ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — First Quarter, 2019

Benchmark Returns as of March 31, 2019

INDEX	Last 3 Mo.	Last 6 Mo.	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	13.65	(1.72)	9.50
Russell 2000 Index (small-cap stocks)	14.58	(8.56)	2.05
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	9.98	(3.81)	(3.71)
S&P Europe 350 Index Net Total Return Index (US$)	12.99	0.26	5.74
MSCI Japan Net Total Return Index (US$)	6.67	(8.52)	(7.84)
MSCI Emerging Markets Net Total Return Index (US$)	9.91	1.71	(7.41)
COMMODITIES			
US Dollar Index (DXY)	1.16	2.26	8.13
Euro	(2.17)	(3.33)	(8.97)
Gold	0.77	8.52	(2.50)
Oil (West Texas Intermediate)	32.44	(17.90)	(7.39)
Bitcoin	10.83	(38.70)	(40.57)
BONDS			
BloomBar* US Aggregate Bond (investment-grade bonds)	2.94	4.63	4.48
ICE US Treasury 20+ Year TR Index	4.72	9.10	6.22
BloomBar* US Treas. Inflation Protected Securities (TIPS)	3.19	2.76	2.70
Bloomberg Barclays Municipal Bond Index	2.90	4.63	5.38
BBG* US Corporate Total Return (corporate bonds)	5.14	4.96	4.94
BloomBar* US Corp. High Yield Tot. Rtn. (high yield bonds)	7.26	2.39	5.93
BloomBar* Global Aggregate Treasuries Total Return	1.60	3.75	(1.62)

**Bloomberg Barclays; Source: Bloomberg Finance LP*

What a difference a quarter makes.

US large-cap stocks turned in the best start to a year since 1998. As shown above, the S&P 500 returned 13.65% and the Russell 2000 (small-cap stocks) returned 14.58% during the first quarter. Whereas during the fourth quarter of 2018, their returns were -13.53% and -20.20%, respectively (Chart 1, Panel 1).

US Treasury bonds also rallied as the yield on the 10-year Treasury Note continued its decline from 3.24% in mid-November 2018 to 2.41% on March 29, 2019 (Chart 1, Panel 2) generating a total return (capital appreciation plus income) of almost 5.5% over that time period.

The volatility index also returned to near its pre-fourth quarter 2018 lows (Chart 1, Panel 3) and the price of oil rose over 30%.

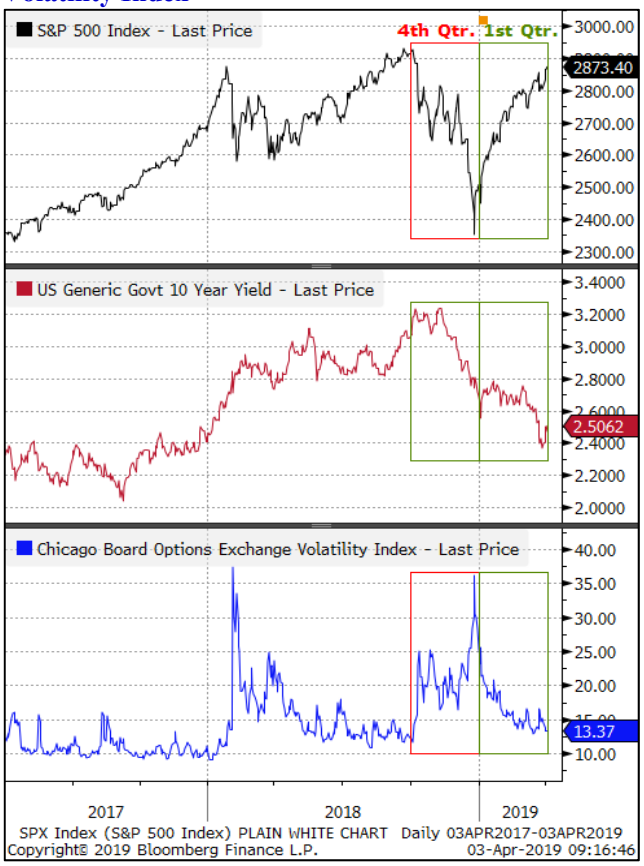
In writing about the weakness in risk assets during the fourth quarter in our outlook for 2019, we made the following remarks:

"It could be argued that the surge upward in interest rates was the catalyst for stock market weakness as higher interest rates preceded stock market weakness. US stocks have been hypersensitive to perceived inflection points in monetary policy throughout the fourth quarter sell-off, which began roughly after Fed

"Chairman Jay Powell said in an October 3 interview that interest rates were "a long way from neutral" implying that the Federal Open Market Committee (the FOMC) would likely continue raising short-term interest rates meaningfully."

And that "*From a policy perspective, I believe the Fed is having the strongest impact on financial markets at this time. Higher rate expectations preceded both the first quarter and fourth quarter stock market declines. One of the main takeaways from 2018 is that equity markets are terrified of higher rates. While trade policy, the lack of fiscal discipline, government shutdowns, and geopolitics have all been negative and no doubt exacerbated the moves to the downside in the financial markets, I expect Fed policy will continue to be a key driver of success or failure of stocks for most of 2019.*"

Chart 1: S&P 500, 10-Year Treasury Yield, Volatility Index



Source: Bloomberg Finance LP

The performance of risk assets essentially comes down to a battle between growth and monetary policy/interest rates. Last September, despite the fact that global economic growth was clearly slowing, the Fed sounded hawkish. This triggered an 18% drop in global equities during the fourth quarter.

Monetary policy has changed significantly since late last year. All major developed central banks have turned more dovish, culminating in March's decision by the European Central Bank to push back its guidance for its first rate hike and the Federal Open Market Committee's wiping out its two planned interest rate hikes for 2019. At the same time, US economic growth is showing resilience, and we see the first "green shoots" of a cyclical pickup in growth outside the US. This is an environment in which risk assets should continue to hold up.

This change in tune by the Fed has reset expectations for future changes in short term interest rates from three 0.25% *hikes* expected over the following 12-months in September to one 0.25% *cut* over the next 12-months today (Chart 2). As shown in Chart 3 which plots interest rates (Y axis) for various bond maturities going out to 30-years (X axis), actual interest rates have declined significantly across the maturity spectrum for maturities between 1-year and 30 years over the last six-months.

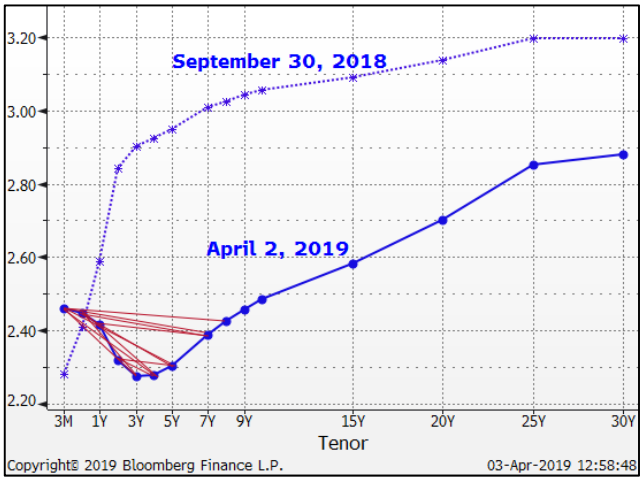
Chart 2: Market Implied Projected One-Year Change in Fed Funds Rate*

**As discounted in the Eurodollar futures market*
Source: Bloomberg Finance LP

A normal yield curve is one that slopes upward from left to right. The inverted portion of the yield curve (the area where shorter-term interest rates are higher than longer term interest rates – shown as red lines on Chart 3) – is also signaling market expectations of an easing in monetary policy in the near future.

While the market expected the Fed to deliver a dovish message following its March gathering, what actually came was one of those rare moments when central bankers manage to surprise markets by going further than expected in the forecast direction. The meeting set off a strong rally in Treasuries and continued to provide support for risk assets.

Chart 3: Term Structure of Interest Rates/Yield Curve



Source: Bloomberg Finance LP

In contrast to market projections for a *decline* in the fed funds rate over the next year (Chart 2), the Fed's own estimated path of short-term interest rates calls for no change in 2019 and a single 0.25% *increase* in 2020. We're inclined to take the Fed at its word at this point.

With global long bond yields recently hitting a two-year low, one consequence is that high quality bonds have become *riskier.* To make this point, consider the 10-year German Government bond which is yielding 0% (the 10-year US equivalent bond is at 2.5%). The short-term potential for capital appreciation has all but vanished (bond prices move inversely with interest rates) while the potential for steep losses has increased. The technical term for this negative asymmetry is negative skew. Much research in a field of behavioral economics concludes that negative skew is the metric that best encapsulates investment risk.

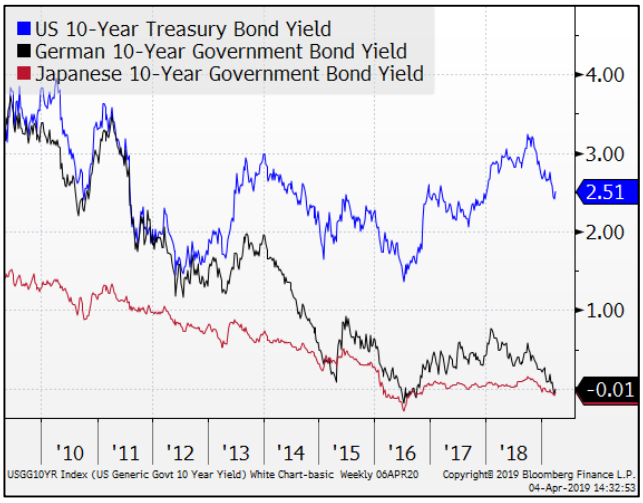
A common misunderstanding in finance is to equate risk with volatility. Risky assets, such as stocks, are risky not because they are volatile in the conventional sense – no one minds when the price of an investment goes up sharply. Risky assets are risky because they have the propensity to experience much larger short-term losses than short-term gains. This is captured in the saying: equities take an escalator up and an elevator down.

So, it makes more sense from our perspective to think about investment risk along these lines:

> An investment's risk depends on the negative skew of its short-term returns.
> At very low bond yields, bond returns develop the same negative skew as stock returns.
> This means that stocks lose their excess riskiness *versus* bonds as bond yields approach their lower bounds allowing stock market valuations to transition higher.
> When bond yields move higher, stocks regain their excess riskiness versus bonds – and their valuations must suffer a transition lower.

With global bond yields at their current low levels (Chart 4), this dynamic bears watching. Essentially, higher bond yields can seriously undermine the valuation support of low interest rates for stocks, triggering a decline in the stock market and other risk assets which threatens a negative economic impulse. The unsurprising response from central banks is to pivot back to a dovish stance, pulling bond yields back down. These lower bond yields then push equity (and other risk-asset) valuations back up – at least temporarily.

Chart 4: Global Government Bond Yields

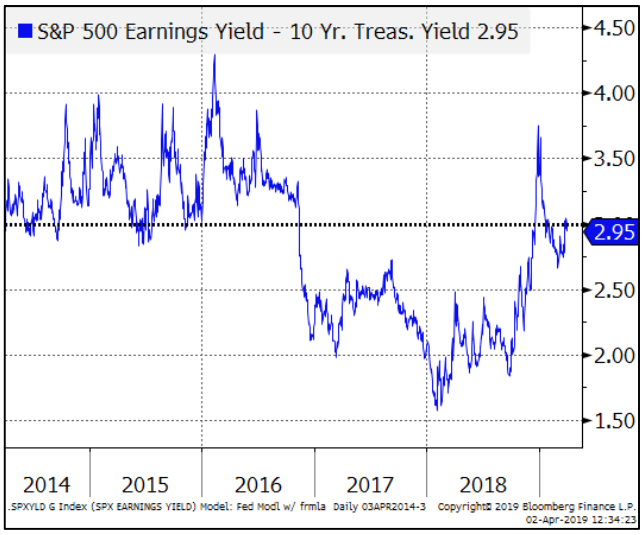


Source: Bloomberg Finance LP

Thanks to lower Treasury yields, the relative attractiveness of stocks has improved according to the so-called "Fed model". The model compares the stock market's earnings yield (earnings per share divided by price) with the yield on 10-year Treasury.

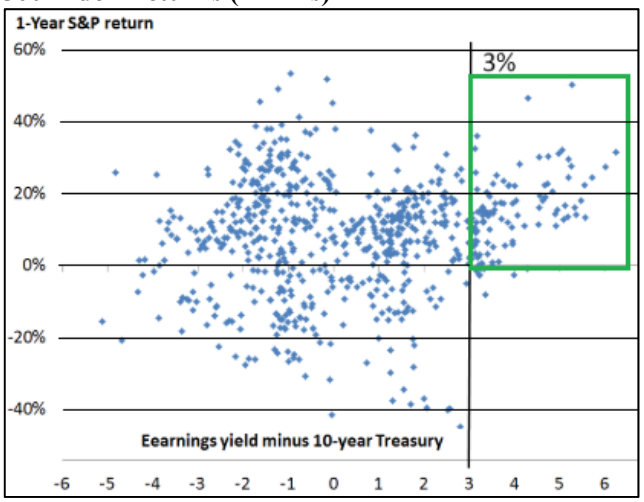
The S&P 500's current earnings yield is about 3% higher than the yield on 10-year Treasuries (Chart 5), meaning that stocks yield more in terms of corporate earnings than 10-Year Treasuries do in terms of interest paid. This model has been an effective barometer of where stocks are headed over the following year. A gap of 3% or more has resulted in positive US stock market returns in almost all cases going back to 1962 (Chart 6).

Chart 5: Fed Model



Source: Bloomberg Finance LP

Chart 6: Fed Model (X-Axis) & 1-Yr. Forward S&P 500 Index Returns (Y-Axis)



Source: Bloomberg Finance LP

Returning to our earlier remark – that the performance of risk assets essentially comes down to a battle between growth and monetary policy/interest rates – with interest rates low across the yield curve and global central banks backing away from tightening monetary policy, the monetary policy/interest rate environment remains supportive of risk assets.

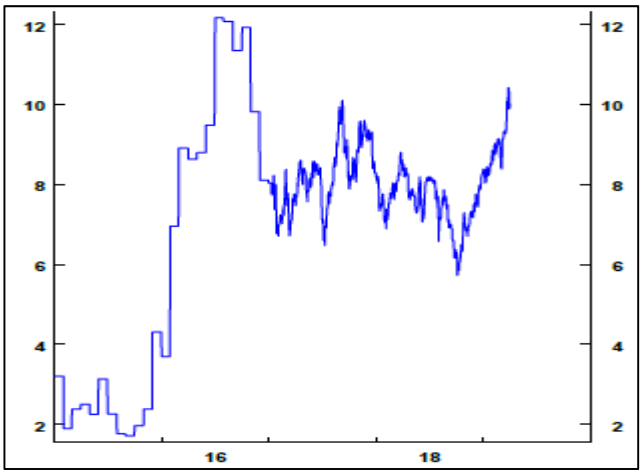
While people start to talk about stock market bubbles as stocks move higher, the biggest bubble we currently see is in bonds. Table 1 shows government bond yields at various maturities for a number of developed market countries. Negative yields are taking over which is reminiscent of mid-year 2016 when the 10-year US Treasury yield troughed a bit above 1.3%. Globally, negative yielding debt is nearing the all-time highs of mid-2016 (Chart 7).

Table 1: Sovereign Bond Yields

As of Apr. 3, 2019	2-YEAR	5-YEAR	7-YEAR	10-YEAR
SWITZERLAND	(0.84)	(0.70)	(0.56)	(0.33)
JAPAN	(0.17)	(0.18)	(0.18)	(0.06)
GERMANY	(0.60)	(0.41)	(0.29)	0.00
FINLAND	(0.62)	(0.24)	(0.12)	0.24
NETHERLANDS	(0.61)	(0.41)	(0.21)	0.09
DENMARK	(0.67)	(0.48)	NA	0.06
AUSTRIA	(0.56)	(0.23)	0.02	0.31
FRANCE	(0.53)	(0.22)	0.02	0.39
BELGIUM	(0.50)	(0.13)	0.09	0.47
SWEDEN	(0.50)	(0.23)	NA	0.37
SPAIN	(0.37)	0.07	0.64	1.13
ITALY	0.25	1.55	2.09	2.54
UK	0.68	0.82	0.90	1.09
AUSTRALIA	1.45	1.47	1.65	1.84
CANADA	1.58	1.58	1.61	1.70
US	2.33	2.32	2.41	2.51

Source: BCA Research

Chart 7: Global Negative Yielding Bonds in Trillions of US Dollars



Source: BCA Research

The excesses in the bond market are even larger in the emerging market sovereign space and in select developed market corporate bonds. Mexico raising century debt (bonds with a 100-year maturity) in US dollars, in the British pound and in euros (some of the so called "hard currencies") is almost unbelievable, as Mexico was at the epicenter of the 1982 Latin American crisis and again in 1994 with the "Tequila" crisis. Argentina, also raising century debt recently in hard currency, further supports the notion of a growing bond market bubble.

Turning to corporate bonds, Sanofi and LVMH Moet Hennessy Louis Vuitton selling negative yielding debt is beyond our understanding. So is Total (the French multinational integrated oil and gas company) issuing a perpetual bond (a bond with no stated maturity) with a 1.75% coupon.

All of this is linked to the unintended consequences of ultra-easy central bank policy that began in 2009, particularly from what is known as quantitative easing (QE; the purchase of a large quantity of longer-term debt by central banks on the assumption that it will reduce long-term interest rates) around the world. QE causes bond investors to push further and further out on the risk spectrum in order to find securities with an acceptable yield. This is known as the portfolio balance channel which, according to then Fed Chair Ben Bernanake on August 27, 2010 "…relies on the presumption that different financial assets are not perfect substitutes in investors' portfolios… For example, some investors who sold [government issued securities] to the Fed may have replaced them in their portfolios with longer-term, high quality corporate bonds, depressing the yields on those assets as well." This has continued as investors moved from high quality corporate bonds to low quality bonds to emerging market bonds and so on.

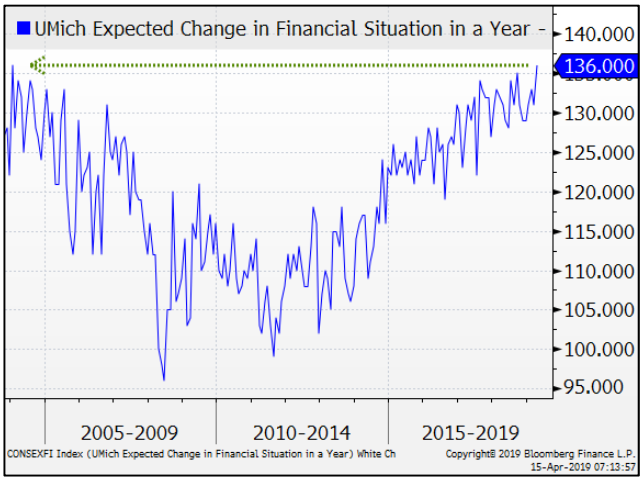
When this bond bubble gets pricked it will end in tears as it always does. The catalyst could be the Fed hiking short term interest rates in an environment where the market is priced for a cut, the inevitable next recession, or something unforeseen in the interim.

Evaluating US growth is interesting when viewed from the perspective of economic growth vs. corporate earnings growth. Fundamentally economic growth is on solid ground. For example, unlike a decade ago, the housing market is in good shape. The homeowner vacancy rate stands near a record low and the quality of mortgage lending remains high. Households have deleveraged and debt service payments relative to disposable income are at multi-generational lows. The labor market is also firm, with job openings hitting another record high in February, the March US Payroll report showing 196,000 jobs added, average hourly earnings up 3.2% year-over-year, and the unemployment rate at 3.8% - near a 50-year low. Americans are also the most upbeat in 15 years about their personal finances. A University of Michigan index measuring their confidence one year out reached the highest since January 2004 in April (Chart 8). The combination of a healthy housing and labor market, and strong confidence about personal finances is good for consumers and should support economic growth in the coming months.

Corporate capital spending intentions have dipped over the past few months but remain reasonably elevated by historic standards. Real nonresidential capital stock (such as commercial real estate, tools, machinery, factories, etc.) has grown by an average of only 1.7% since the start of the recovery, down from 3% in the pre-recession period. A cyclical upswing in productivity growth, rising labor costs, and low levels of spare

capacity should motivate businesses to invest in new property, plant and equipment.

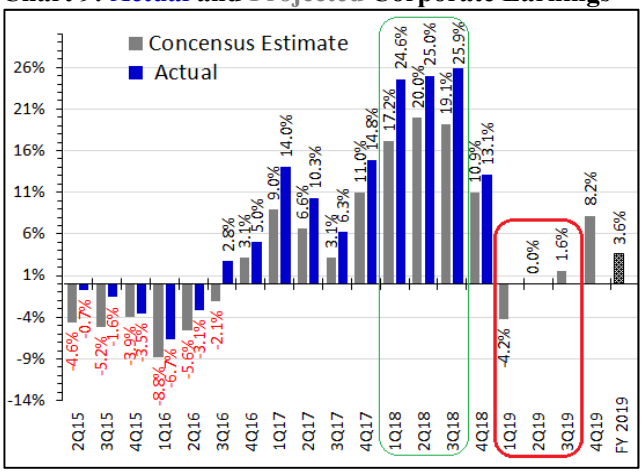
Chart 8



Source: Bloomberg Finance LP

Corporate earnings growth, on the other hand, has been decelerating since the fourth quarter, 2018. Growth rates are projected to be negative for the first quarter, flat for the second, and only slightly positive for the third quarter (Chart 9).

Chart 9: Actual and Projected Corporate Earnings



Source: FactSet Research Systems, Inc.

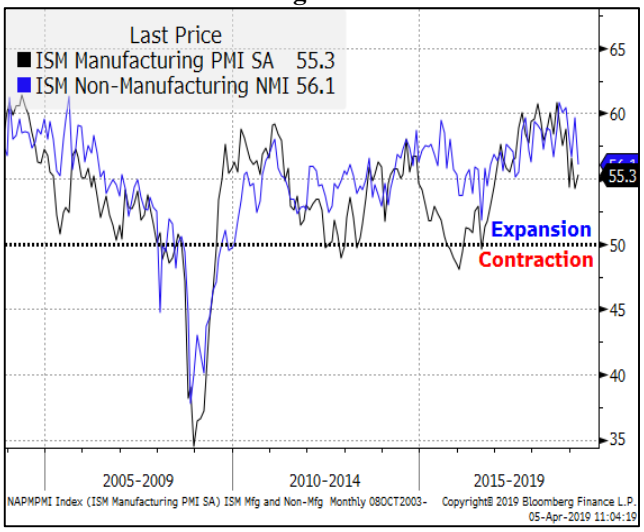
However, macroeconomic and other factors suggest analysts may be a bit too pessimistic about S&P 500 earnings per share (EPS) potential this year.

First, management teams seek to under-promise and over-deliver. They do their best to guide analysts' expectations to a level their companies can exceed.

Second, as we discussed in last quarter's letter, actual earnings reported by S&P 500 companies have consistently exceed analysts' estimates. Over the last five years, the average difference has been 4.8%.

Finally, leading economic indicators such as Institute for Supply Management surveys (ISM; Chart 10) suggest S&P 500 EPS may be on more solid footing than what analysts think, with the consensus for 0% second quarter improvement off the -4.2% decline expected in the first quarter (Chart 9). The purchasing managers' survey level of 55.3 is abnormally high for an earnings recession. Minor ones that occurred in 1998 and 2015 included a dip in the ISM below 50, while economic recessions have included a drop in the survey to 43 or lower. Analyst forecasts imply a deeper period of gloom for S&P 500 earnings growth than the ISM survey suggests. While it's true that the ISM is domestically focused and may miss sector-specific and non-domestic EPS weakness, the expected level of profit softness appears to overshoot what's implied in macro indicators.

Chart 10: Manufacturing & Service Sectors

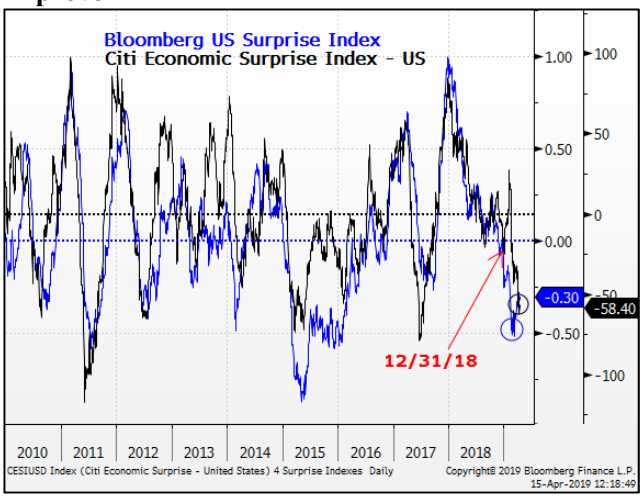


Source: Bloomberg Finance LP

It's also interesting that while many economic indicators have held up well, the actual data being reported is still coming in consistently below that of what has been expected according to a pair of US surprise indices[1] (Chart 11). With that said, the Bloomberg US Surprise Index and the Citi US Economic Surprise Index are both at levels that have historically marked turning points in the indices. This happens when expectations are reduced to such a level that it's almost impossible for incoming data to continue surprising to the downside. Financial markets react more to surprises than actual data and it looks like the surprises are moving from being negative to positive.

[1] Surprise Indices show the degree to which analysts under- or over-estimate the trends in the business cycle. The surprise element is defined as the percentage (or percentage point) difference between analyst forecasts and the published value of economic data releases.

Chart 11: Surprise Indices May Be About to Improve

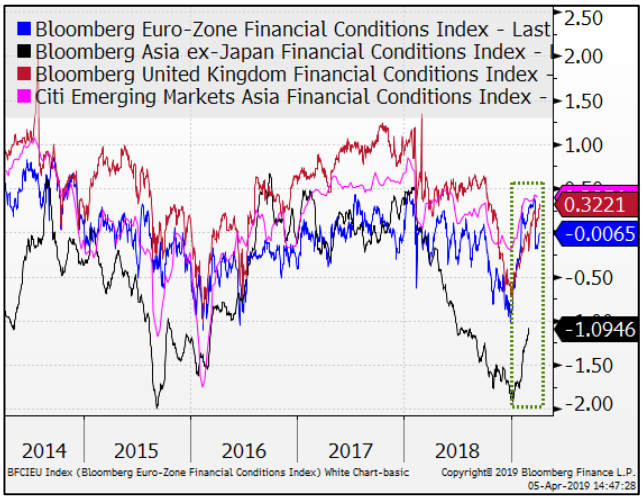


Source: Bloomberg Finance LP

The US is not an island unto itself and hopefully the cliché that it is darkest before the dawn is a fitting description of the world economy outside the US right now. Global trade is depressed, global purchasing managers indices are declining and very little actually looks good. But it is exactly when nothing is going well that one needs to wonder what may cause the outlook to turn for the better. Thankfully, some positive signs are emerging.

To begin with, central banks around the world have taken a more dovish slant. This dovish forward guidance is fostering global activity via a significant easing in global financial conditions (Chart 12), which is undoing the headwinds imposed on global growth in the fourth quarter of 2018.

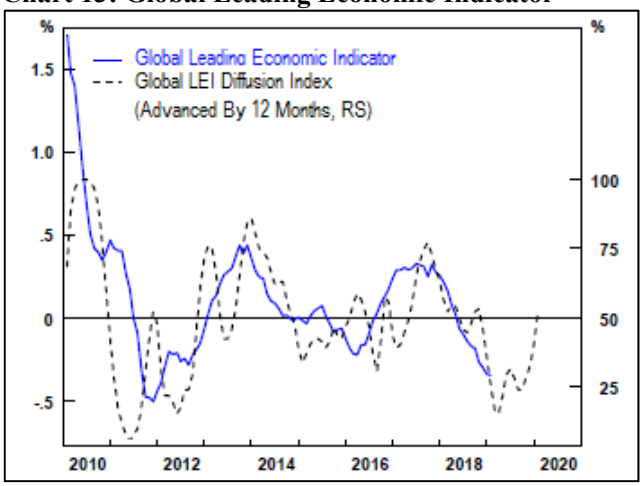
Chart 12: Global Financial Conditions



Source: Bloomberg Finance LP

This should soon be reflected in a global leading economic indicator (LEI). As shown in Chart 13, the diffusion index for the LEI which illustrates the percent of the 23 countries in the index experiencing a sequential improvement in their LEIs has risen to 50%. This measure tends to lead the overall global LEI by around 12-months. Investors do not seem to be anticipating such a rebound. Therefore, there is room for upside growth surprises around the world.

Chart 13: Global Leading Economic Indicator



**LEI is based on 23 countries. Diffusion Index shown smoothed except for last data point. Source: BCA Research*

Beyond these positive leading indicators, a resolution to the US/China trade negotiations and China's "trifecta" of policy easing measures (credit, fiscal & monetary) will also aid in turning profit growth around.

New credit data out of China improves the chances that Beijing's stimulus measures will overshoot this year, causing China's economy to bottom in 2019 and help jumpstart global growth. Without digging in too far, some examples of China's turn around are:

> China's credit growth exceeded all estimates in March. Aggregate financing was 2.86 trillion yuan ($426 billion) last month, compared with about 700 billion yuan in February. The median estimate was 1.85 trillion yuan in a Bloomberg survey.
> Broad M2 money supply increased 8.6 percent, the fastest pace since February 2018.
> "Economic activities are strengthening" and business confidence has recovered, according Tommy Xie, an economist at Oversea-Chinese Banking Corp. in Singapore.
> M1 money supply growth, a proxy for corporate investment sentiments, increased 4.6 percent, fastest pace since mid-2018.
> While more volatile than the US's, the Citi Economic Surprise Index for China has risen from -45.0 on March 8 to 31 on April 15.

A stimulus overshoot is positive for Chinese demand in the short run but negative in the long run. A traditional credit surge of this nature cannot be surgically targeted at small and medium size enterprises or households as would be ideal. Instead, it will go to state-owned enterprises, privileged corporations, property developers, and other similar institutions that are already highly leveraged. The bottom line is that China's stimulus measures have positive implications for both Chinese and global growth over the near term.

What about the trade war? The reality is that China's strengthened credit origination is a bigger factor for the global economy than China's exports to the US. The trade war can escalate from here, but if China's stimulus works as it has in the past, the results will be manageable for China's economy other than for Chinese companies particularly exposed to the US economy through exports. The reality is that both the US and China are now stimulating their economies and global trade will benefit regardless of bilateral tariffs.

It's very possible, however, that just as global stock markets ignored China's economic slowdown and only sold off when the tariffs were imposed, they may not continue to rally much on China's strong credit data. Given the already considerable rally in global risk assets since late-December, markets may not remain satisfied with solid credit data out of China without a clear resolution to the trade conflict.

We think that much of the market's recent strength is based on investors' belief that a trade deal with China is just a matter of a little more time. While we believe a deal will get done, it will likely take longer than the market expects. For instance, while the headlines seem to suggest that a deal is all but finished, President Donald Trump and President Xi Jinping have not yet scheduled a summit to sign a trade agreement, even though Trump insists a summit is necessary. Chief US negotiator Robert Lighthizer says that he is "hoping but not necessarily hopeful."

Much of the recent news flow is encouraging. Trump has said "we've agreed to far more than we have left to agree to," and Xi Jinping has called for an "early conclusion of negotiations." Other negotiators are also sounding positive, with Vice Premier Liu He saying that a "new consensus" has been reached and National Economic Council Director Larry Kudlow said that key structural issues are on the table and that negotiations are continuing after two successful rounds of direct talks in Beijing and Washington. All in all, the signs are stacking up in favor of a deal.
If a deal gets done, China will be at the center of two market positive outcomes in the near term: more domestic stimulus and less conflict with the US. Once there is a concluded trade deal and clarity over stimulus, emerging markets can also outperform their developed market counterparts for a period.

Despite a likely trade deal, it is very unlikely that we are not on the verge of a grand compromise that will lead to a new era of US-China engagement. Without diving into details in this letter, there are many underlying strategic conflicts between the two superpowers. As long as China's economy and industrial capabilities continue to grow relative to the US, its geographic surroundings remain an area of geopolitical risks, and its technological advancement remains rapid, conflict and competition will continue. The US and China will likely shift their focus to these areas in the months and years after any trade deal.

Above-potential growth in the US and rebounding economic activity in the rest of the world are consistent with higher US inflation:

> Rebounding global growth is normally associated with a weakening dollar. A weaker dollar will lift import prices, commodity prices, and goods prices, helping inflation move higher.
> The change in the velocity of the money[2] of zero maturity (MZM)[3] in the US is consistent with a further strengthening in core inflation (Chart 14).
> The Fed's Underlying Inflation Gauge is signaling higher inflation.
> The price of oil has rebounded 30% from its recent lows which means that headline inflation prints will soon stabilize or begin to pick up.

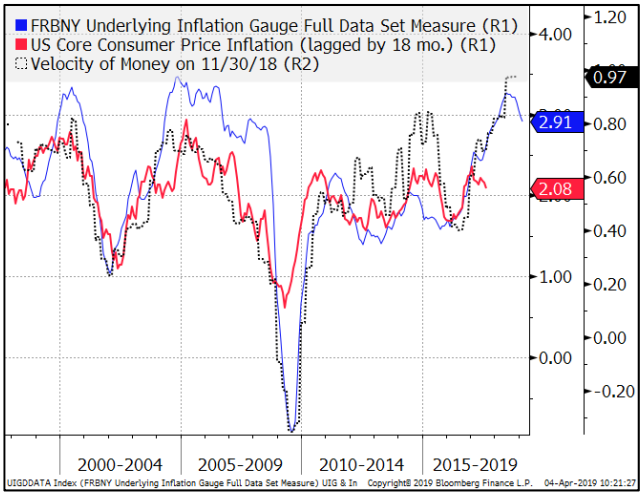
If these indicators are accurate, core personal consumption expenditure inflation (the Fed's preferred inflation gauge) should move above 2% (the Fed's inflation target) as early as the second half of 2019. This will likely result in inflation expectations firming. Additionally, the combination of positive growth surprises around the world and easy monetary and liquidity conditions will prove supportive of asset prices globally, implying further easing in global and US financial conditions. This set of circumstances will

[2] The velocity of money is the number of times one dollar is spent to buy goods and services per unit of time. If the velocity of money is increasing, then more transactions are occurring between individuals in an economy.

[3] MZM is the broadest measure of the supply of financial assets redeemable at no loss on demand including: notes and coins in circulation, traveler's checks (non-bank issuers), demand deposits, other checkable deposits, savings deposits, and all money market funds.

allow the Fed to shift its tone toward the end of 2019, firming up additional interest rate hikes in 2020.

Chart 14: Leading Indicators Point To Higher Inflation



Core consumer price inflation excludes food & energy.
Velocity of money is nominal GDP divided by money of zero maturity.
Source: Bloomberg Finance LP

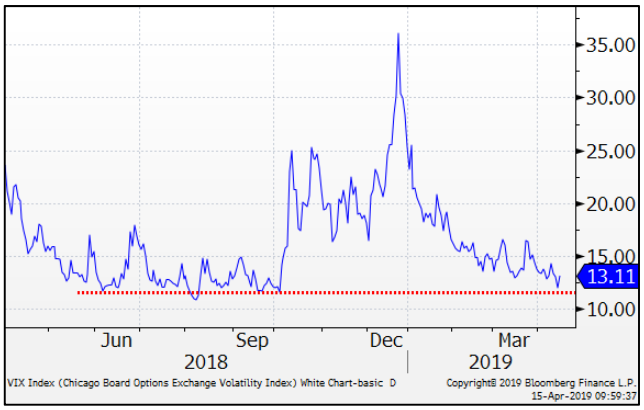
The outlook for the economy and financial markets has improved significantly since the beginning of the year. Easing monetary policy, lower long-term interest rates, a growing likelihood of positive economic and earnings surprises, strength in the consumer sector and progress toward a trade deal have all driven risk assets meaningfully higher and restored market volatility to very low levels.

This is all great news and supports the argument for additional gains in stocks and other risk assets over the rest of the year. With that said, markets and investors appear once again to be becoming increasingly complacent as financial assets move steadily higher.

In particular, the CBOE Volatility Index[4] (the VIX Index) has dropped to its lowest level since October (Chart 15) and hedge funds are becoming increasingly comfortable with the current low level of volatility as they are once again selling short volatility (as measured by net short positions on VIX Index futures; Chart 16). What this means is that market participants are so confident that volatility will stay low, they are willing to sell protection (selling short VIX options to collect a premium) against a decline in stocks at very low rates. As we've said before, this is similar to an insurance company reducing premiums on hurricane insurance to unsustainable low levels because an insurable event hasn't occurred for a while.

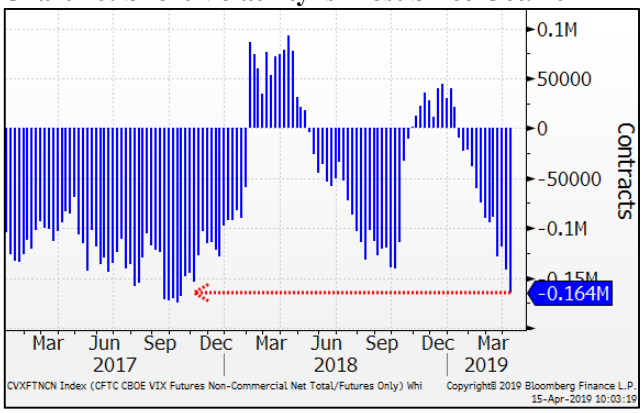
[4] The VIX Index measures the market's view of expected future volatility. Conceptually, it can be thought of as the price of buying protection against a decline in the S&P 500.

Chart 15: VIX Index



Source: Bloomberg Finance LP

Chart 16: Short Volatility is Most Since Oct. 2017



Source: Bloomberg Finance LP

With stocks having advanced and volatility having declined so much, we are not in love with global stocks at current levels and will be surprised if they continue to appreciate at the current pace. However, the policy climate – monetary and fiscal – is conducive to stocks outperforming cash and high-quality bonds and the Fed's implicit pledge to remain on the sidelines into the second half of this year extends the runway for risk asset outperformance. We are generally holding some capital in reserve to deploy in the event of a pullback but continue to favor a risk-friendly portfolio tilt as conditions remain favorable for stocks and spread product (bonds other than Treasuries) and unfavorable for Treasuries.

Brant Kairies