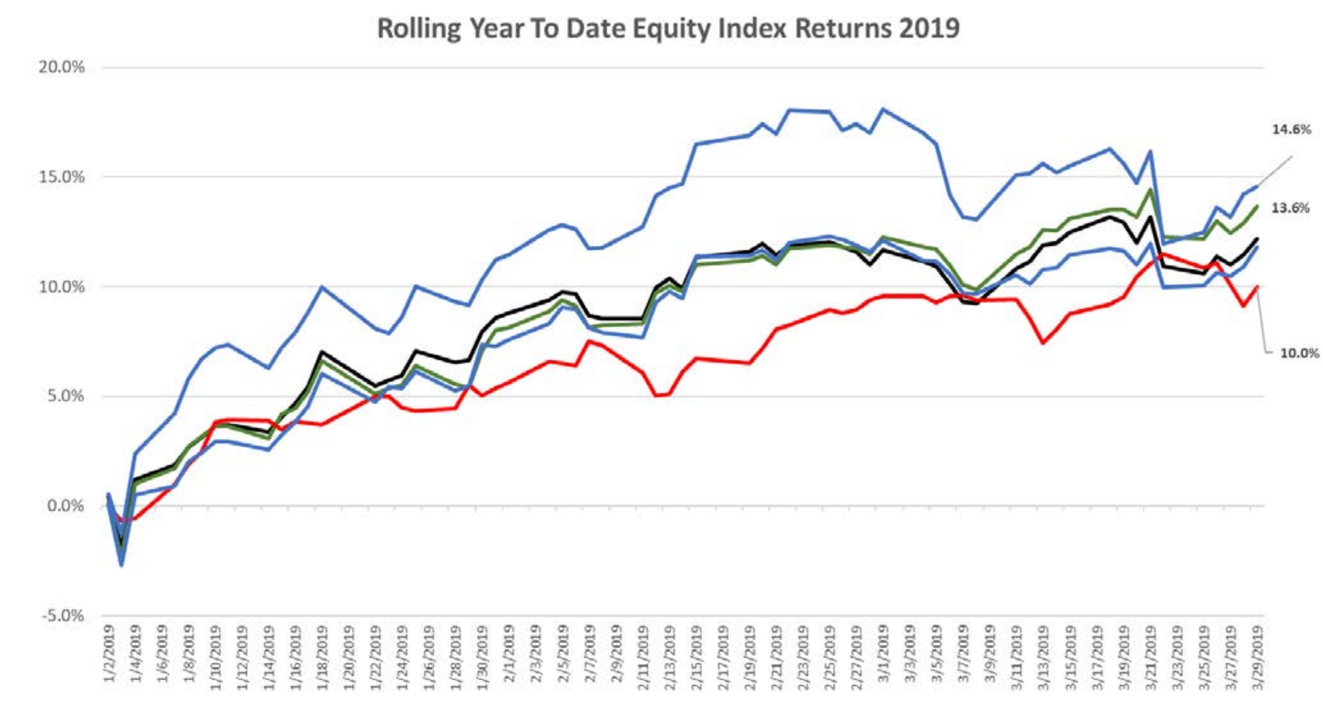
TURTLE CREEK

Quarterly Update – First Quarter 2019

Dear Turtle Creek Client,

Global stock markets rebounded sharply through the first few months of 2019, recouping most of the steep declines that marked the end of the previous year. Market performance ended the first-quarter with a distinct wobble, however, as both the U.S. and international economies registered slowing economic numbers. Global bond markets saw rates drop sharply due to poor economic figures and the yield curve on U.S. Treasuries once again flattened and inverted in certain sections.

Bond and stock markets sent distinct and conflicting messages during the quarter. The rapid appreciation in stock values signaled future growth and made the volatile performance of 2018 appear unjustified. Fixed Income investors, on the other hand, reacted swiftly to slowing economic datapoints by buying bonds aggressively and pushing down interest rates, a signal of economic weakness ahead. The risks and rewards of your portfolio should be considered carefully in light of these conflicting signals.

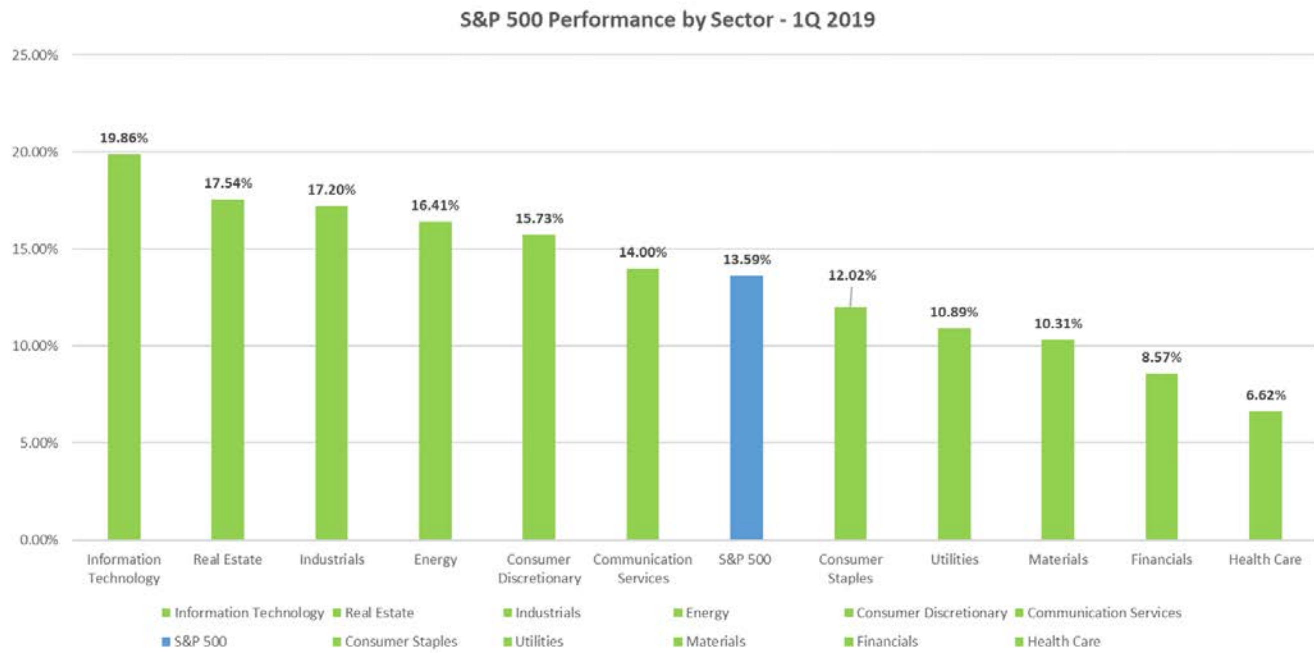


Source: Bloomberg

<u>Factors in Stock Performance</u>

The most beaten-down sectors of the economy lead markets higher during the first quarter. Real Estate firms which had reeled throughout 2018 in the face of escalating financing costs outperformed the market handily. Technology, Consumer Discretionary, Industrial, and Energy businesses all had declined significantly in 2018 due to concerns over global growth and trade tensions but outperformed the broader market to start the year.

The few laggard sectors were defensive groups such as Health Care, Consumer Staples, and Utility companies. Financial stocks, normally a beneficiary of rising markets, also posted mixed results due to interest rate shifts that pressure bank profitability and escalating claims costs that hurt insurance firms. Stock market performance in general reflected a distinct return to risk-taking and a shift away from defensive positioning by investors.



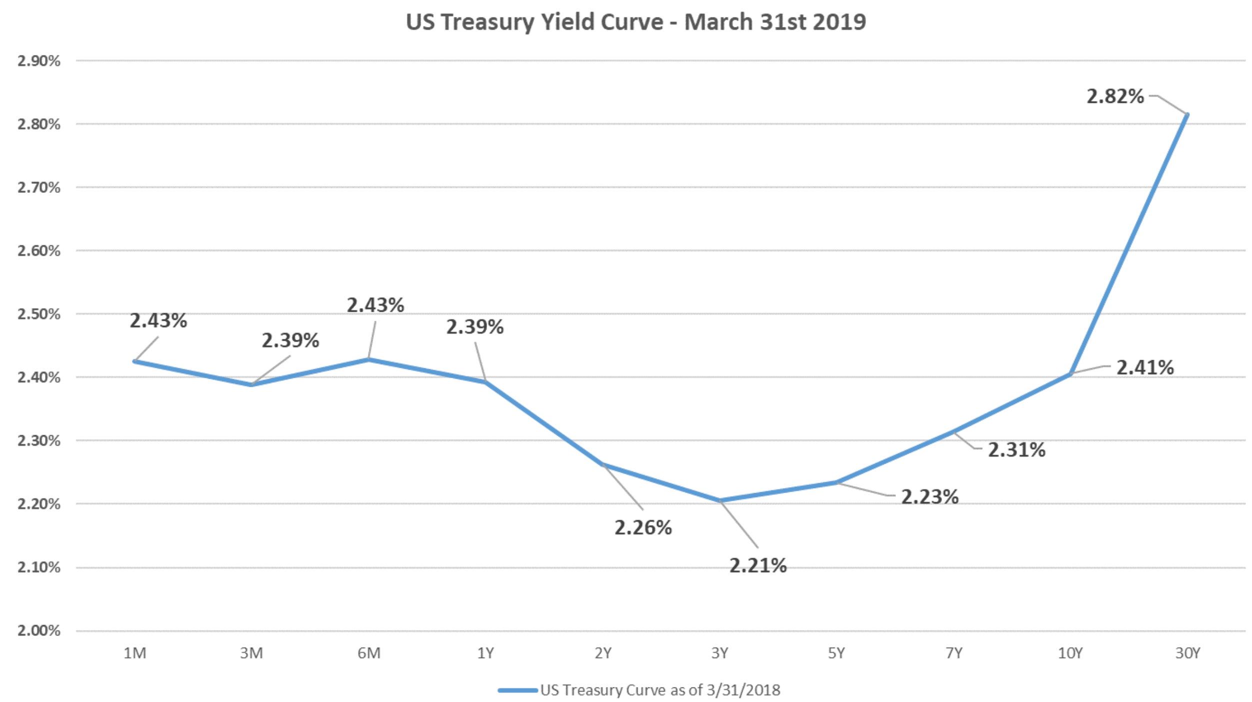
Source: Bloomberg

Fixed Income Markets

Economic datapoints slowed in the first quarter and bond yields shifted downwards in response. In the U.S., rising borrowing costs translated to noticeable declines in mortgage applications and home sales. The long-pondered impact of the Trump administration's tariffs materialized as exports declined and manufacturing demand sagged. The U.S. consumer, reeling from the recent market sell-off and the uncertainty of a government shutdown, largely stayed home. Retail sales declined during the quarter and consumer confidence dipped in the latest surveys. The news was more severe in international markets. Europe's leading economies flirted with recession and key emerging markets such as China saw steep declines in key economic indicators.

These data-points represent a quick reversal in the momentum of the U.S. Economy. The potential for more rapid economic expansion and corresponding inflation had justified the Federal Reserve Bank planned rate hikes and expectations that government bond yields would rise significantly in the years ahead. Acknowledging the mounting costs of its policies, the Federal Reserve quickly reversed its plan for further rate increases and the unwinding of crisis era stimulus measures. International Central Banks like the ECB, The Bank of Japan, and the Peoples Bank of China all returned to aggressive economic stimulus at the same time.

The U.S. Treasury Yield Curve, which had been solidly upward sloping as recently as mid-December, either flattened or inverted throughout the first quarter and rates at most points along the curve dropped a quarter percentage point or more. In contrast to equities, the bond market predicted economic weakness ahead.



Source: Bloomberg

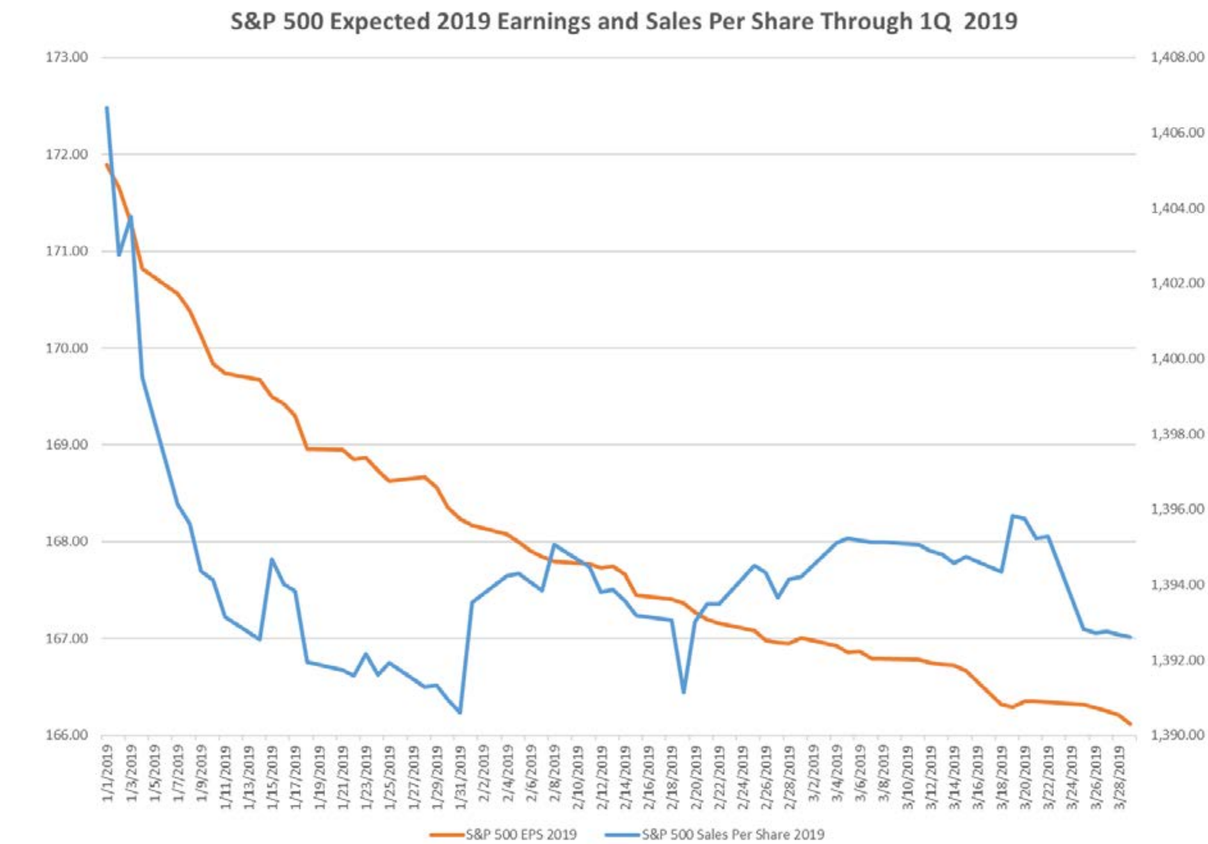
Reconciling Dueling Market Signals

While credit and equity markets appear to contradict one another, it is possible to reconcile their messages. Bond markets are primarily reacting to shifting Federal Reserve policy that could head off the economic slowdown that spooked the stock market so badly. It is also reacting to other factors like offshore demand for U.S. bonds and the curious lack of inflation in our economy.

While Americans gripe about earning just a few percentage points on safe investments, Japanese and European investors must grapple with zero or even negative rates on safe bonds in their home countries. These investors rationally re-direct their savings abroad to the U.S. to earn higher yields. This excess demand from international investors, dubbed the "Global Savings Glut" by former Fed Chairman Ben Bernanke, pushes up demand U.S. debt instruments and suppresses yields in the process.

The cost of low rate regimes like the current one has historically been excess inflation. Despite significant concern from a multitude of economists and investors going back a decade, the historically low interest rates of the last ten years have not pushed inflation from its current moribund levels. Economists have attempted to explain this through the "Amazon Effect" (dropping retail prices through online commerce), slowing demographics, and a multitude of other theories. Whatever the reason, bond markets don't see inflation any time soon nor the need for higher rates to combat that trend.

The steep stock market rebound in the first quarter is an admission that the "flash bear market" during the 4th quarter of 2018 reflected a far too pessimistic forecast for corporate earnings and economic growth. The market correctly sniffed out the negative impact of Federal Reserve rate hikes and Trump Administration's trade wars on corporate earnings, evidenced by steadily declining 2019 corporate profit forecasts through the first few months of the year. These profit outlooks stabilized as the quarter came to close, however, and corporate sales expectations actually improved through the end of March. Datapoints indicate the economy hit a rough patch that has since stabilized and is not heading towards a recession over the near term. Stock values rebounded on this news.



Source: Bloomberg

The Presidential Election Cycle

The Presidential election of 2020 is now just 19 short months away and candidates are already wooing voters with promises of big change. The traditional whipping boys of presidential platforms are the Health Care, Energy, and Financial Services sectors and they will no doubt be the focus of potential government-enforced change in the months ahead. Regulation of credit providers, proposals to break up large banks, carbon taxes on energy producers, and curtailment of energy exploration are sure to be featured in the platforms of various candidates.

The Health Care sector looks to receive the greatest scrutiny as the Republicans have joined with the Democrats in proposing government remedies to the spiraling cost of health care. Democratic proposals have ranged from re-enforcement of the now scaled back Obamacare structures to the full nationalization of all healthcare costs under a "Single-Payer" structure that would eliminate private health insurance. Republicans have been less ambitious, focusing on fining and regulating insurance middle men and introducing more competition in the biotechnology and prescription drug market.

Voters, no matter their political slant, have historically never been able to steer around the sheer impracticality of quick and wholesale change in the trillion-dollar Health Care industry. The punishing implications for budget deficit and the need for significantly higher taxes embedded in single payer proposals also imply a near zero likelihood of implementation. This has historically made the outcomes to these presidential election cycles to be more of the same old Health Care industry. This will likely be the case again for this election cycle, but the stock prices of Health Care providers and to a lesser extent banks and energy companies will encounter a very bumpy ride through this process.

Portfolio Positioning

The risks and rewards related to your investments seem evenly balanced at the moment. The government-induced headwinds plaguing the stock market appear to be in retreat. The accommodative shift by the Federal Reserve was accompanied a wholesale push by the Trump administration to strike deals with key trading partners in Europe and China. Current year sales and earnings forecasts for S&P 500 companies have stabilized and companies still expect to expand profits in the next several years. Spreads on riskier corporate debt have tightened and unemployment remains at historic lows. Consumer confidence and retail spending showed some pressure but remain robust. All of these traditional leading indicators signal ongoing economic expansion.

The optimistic rebound has to be matched by to improved fundamentals, however. Earnings growth through the remainder of year is a critical variable and recent gains will prove only temporary should corporate profits growth fail to materialize. Over the longer-term, the aging economic cycle remains an ongoing risk. There will be a recession eventually, but the current economic backdrop implies only a remote chance of one over the near term.

In this environment, equities should continue to drive the returns in your portfolio. The collapse in yields on quality fixed income instruments has resurrected the TINA effect, namely that “There Is No Alternative” to quality stocks featuring earnings growth and reasonable valuations.

We appreciate the ongoing trust your place in our firm. Please call or write with any questions.

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