Sterling Advisors

REVIEW & OUTLOOK – 1Q2019

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available from Sterling Advisors.

Closing Prices 3/31/2019	
DJIA	25,928.68
S&P 500 Index	2,834.40
Barclays Intermediate U.S. Govt.	2,142.11
Russell 1000 Value	1,521.18
NASDAQ	7,729.32
U.S. Treasury Bond	
Current Yield 10-year Bond	2.405%
Current Yield 30-year Bond	2.814%

Source: Bloomberg

The Market Environment

U.S. stocks staged a strong recovery in early 2019, erasing the losses experienced in December and leaving major indices within striking distance of record highs. Although the pace of corporate earnings growth continues to slow both here and abroad, investors were emboldened by earnings results that exceeded lowered expectations and the Federal Reserve's unexpected shift to a more accommodative monetary policy. Large Cap U.S. stocks, represented by the S&P 500 Index, rose 13.65% in Q1 – marking their strongest quarterly gain in a decade. Bonds also began the year on strong footing, with the Barclay's U.S. Aggregate Index advancing 2.94%.

During the March 19 Federal Open Market Committee (FOMC) meeting, Federal Reserve Chair Jerome Powell kept interest rates unchanged and stated no further increases would occur this year. Additionally, the Fed's balance sheet reduction plan has been paused as part of a more patient approach. Given that Powell had spoken hawkishly as recently as October, citing the need for multiple interest rate hikes in 2019, his March comments were contrary to expectations and did not contain unequivocal language that would leave the door open for another policy pivot this year. Financial markets reacted with a brief bout of volatility, as we often see when unexpected macro events are digested. The most dramatic result was a sharp decline in bond yields, causing a significant flattening of the U.S. Treasury yield curve, a phenomenon that typically signals a slowing economy on the horizon. With further quantitative tightening off the table for now, a bullish case can be made for reaccelerating earnings growth and a resumption of the decade-long bull market in stocks. On the other hand, we are mindful of the lingering impact of nine interest rate increases over the last three years, which may constrict liquidity and economic growth throughout 2019.

Turning to the internals of the stock market, many of the hardest hit areas in the December selloff notched the strongest gains in the first quarter. Smaller companies outperformed large, growth bested value, and volatility levels eased dramatically. In addition to leadership from the tech-heavy Nasdaq Composite Index, sectors with defensive characteristics such as Utilities, Consumer Staples and Real Estate reasserted themselves. It's unusual to see strong performance from cyclical technology stocks at the same time as defensive, high dividend-yielding issues. We see this result as a representation of investors' desire for growth and yield in a global market environment that has become increasingly starved for sources of both.

Large Cap Value Strategy

The Large Cap Value Strategy participated in the strong equity market gains experienced in the first quarter, but fell just short of matching the 11.95% advance of its benchmark, the Russell 1000 Value Index. The Strategy's shortfall was mainly due to the drag on performance created by holding an average of 7.2% cash in a rising stock market. Interestingly, cash provided a noticeable boost to performance during the decline of late 2018, while also reducing volatility, so we can see its impact is equally significant during periods of market turmoil. Growth stocks continued to outpace value stocks, as they did in 2018, fueled by investors' renewed appetite for risk and a more accommodative central bank policy than previously anticipated. While the Russell 1000 Value's 11.19% advance in Q1 marks its strongest start in years, it paled in comparison to the Russell 1000 Growth Index's 15.71% Q1 total return. The good news is this preference for growth over value continues to create attractive opportunities in value-oriented equities we had previously viewed as fully valued. Our goal is to identify relative value by analyzing individual companies vs. their peers and apply those findings to the Strategy, with a long-term view. Although the stock market as a whole is trading near its historical average price-to-earnings ratio in the face of slowing earnings growth, we remain optimistic that our relative value strategy can produce competitive risk-adjusted returns in today's late-cycle environment.

Turning to a deeper analysis of the relative performance in the first quarter, individual security selection decisions accounted for the majority of the 1.25% underperformance of the Large Cap Value Strategy vs. its benchmark. Our Healthcare holdings were the most notable detractors, partially due to their traditionally defensive qualities being shunned in a pro-cyclical market environment, but also due to more company specific concerns about pharmaceutical pricing, the pharmacy benefit management business, and mega-mergers in the managed care space. Four of our eight Healthcare holdings showed declines in the first quarter, and it was the companies with the least exposure to manufacturing and distribution of drugs that fared the best. The Materials sector was the other area of noticeable selection weakness, with our two holdings posting flat returns in a sector that posted an average return of 9.37% in Q1. We have since eliminated one Materials holding, and we remain optimistic about the prospects of the second, a leading global chemical company in the process of breaking into three more focused pieces to unlock shareholder value. On the other hand, our investment team and clients enjoyed selection success in several sectors, including Financial Services, by far the largest sector in the Strategy's benchmark index, at a 23.5% weighting. Our holdings, which include large money center banks, a major insurance company and a global investment bank, produced a total return of 11.8% vs. the 8.4% of the benchmark index's Financials. We believe this was due to our preference for companies possessing strong balance sheets, proven management teams and growing dividends. Selection within the Consumer Discretionary sector also provided a tailwind to performance as our sole position outperformed its peers by a wide margin, due in part to its deep-discount retail model and growing online presence, making its earnings more defensible vs. Amazon.com, the dominant retail disruptor of our time.

Sector allocation relative performance during the quarter is reflective of a rising stock market with cyclical "risk-on" sectors leading the way higher. As discussed above, the cash allocation was the main allocation drag, accounting for over two thirds of the Strategy's total underperformance in Q1. Ex-cash, sector allocation decisions provided a healthy boost to performance. The Strategy's returns were helped by overweight positions vs. the benchmark in Technology, Industrials, and its underweight stance in Financial Services. Our below benchmark exposure to the Energy sector and overweight in the Healthcare area weighed on relative performance from an allocation perspective. We continue to adjust the Strategy's sector allocation in accordance with our top-down view of the global macroeconomic environment, being careful to remain properly diversified while expressing our view.

Large Cap Core Strategy

The stock markets strongest advance since the start of 2019 transformed investor sentiment from fearful and nervous at the end of 2018, to fearless and calm in just a few short months. We continue to see evidence of strong employment and production levels, rising wage growth, the acknowledgement from the Federal Reserve that they will be patient with further monetary tightening and constructive headlines on trade negotiations with China as catalysts for the markets rally. We will see if this late cycle rally in the first quarter of 2019 is powerful enough to be sustained despite slowing fundamentals.

Even with slowing economic growth, the world is not coming to an end. Markets and businesses will figure out how to survive. New businesses will keep launching. We will continue to need food, shelter, transportation, communication and everything else we think as normal. Everyone needs medical attention and the potential for living longer will bring investment opportunities everywhere. Industries are constantly being disrupted. The challenge will be finding them, getting access and paying a fair price for future earnings growth projections.

How much do you pay for each dollar of earnings? Clearly more now than just a few short months ago. Moving forward, the markets will be tested as a looming pullback in corporate profit growth may set up a fresh bout of volatility. Investors have lived through the period of quantitative easing and are now leaving the era of fiscal austerity. When that happens, real interest rates go up, which means investors need to be cognizant of the amount of capital that has been concentrated in certain types of investments. Investor's portfolios may have to shift towards quality, safety and value and away from higher growth and indebted companies. Debt that is not self-funding is future consumption brought forward. As a result, debt and the amount of debt in the world now might be a drag on future growth. Will ballooning corporate debt, student debt, and government debt precipitate a liquidity crisis, create havoc, and unintended consequences across various markets? Hopefully not. However, just like during the credit crisis of 2008, global asset classes are highly correlated in a crisis. We will continue to invest in the highest quality investments in our portfolios.

From a sector standpoint, we continue to underweight the Consumer and question ability to keeping spending like they have these past several years. Also, we have reduced Technology. We remain overweight Healthcare and Communications and have equal weight positions in Industrials, Financials and Energy. We are looking for companies that have pricing power, very large barriers to entry and high switching costs. Additionally, we like stocks not adversely affected by a rise in interest rates. We like products and services the world will need in the future to streamline operations, upgrade to a more digital world, improve efficiency and improve health.

Looking forward, our team plans to be flexible. Trading opportunistically and continually evaluating the market based on risk vs. reward. On any given day, the sheer number of investor behaviors, economic factors and business developments defy anyone's ability to fully grasp what is going on and why. That's why many investors follow the crowd behavior and you see herd mentality, a basic condition of speculation. Our team of experienced investment professionals develop, monitor and follow a game plan of action that does not purport to tell us what to do moment by moment, but rather leads us to successfully navigate the most challenging market tumult.

Intermediate Fixed Income Strategy

From a fixed income standpoint, we continue to remain constructive on the economy & financial markets in general. There has been a strong bid for fixed income issues and U.S. sovereign yield as the yield curve inverted and longer dated issues appreciated, aided by the reversal in Japanese and European yields below zero. At the same time, inflation expectations have drifted lower as investors have priced out any probability of Fed-rate hikes for 2019.

During the March 19th FOMC meeting, Federal Reserve Chair Jerome Powell kept interest rates unchanged and stated that no further increases would occur this year. Additionally, the Fed's balance sheet reduction plan has been paused as part of a more patient approach. Given that Powell had spoken hawkishly as recently as October, citing the need for multiple interest rate hikes in 2019, his March comments were contrary to expectations and did not contain unequivocal language that would leave the door open for another policy pivot this year. Financial markets reacted with a brief bout of volatility, as we often see when unexpected macro events are digested. The most dramatic result was a sharp decline in bond yields, causing a significant flattening of the U.S. Treasury yield curve, a phenomenon that typically signals a slowing economy on the horizon. With further quantitative tightening off the table for now, a bullish case can be made for re-accelerating growth. Nevertheless, we have taken note of the inversion of the yield curve but will not overreact to it, as it has historically sounded recession alarm too early. On the other hand, we are mindful of the lingering impact of nine interest rate increases over the last three years, which may constrict liquidity and economic growth throughout 2019. We continue to interpret the domestic economic data as indicative of being late in the cycle, requiring careful risk management and a close eye on asset allocation. Slowing growth, trade/tariff disputes with China, and falling bond yields are risk factors we are closely monitoring as we shape our investment policy.

The search for yield and the decline in major sovereign yields around the world should keep U.S. fixed income issues reasonably well bid. Thus, we prefer to not incorporate too much pessimism with regard to bonds at the moment. Tactically, our position remains unchanged with a quality bent in respect, of the late cycle, and slightly short to neutral duration relative to the benchmark.

Outlook

As we reflect on the first quarter and shape our outlook for the balance of 2019, it's apparent that asset prices and sentiment have increased dramatically in a short period of time. The key question is whether the sharp recovery in financial markets is justified given the existing macroeconomic landscape. Looking back at the key risks to markets we highlighted in our last quarterly piece, we pointed to a policy error by the Federal Reserve as a possible hindrance to global growth or catalyst for a recessionary period. We now see this as a less imminent threat given the Fed's recent about-face to a far more accommodative stance. Weakness in global economies, specifically Europe and Emerging Markets, was another prominent risk factor that has partially abated in recent months. Europe continues to be fraught with uncertainty surrounding Brexit, with several EU nations' economies slowing meaningfully with negative sovereign bond yields. On the other hand, Emerging Markets have shown signs of improving economic data and strong stock market performance. China, viewed as a key proxy for global growth prospects, has seen its stock market rise to 23.93% in Q1 in response to better economic data and increased enthusiasm from investors. These rising asset prices across the globe leads us to another potential negative influence that has subsided, the impact of a negative "wealth effect" from investors reigning in spending as a behavioral response to seeing their net worth decrease. With these positive changes in mind, our Investment Team continues to monitor the following risks, which have the potential to disrupt financial markets:

- Escalation of trade and tariff tensions with China
- Corporate debt overhang
- Lagging impact of interest rate hikes on liquidity
- U.S. Dollar strength hurting corporate earnings
- Sharp increase in IPO activity creating oversupply
- Slowing (but positive) earnings growth

Our view is the global macro-economic landscape has de-risked modestly since the growth scare that sent markets reeling in late 2018. However, this has been adequately discounted in the form of higher asset prices, leading us to maintain a cautiously optimistic outlook for the balance of the year. The U.S. economy is enjoying low inflation, low interest rates, extremely low unemployment and a benign central bank policy – conditions that have historically fostered periods of above average stock valuations. Given the high likelihood the U.S. economy is late in the cycle as we enter year 11 of the current bull market, we think it is imperative that investors avoid overpaying for securities with unreasonable valuations, especially considering the pace of corporate earnings growth has begun to slow. Our top-down view warrants healthy allocations to areas of the stock market that can produce consistent earnings and dividends in a more tepid growth environment. We favor businesses with proven management teams that have not overleveraged during the prior decade of near-zero interest rates. We continue to find equities that display the characteristics needed to build long-term wealth for clients. As always, your fixed-income investments will be of high credit quality and are selected to provide the diversification needed to match your risk tolerance and help achieve your financial goals. This quality-first approach is a strategy that can provide competitive returns with less volatility, as we protect and grow your wealth.

In conclusion, the stock market rally in the first quarter corrected the oversold conditions of three months ago and has rapidly repaired investors' confidence. We continue to interpret the domestic economic data as indicative of being late in the cycle, requiring careful risk management and a close eye on asset allocation. Although the torrid pace of the U.S. stock market's advance in the first quarter is extremely unlikely to continue uninterrupted, we remain constructive that equity markets can move modestly higher in 2019, providing us with continued opportunities to apply our patient and disciplined investment approach on your behalf.

Sources: Bloomberg and FactSet

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.