PRIVATE CAPITAL MANAGEMENT
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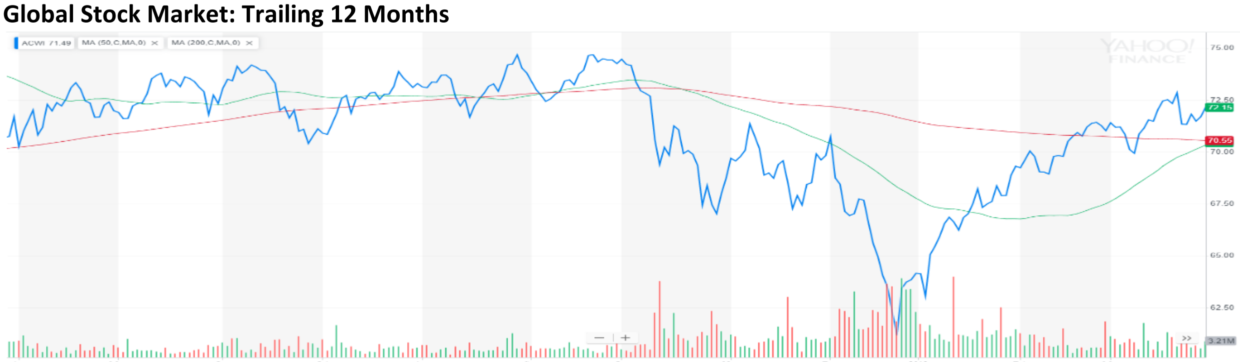
First Quarter 2019

"There is no risk-free path for monetary policy." Jerome Powell

Markets experienced a sharp upside reversal during the first quarter of 2019. Global stocks, commodities, REITs, and bonds all performed well, erasing much of the portfolio losses experienced late last year. Positive returns were broad-based, not only across asset classes, but also across sectors. All eleven sectors of the U.S. stock market, for example, had positive performance, with nine sectors posting double-digit gains.

Global Stock Market: Trailing 12 Months



Source: Yahoo Finance; blue line shows iShares MSCI ACWI ETF performance

Several factors drove returns, including a shift away from monetary tightening by central banks, perceived progress on U.S.-China trade negotiations, and relatively attractive valuations for most risk-based assets following last year's sell-off.

Both stocks and bonds rallied during the quarter in response to a markedly more dovish tone from the U.S. Federal Reserve and other central banks. After raising rates for the ninth time in mid-December and signaling the likely need for additional increases in 2019, the Federal Reserve quickly moderated its stance at year-end in an effort to calm nervous markets. The Fed maintained this patient approach throughout the first quarter, noting a downshift in economic data both in the U.S. and abroad. Other countries followed suit. The European Central Bank delayed the possibility of any rate increase until late 2019, the Bank of England steadfastly remained on hold with its current low policy rate, and China implemented easier credit and additional fiscal stimulus measures. All of these moves are designed to help sustain economic growth and inflation as the current expansion approaches its tenth year.

In the U.S., the change in policy stance has left many investors seeking the safety of bonds amid heightened recession fears. Fund flow data bears this out, as inflows into bonds and cash have significantly outpaced flows to stocks and other asset classes YTD. Demand for bonds and a lower outlook for both growth and inflation led to a brief (so far) inversion between the 10-year and 3-month treasuries late in the quarter. The 10-year treasury yield fell as much as 5 basis points below the 3-month treasury before recovering to a positive spread a week later. The spread between the 10-year and 2-year rates has not yet inverted.

Historically, yield curve inversions—defined as periods when the yield on shorter-term rates is greater than the yield on longer-term rates—have been among the most reliable leading indicators of a recession. The relationship between an inverted yield curve and a recession primarily relates to bank lending. With a normal curve, banks can earn a positive spread between borrowing at short-term rates and lending at long term rates. When short-term rates are above long-term rates, however, the profitability of loans diminishes and loan volume declines. Lower loan volume eventually leads to lower economic growth and recession.

It should be noted that risk assets can perform well even after the yield curve inverts. During the last three economic cycles, stocks have gained an average of 36% from the date of the initial inversion to the peak. These gains have occurred over an average period of almost two years.

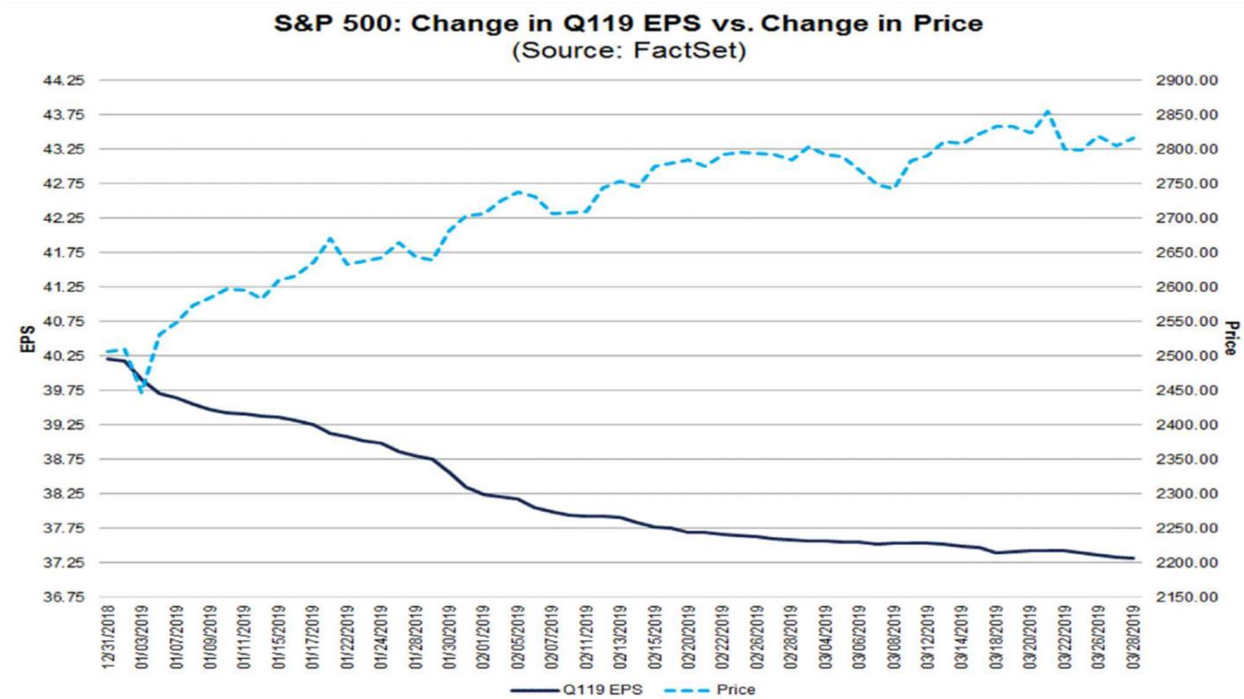
Dates of Yield Curve Inversion*	Months until the recession	Months until the stock market peaked
Start 12/88 End 3/90*	19 months 7/90- 3/91	17 Months Peak 5/90 (+36.7%), Low 10/90 (-14.7%)
Start 5/98 End 12/00*	34 months 3/01- 11/01	27 Months Peak 8/00 (+43.2%), Low 9/02 (-45%)
Start 12/05 End 06/07*	24 months 12/07- 6/09	22 Months Peak 10/07 (+28.4%), Low 2/09 (-51%)

Source: Blackrock, Morningstar, National Bureau of Economic Research

Perceived progress on U.S.-China trade discussions also helped boost prices for risk assets in the quarter. The two sides have engaged in regular talks this year in an effort to come to terms over trade and intellectual property practices, industrial subsidies, and market access. While few details have been released to the public, Presidential tweets and other generic commentary generally remain upbeat. Moreover, the original March deadline was extended indefinitely by the President in recognition of the progress made to date.

While the terms of the deal are still subject to negotiation in the coming weeks or months, China does seem prepared to directly reduce the existing trade imbalance between the two countries through a commitment to increased purchases of U.S. goods, including soybeans and energy, over a multi-year timeframe. Beijing has also taken early steps to open up more imports, including lowering tariffs on imported cars and allowing foreign companies in some sectors to own a majority of their operations in China. While these actions represent steps in the right direction, the real challenge is likely to be Chinese concessions on structural reform demands related to intellectual property protection and forced technology transfer. Both sides should be motivated to get a deal done in the near term, for economic as well as political reasons. This is something we will be watching closely.

Most risk assets were priced attractively following the fourth quarter sell-off in markets, adding fuel to the significant first quarter rally. Not surprisingly, asset valuations are now less compelling versus year-end. The S&P 500, for example, ended 2018 with a forward PE ratio of 14.4x. At quarter-end, that ratio stood a full two points higher at 16.4x. While this level is only slightly above the 25-year average, it has been the result of both higher prices and lower earnings estimates. Notably, analysts revised down first quarter earnings growth estimates by over seven percentage points during the quarter. Full year estimates remain positive, but have likewise seen large cuts. Fading tax benefits, tough comparisons, and potential margin pressure are the biggest drivers of the slowdown. While the deceleration in earnings growth may be largely priced-in to stocks, the sharp move up in prices during the first quarter will likely need to be supported by better than expected results going forward. If earnings reports and management guidance disappoint, then the current gap between price and earnings presents obvious downside risk for stock prices.



Source: Factset Earnings Insight, March 29, 2019

Looking forward, we remain cognizant of late cycle risks. Slowing economic and earnings growth, rising asset prices, an inverted yield curve, and trade uncertainty are all valid concerns that raise the potential for recession. Conversely, strong jobs data, accommodative monetary policy, and reasonable inflation levels support the potential for an extended cycle. Regardless of the near term outcome for markets, we remain committed to a thoughtful, well-diversified portfolio of high quality assets that provides opportunities for solid risk-adjusted returns over time.

The Private Capital Management Team

By the numbers…

Index	YTD
S&P 500	13.65%
Dow Jones Industrial Average	11.81%
Russell 2000	14.58%
MSCI EAFE	9.98%
MSCI Emerging Markets	9.91%
Barclay's US Aggregate Bond	2.94%
Bloomberg Commodity	6.32%

Source: Morningstar as of 3/31/2019