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