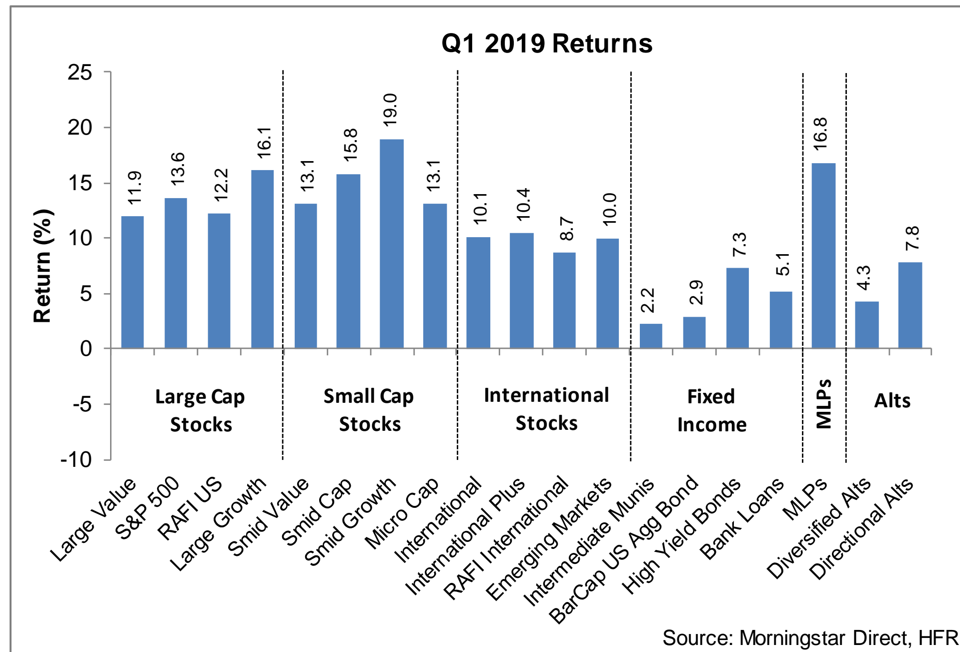
NEXTCAPITAL

Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

First Quarter 2019 Investment Review & Outlook



EXECUTIVE SUMMARY

Q1 2019 Recap:

- Global stocks erased most of their fourth quarter losses with their best start to the year in more than two decades
- US growth stocks outperformed, perpetuating the dominance of this sector over the rest of the market
- Interest rates declined throughout the quarter, an odd development amidst a strong market rally. This boosted fixed income investments, especially longer duration bonds

NEXT Outlook:

- Fundamentals have moderated from the tax cut-induced surge of 2018, but the overall economy remains on solid footing
- The Fed has altered course on tightening interest rate policy, giving the markets further room to rally in the near term
- Investor risk appetites seem fragile to us amid the fourth quarter's volatility; although we are not explicitly cutting equity risk, we are beginning to modestly shift risk exposures
- 2020 election rhetoric may prove to be a source of volatility as we near year-end, particularly if the 2017 tax bill is threatened

To Our Clients and Friends,

Stock markets got off to a quick start in 2019, continuing the rally that began in the final days of December. The strength of this move largely erased the double-digit losses that occurred in the fourth quarter (and, as we finalize this piece in late April, the S&P 500 has since regained all-time highs set in September). Ultimately, the S&P 500 finished the first quarter up 13.6%, the best three month start to a year since 1998.

As we opined in our fourth quarter letter, last year's stock price movements were driven more by technical factors rather than fundamental ones. A negative news cycle surrounding President Trump's trade spat with China and Federal Reserve policy overwhelmed a healthy economic and corporate backdrop. We noted then that the depths of the fourth quarter declines did not seem commensurate with the state of the fundamentals. In that context, then, it is not terribly surprising that markets have recovered their losses.

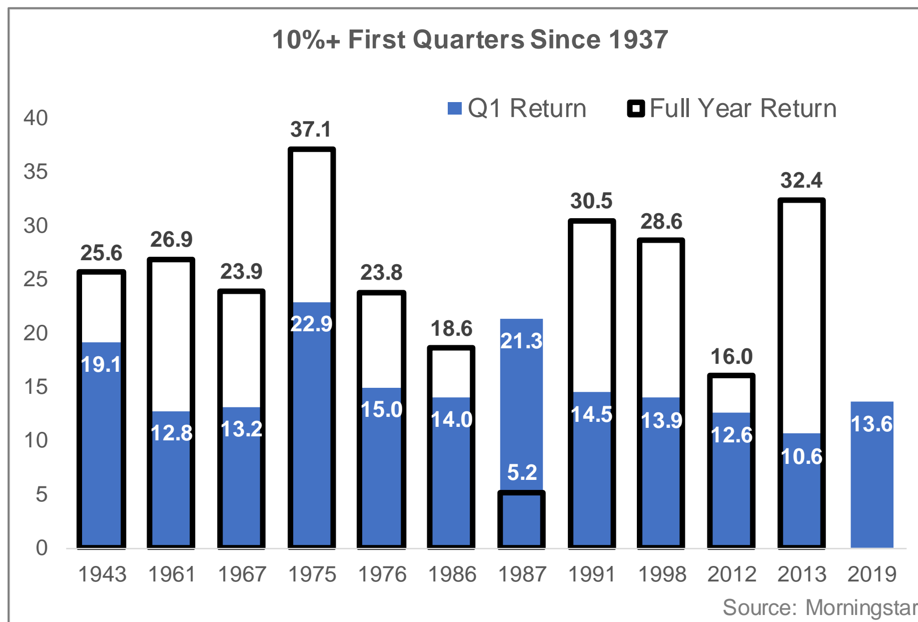
In the moment, it is always difficult to maintain that rational perspective. Last year served as an unsettling reminder – after roughly two years of relatively smooth sailing – that the equity markets are indeed a volatile and risky asset class. The rise of ETFs and quantitative trading in the market seems to have only amplified the speed with which those market moves occur.

To that end, we note that although most risk assets are higher thus far in 2019, the market's riskiest sectors have not significantly outperformed the broader market. Typically, we would expect a greater level of dispersion between large cap stocks and areas like small cap stocks and emerging markets. This suggests to us that although investors were willing to re-allocate to equity risk in the wake of last year's decline, they largely stayed "up in quality." That may foreshadow a fragility to the markets and investor sentiment that we are monitoring closely.

Fortunately, history would tell us that market performance following a 20% decline is typically pretty strong[1]. So too, is the track record of stocks following a double digit gain like we experienced in the first

[1] Markets have been positive in the 12 months following 20% declines in 10 of 13 instances since WWII

quarter. The stock market has only started the year with a double digit gain 11 other times dating back to 1937; in 10 of those 11 instances, the market finished the year higher by an average of an additional 11.5%. The infamous stock market crash of October 1987 was the only instance of a subsequent decline in this (admittedly limited) dataset.



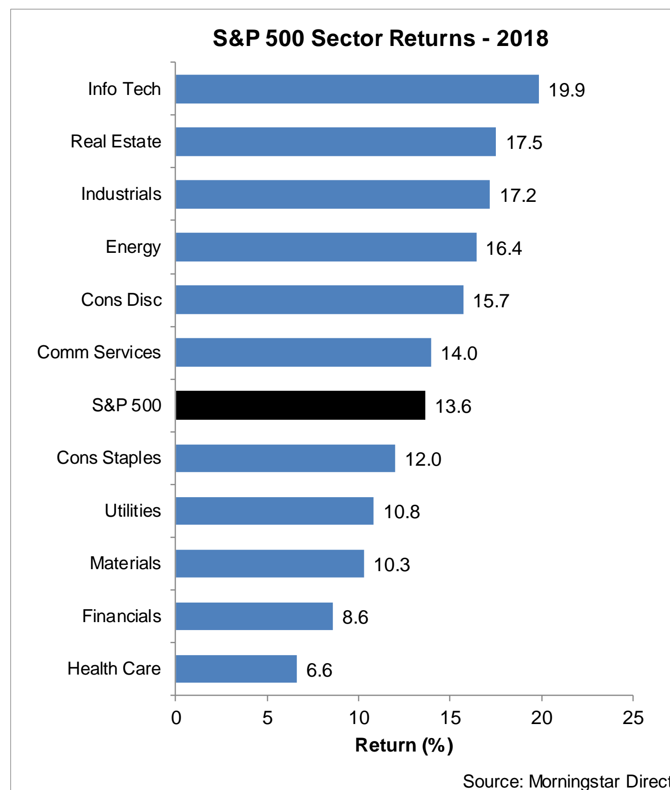
Fundamental drivers, of course, will ultimately dictate the direction of equity markets over the intermediate to longer-term. From that perspective, we remain on solid footing. Growth levels are moderating from the tax cut-induced growth spurt of 2018, but data has thus far come in better than expected. Corporate earnings growth is about 5% above estimates, while first quarter GDP surprised many by coming in at 3.2% annualized (versus expectations for 2.1%). The market tends to be rather myopic about shorter-term changes in growth; from a big picture perspective, economic and corporate conditions are healthy.

Many of the headline risks that "ruined the party" in the fourth quarter have also substantially eased. President Trump's rhetoric with China has significantly de-escalated (so much so that many expect a deal to be forthcoming) while the Federal Reserve has all but reversed course on its policy of interest rate increases. When combined with a series of better than expected data, the biggest near-term risk factors for investors are effectively off the table. That backdrop has paved the way for a continued market rally.

Market Review

Virtually every major market segment was positive in the first quarter, headlined by the S&P 500 rising 13.6% - a near mirror image of the index's 13.5% Q4 decline. Small cap stocks provided a slight premium, climbing 15.8%, while growth once again outperformed value stocks. The persistence of the FAANG phenomenon – discussed exhaustively here in the past – continues to drive significant performance divergence between growth and value strategies. The Russell 1000 Growth index ("large cap growth stocks") is currently on track to outperform the Russell 1000 Value Index by 10% or more for the third straight year.

Given this dynamic, it should not be a surprise that technology once again led the way in terms of sector performance. The tremendous gains in that sector – the largest in the index at over a 20% weight – continues to fuel the performance of the US market. On the other hand, health care, the S&P 500's second largest sector, has materially underperformed this year with a 6.6% return. With the fate of the Affordable Care Act in question and negative political rhetoric surrounding drug prices coming from both sides of the aisle, health care stocks have faced several headwinds in 2019.



Despite underperforming in 2018, foreign stocks did not gain any ground on their US counterparts in the first quarter. Both the developed and emerging market stock indices gained approximately 10% in Q1 – certainly a respectable return – but largely a disappointing one after lagging the US market by roughly 10% in 2018. Unlike in recent years, currency was not much of a factor as the US dollar has been relatively stable this year. With the Fed pulling back on further interest rate hikes, there is less upward pressure on the dollar versus other global currencies.

The outlook may prove to be brighter for those markets, as China appears to stimulating their economy following a weak stretch in 2018. China is a big driver of growth in both segments, with much of Europe and other emerging economies dependent on the world's second largest economy. China has recently experienced some growing pains as it attempts to transition to more of a consumer, domestically driven economy (rather than an export, government investment driven one).

Within the fixed income markets, one of the more unusual developments in 2019 has been the path of longer dated interest rates. Despite the immense rally in risk assets, the yield on the 10-year Treasury has continued to decline. The 10-year peaked in early November at 3.24%; by the end of the first quarter, that yield stood at just 2.41%. While Next Capital has largely avoided longer duration fixed income, due to its higher level of interest rate sensitivity, this move lower has been a tailwind for those assets. This an important observation: the performance of "plain vanilla" bonds represented by the US Aggregate Bond index has been significantly boosted this year simply by this move lower in interest rates. This masks a poor combination of low yield and significant interest rate exposure; we do not feel as though investors are adequately compensated for that risk and continue to underweight their exposure in portfolios.

Finally, credit sectors like high yield and bank loans rebounded alongside the equity markets in the first quarter. Fixed rate high yield bonds, which have more interest rate sensitivity than floating rate bank loans, outperformed by rising more than 7%. Bank loan performance was also robust, up more than 5% despite the market's apparent disregard for low duration assets in the first quarter. Valuations in the space remain pretty reasonable at this juncture, having improved after Q4's dislocation. With no visible signs

of an economic recession and strong corporate fundamentals still in place, we continue to favor credit sectors such as these in fixed income portfolios.

Outlook

In the near term, we here at Next Capital believe the outlook for the equity markets remains positive – and, by extension, other risk assets like credit. The abrupt about-face by the Federal Reserve regarding interest rate policy has eliminated one of the biggest fears hanging over investors: that the Fed would make a policy error by hiking interest rates too much and tip the US into a recession.

Separately, we are inclined to believe that Trump probably finalizes a trade deal with China at some point this year. Like the new NAFTA deal, the substance of any such accord will probably be questionable, but Trump would like another political victory amid a deeply divided Congress. From the market's perspective, it simply removes a disruptive element that will likely be a positive catalyst to performance.

As we move deeper into the year, however, we are concerned that a new issue will start to dominate the market narrative: the 2020 election cycle. Our concern stems not from any partisan view; rather, we observe that a threat to the Tax Cut & Jobs Act of 2017 – which cut the corporate income tax rate from 35% to 21% – is likely a very negative development for the markets. With a very real possibility that Democrats sweep the presidency and both houses of Congress, their rhetoric regarding this issue could begin to create significant volatility as we near primary season this Fall.

We are, of course, long-term investors, first and foremost. We must re-emphasize that diversified portfolios are designed to weather periodic volatility and compound wealth over time. If we can add value, on the margins, however, by taking advantage of potential risks and opportunities in the environment, we will attempt to do so. We will be monitoring these issues closely and will update you on our views as we enter the latter stages of 2019.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest Regards,
Your Investment Team
4/30/2019

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