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Firm Inception 08/03/10

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Quarter in Review

The Markets

The Lord taketh away and sometimes he giveth back, or at least that is what looked like it happened in Q1. Equity Markets erased the majority of losses in Q4 2018. The bulk of the gains occurred in January and faded or started to reverse course in March. **Large cap and small cap value stocks were up about 12%** whereas **mid-cap value stocks were up about 14%**. Even **international stocks** showed recovery with **developed value markets up 8% while emerging large cap names were up over 10%**. Equities weren't alone as Fixed Income posted positive results as well. With the Fed turning dovish and taking an interest rate hike pause, **long bonds rallied close to 6.5%** for the quarter only beaten by **High Yield at 8%**. With inflation also pausing in Q1, Tips should have underperformed, but they still returned over 3% for the quarter. The alternative sectors, **real estate and commodities also performed well, up over 16% and close to 10%** respectively as oil rallied from \$48 to over \$60 in the first three months of the year.

In domestic news, the government shutdown over border security that started on December 22nd ended on January 25, 2019, becoming the longest government shut down recorded at 35 days. The CBO estimates that the government lost about \$5 billion, whereas the street believes the effect was somewhere between 20 to 40 bps or 0.2 to 0.4% of lost GDP for Q1 (somewhere between \$40 to \$80 billion). With estimates for Q1 real GDP being reported at 3.2% the overall affect looks minimal. The Federal Reserve altered course dramatically in Q1, removing the estimated two rate hikes from their dot plots, and even going as far as to state that the next move could come in 2020, and it could be a hike OR a cut. At the end of January, the US formally charged Huawei with stealing trade secrets and committing bank fraud by violating sanctions against doing business with Iran. The president declared a state of emergency to fund the border wall and has been met with legal challenges from both the private and public sectors. Last but not least, special counsel Robert Mueller's 22-month inquiry concluded that there was no collusion with Russia during the 2016 campaign.

Internationally, US trade talks began on January 4th with China, and, as of this write up, have still not concluded. Robert Lighthizer and Steve Mnuchin met most recently with Vice Premier Liu He again on April 30th still with significant issues to be resolved. China promised its people large scale tax cuts to help with the ailing economy but decided against quantitative easing. But in early March China's stocks had taken a plunge and China lowered its growth forecast to somewhere between 6 and 6.5% this year. With German industrial output slowing and Ford cutting thousands of jobs in Europe, the ECB put any policy changes on hold. The Spanish Prime minister called a



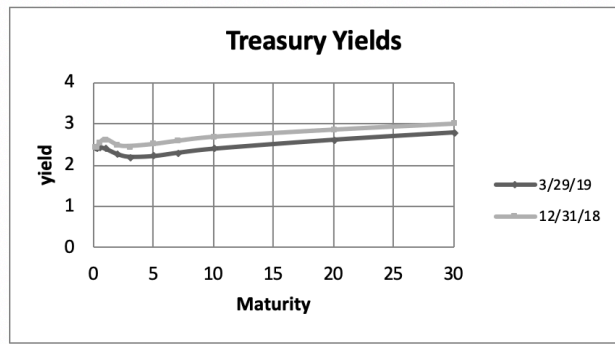
snap election after parliament failed to back the budget; this is the third election in four years. India and Pakistan got into it again in late February after India launched an air-strike at a terrorist camp in Pakistan. Pakistan shot down one of India's military aircraft and captured its pilot who was later released on March 1st. In South America the struggle still continues in Venezuela as now two people, Juan Guaido and Nicolas Maduro, claim the presidency, the former being recognized by 54 international bodies including the United States. Also, at the end of January, a Vale dam collapse took the lives of over 200 people; the investigation is still ongoing. This is the second dam disaster under Vale's watch since 2015. The US and North Korean denuclearization summit at the end of February ended quickly after the two sides couldn't agree on a deal. Since then Kim Jong-Un has visited Russia which now supports them in the process. In the middle of March two terrorist attacks in New Zealand left 50 dead at mosques in Christchurch. Moving to Africa, a second Boeing 737 Max flight crashed, this time in Ethiopia. The crash was linked to the same software malfunction that took down the Indonesian Lion Air in October of 2018. The 737 Max was grounded shortly afterward by dozens of countries to include the United States. Lastly, and of little surprise to anyone, the UK failed to leave the EU on 03/29/19, having rejected thrice PM Theresa Mays much negotiated deal. The new Brexit deadline has been set to October 31, 2019 – for now...

Interest Rates

The Federal Reserve drastically changed its position from the December 2018 and January 2019 meeting, leaving little doubt that market volatility in the fourth quarter affected their decision making. Another two rate hikes in 2019 were expected prior to the January meeting, and now the Fed isn't expected to move until 2020. Looking at the below yield curve, from the 5 year to the 30 it looks like we are now pricing in a 25bps cut to interest rates. Having met their unemployment mandate, the Fed concentration is centered on inflation which by using PCE or CPI, has not been above 2% since December. The curve was also affected by the Fed stating their end to balance sheet reduction. Once believed to end somewhere near 2.5 Trillion, the Fed will now start tapering its balance sheet runoff in May 2019 and end completely in September 2019. This should put us somewhere higher than 3.5 Trillion on the balance sheet. Beginning October, the Fed will reinvest proceeds from MBS securities back into Treasuries, and it appears that will be across the curve, not just in shorter duration instruments. Last quarter I thought that slowing the rate hike increases and not reducing the balance sheet was a bad idea, and after the recent report in GDP I still feel this way. It looks like the Fed is becoming increasingly sensitive to data points that get revised as part of their decision function instead of having a forward-looking plan. The recent Q1 GDP estimate of 3.2% confirms what many believed was an overreaction from the Fed on limited data, and that they could be walking back some of the comments made in the March meeting going forward.



Years	3/29/19	12/31/18	Difference
0.08	2.43	2.44	-0.01
0.24	2.4	2.45	-0.05
0.5	2.44	2.56	-0.12
1	2.4	2.63	-0.23
2	2.27	2.48	-0.21
3	2.21	2.46	-0.25
5	2.23	2.51	-0.28
7	2.31	2.59	-0.28
10	2.41	2.69	-0.28
20	2.63	2.87	-0.24
30	2.81	3.02	-0.21



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has continued to drop over the quarter from 4.55% to 4.06%. 15-year conforming balance moved down from 4.01% to 3.57%. The Mortgage Bankers Association information as of 04/24/19 showed the 30-year conforming balance FRM is down from 4.75% with .44 points in January to 4.46% with points staying the same. Jumbos loans were also down from 4.59% with .25 pts to 4.35% with points staying the same. 15-year conforming balance FRMs were also down from 4.12% with .53 points to 3.87 with .44 points.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.9 for March 2019 (revised 111.4 for December 2018). Since September of last year, the index has almost stood still with only half of the indicators being additive to the index. March's numbers show almost all indicators providing additive values but three of those numbers are always estimates or "statistical imputations". They are manufacturers' new orders; consumer goods and materials, manufacturers', new orders; nondefense capital goods excluding aircraft, and building permits. Those three have been detractors almost as frequently as they have been additive to the index since September and are the reason for the revisions. With that said the monthly advance report for Manufacturers' shipments, inventories and orders showed durables were up, but permits were down. The take away here is that there doesn't seem to be any glaring evidence of a slowdown, but more of the status quo.

Jobs

At the time of this write up, **nonfarm payrolls** posted an increase of 196,000 jobs for March (consensus was 177k). Last year the average monthly gain in payrolls was about 223k, but in 2019 the average has been about 180k. This is definitely indicative of where jobs gains should be at the tail end of an expansion. It isn't a sign of impending recession, but a normal rate given where we are in the cycle. Average hourly earnings are still up 3.2% (same as Q4



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2018), but it hasn't bled into inflation yet. Labor force participation rate is hovering around the 63 level keeping the unemployment rate from drifting much lower, but the expectation is it will as the participation rate stays put for the year. Temporary help services have started to drift lower but still up year over year. They are good leading indicator when the job market begins to soften. It did go negative for the second half of 2016 but reversed its course in 2017. The median duration of unemployment started to tick back up to 9.6 since reaching its lowest level of 8.9 since the recession. The ISM survey for manufacturing jobs averaged 55 for the quarter, off from the 57 number from Q4 2018, which was off from Q3 2018. Only about 4k manufacturing jobs were estimated to be created during the first quarter of this year. This wasn't a fantastic or a terrible quarter for jobs, just a good one.

Industrial production

Q4 Industrial production was down -0.33%, significantly lower than Q4 and the previous year. January saw the worst of the decline, but February and March weren't a ton better, meaning that for the quarter this isn't a good number. Given the decline in employment and weekly hours, this wasn't a huge surprise, but I will definitely be watching these numbers closely over the coming months. The largest major market group decline was consumer durables down 8.4% for the quarter. Checking personal consumption expenditures against these numbers shows a definite pull back with it being only up 3.04% over the previous 12 months compared with an average annual increase of 5.72% since the recession ended. There may also be a pull back from durable expenditures since the gains from the tax law change have worked its way through the system. Of all the market groups though, clothing performed the worst down 25.2% for the quarter, and down 14.4% from a year ago. IP was up 3.6% and 4.0% during 2017 and 2018, although a slowdown is expected, the loss in Q1 reduced the LTM to 2.8%. This wasn't a good IP report.

Housing

Single-family new home sale were 692,000 units per year as of March 2019, compared with a 2018 average of 617,000. This pickup in home sales pushed down the monthly supply from a high of 7.4 in December to 6.0 in March. **Existing home sales have been on a pretty slow but steady decline though since 2018.** Granted they have fluctuated up and down over the past 12 months, but the trend is definitely south. The first quarter wasn't any different with January showing an annual 5,210,000 existing homes sold over the last twelve months. In February the S&P CoreLogic Cash-Shiller (you think they would shorten that name by now) 20-city index rose only 0.2%, and was 3.0% higher than a year ago. Boston, Charlotte, Cleveland and Minneapolis were all down for the month, but the west coast cities like Los Angeles, San Diego, and San Francisco grew at a sub 2% rate for the past twelve months. With the mortgage rates coming down this bodes well for home sales, but the 2017 tax changes have seemed to hurt the states with high home prices, and those with high tax rates and high mortgage interest that isn't fully deductible anymore.



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The Consumers

The **Conference Board's consumer confidence index stood at 124.2 as of March 2019**. The first quarter numbers are definitely off from this past fall's numbers, and a good amount of that was due to the government shutdown and trade war with China. January's number was the lowest it had been since September 2017. The **University of Michigan's Consumer Sentiment March number was 98.4**, also off for the first quarter but it definitely rebounded from a January low of 91.2, for the same reasons mentioned above.

Personal income and outlays continued in Q1 to expand on a year over year basis but at a much slower pace than December 5% year over year increase. **Real Personal Income less transfers only expanded by 1.75%** over the past twelve months. The current savings rate is 6.5% while as of February the consumer credit continued to expand at close to 5% over the past twelve months. Revolving credit has slowed down to an annual pace of about 3.5% while nonrevolving debt has increased again to 5.5%. The consumers' concerns with the shutdown and trade war have seem to have abated, savings rates are down, and spending is holding up well. A good sign for the economy.

Inflation

As of March, **CPI was up 1.86% and PCE was up 1.49%** over the past twelve months, but January and February definitely gave the Fed cause for concern as the rates have been declining since July of last year. The GDP Deflator was up 1.83% over the same time period. Chairman Powel has repeatedly stated that inflation has not been consistently above the 2.00% target, and he will need substantial evidence to take his foot off the break here going forward.

The seasonally un-adjusted numbers from the BLS report show **Shelter up the most over the past twelve months at 3.4%**. Food away from home was up 3%, followed by medical care services up 2.3%, over the same time period. Just like the industrial production numbers apparel prices were down 2.2% compared to this time last year. Inflation is soft and somewhat of a concern, but we have definitely seen soft patches in these numbers during the expansion before.

In Closing

We are now **117 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles. The yield curve has stayed inverted in the short end while the Fed reversed its course on interest rate hikes for the foreseeable future. The yield curve had almost a 25bps parallel



shift downwards with the ten-year ending at 2.41% and the two/tens spread is now only 14 bps. The LEI has remained constant and the positive contributors have held constant at near half. Jobs have begun to slow down and is in line with the latter stages of an economic expansion. Industrial production is the one possible dark cloud in the economic news. Whereas other data point to a continued expansion but simply slower, IP, ISM and even Manufacturers' Shipments, Inventories, and Orders are down or softer. The advance report for March did show a rebound, but March ISM numbers showed levels still about 50 but slowing. New home sales saw a rebound whereas existing home sales have steadily declined over the past 12 months as interest rates rose. Mortgage rates have since fallen but housing activity is definitely softer. Consumer confidence rebounded after the government reopened, personal income increased, albeit at a slower pace, and savings rates have dropped again. Inflation definitely cooled so much to give the Fed a reason to pause and introduce the word "adjustment" into the FOMC minutes, meaning the next move could go either way.

I think all the above data shows an economy which is still in expansion, just slower than 2018. There are no recession warning signs flashing, political ineptitude persists, but nothing that would derail the current expansion. The question I am looking for daily is what the catalyst will be for the US to tip into a recession period. The banks are flush with cash, the housing market doesn't seem to be overdone, the stock market looks a little pricey, corporate debt levels are at all-time high, but relative to earnings aren't in an area of concern yet. Mid cap stocks have rebounded well but small caps are still lagers over the past twelve months. Value also continues to underperform to its growth peers.

I haven't made many adjustments to the portfolios for the quarter. The ETF selection stayed the same and the majority of the 401-K and 529 security selection has stayed the same. I will probably hold off on a rebalance until the third quarter or if the economy starts to show signs of weakness. At this point I am showing a higher, 19%, chance of a recession than Q4 which was caused by negative IP and some negative household employment numbers for the quarter. I will need to see more important data points move into the red territory and the probability of recession get above a 30% before I move the portfolios into a more defensive position.