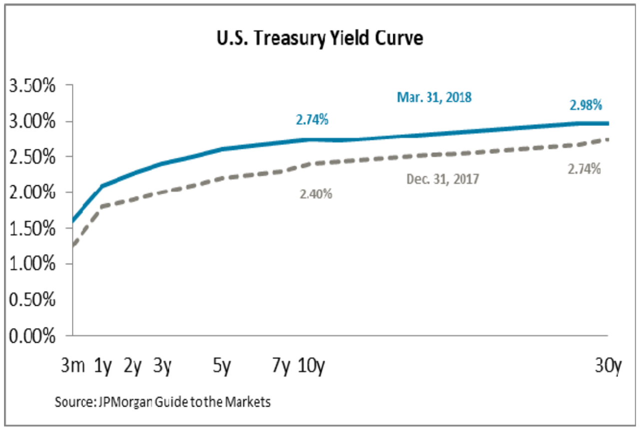
# Quarterly Update & Economic Commentary—March 31, 2018

## QUARTER IN REVIEW

The markets literally went through ups and downs throughout the first quarter. The market started out on a high-note, but the high water mark for the quarter was reached on January 26th when the intra-day high pushed the S&P 500 up 7.44 percent. From there, markets fell into correction territory, only to rebound by about 10 percent before losing steam again in March. The markets fell in both February and March, after the strongest monthly gain in over a year in January. The S&P 500 lost 0.76 percent through the first quarter, snapping a nine quarter streak of positive returns. However, small cap stocks, represented by the S&P SmallCap 600, posted a positive quarterly return of 0.57 percent. For the quarter, growth stocks outperformed value stocks across all market capitalizations. Information Technology (+3.53) was the top performing sector for the quarter followed by Consumer Discretionary (+3.09); these two sectors were the only two S&P 500 sectors to have positive returns during the first quarter. The worst performing sectors were Telecom Services (-7.48) and Consumer Staples (-7.12).

International large cap developed equity markets finished the quarter down 1.53 percent while developed small cap equities were positive by 0.24 percent. Developed markets were led by Finland and Italy while Australia, Switzerland and Israel were the leading detractors. Emerging markets (+1.42) finished the quarter in positive territory. Top performing countries include Brazil, Russia and Malaysia, and detractors were the Philippines, Poland and India.

Interest rates moved swiftly higher during the quarter. Rates on the two-year Treasury increased 38 basis points since the beginning of the year and 99 basis points over the trailing year. The ten-year Treasury increased 34 basis points since the end of 2017 and the 30-year Treasury increased 24 basis points since the beginning of the year. Bond prices fell as a result of rising interest rates, leading to losses for many fixed income investors. The most popular bond index, the Bloomberg Barclays US Aggregate Bond Index, lost 1.46 percent year-to-date; the more conservative Bloomberg Barclays US Government Index lost 0.73 percent and the more aggressive, US Corporate High Yield Index, lost 0.86 percent. In addition to the movement in rates, another important indicator to watch is the spread between the two-year and ten-year Treasury yields. When the spread inverts, meaning the 2-year is higher than the 10-year, this could be an indicator that a recession is forthcoming. The spread has tightened, ending the quarter at 47 basis points.




Oil prices crept higher during the quarter. West Texas Crude Oil increased about 7.5 percent while the more broad energy sector increased 4.82 percent. Natural Gas prices fell by over 7 percent. Gold moved higher, while both Silver and Copper declined. Other big movers in the commodity space included a 35 percent increase in Cocoa, Corn increased by over 10 and Soybeans by 8.63 percent. The largest decliners were the already mentioned Natural Gas, Livestock by 7.44 percent and Coffee by 6.38 percent.

The strong start to the year was a result of the positive sentiment around the tax reform bill that lowered taxes on the majority of Americans and businesses. In addition to the passing of tax reform, the fourth quarter corporate earnings were strong. According to FactSet, companies in the S&P 500 reported revenue growth of 8.2 percent, the highest growth since the fourth quarter of 2011. 77 percent of S&P 500 companies reported sales above analyst estimates. This is the highest percentage since FactSet began tracking the data in 2008. The energy sector had the highest earnings growth rate at 105 percent. The energy sector benefited from an increase in oil prices and a low bar to surpass from last year.

After seeing the market post significant increases in January, higher interest rates spooked the market, causing an initial sell-off which was later exacerbated by technical indicators which pushed markets even lower. The market decline caused a spike in the VIX, also referred to as the "fear indicator." The VIX spiked to over 50, a substantial increase from the low double-digits that many grew accustomed to in 2017. The spike in the VIX also helped trigger some of the later declines, as some large investors had short trades against the VIX. When a short VIX investment lost 80 percent of its value in an after-hours trading session, market traders became concerned of increased volatility and put pressure on broader markets. The February decline was short-lived but substantial, with some major indices falling more than 10 percent—considered to be in correction territory. Markets found their footing and managed to rally over 10 percent, but these gains were wiped out in March after President Trump announced tariffs on steel and aluminum imports.

The tariffs that were announced in early March are a major concern to the markets. The intent of the tariffs is to help American companies be more competitive when selling their products here in the states. If tariffs make imported goods more expensive, then countries that provide these cheaper goods through cheap labor or government subsidies will have a more difficult time selling their goods in the U.S. Wages tend to be higher here in the U.S. than many other countries; this drives up the cost of producing goods here. On the surface this may look like a win for America, but if the price of goods increases there are a handful of potentially damaging consequences. For one, inflation may increase and compel the Fed to raise rates more aggressively. Another likely outcome is that Americans will see their expenses increase without a comparable increase in their wages. In aggregate, this slowdown in consumption could very well translate to a slowdown for the U.S. economy. It is also possible that some exporting countries may subsidize industries affected by American tariffs in order to prop up exports, which would render as pointless the only objective of Trump's tariffs—the protection of American industries with global competition. It would be one thing if the impact was limited to steel and aluminum, but other countries and trading blocs have already begun to threaten tariffs on American exports. Not coincidentally, the tariffs on American exports appear to be selected to apply specific political pressure: bourbon and motorcycles are produced primarily in Kentucky and Wisconsin, respectively, which are the home states of the leading Republican Senate majority leader and speaker in the House. Pork exports, another target, are the provenance of Trump's heartland.

Geopolitical issues, mainly with North Korea, were a consistent concern throughout 2017. However, in the first quarter of 2018 they were basically a non-event from the markets' perspective. Surprisingly, the Trump administration is reportedly planning to meet with the Kim regime as early as May. Whether this will yield any real progress toward denuclearization, or if it just serves to provide propaganda for the North Korean dictator remains to be seen. The U.S. also stood in solidarity with other western democracies by expelling Russian diplomats and spies from U.S. embassies after Russia was believed to have poisoned a Russian defector in Great Britain. The U.S.' role was a departure from Trump's hitherto indifferent response to Putin's aggressions in the West. With tensions rising on this issue as well as conflicting objectives in Syria, the U.S.-Russian relationship may present new cause for spooking the markets during the rest of 2018.

## A LOOK AT THE NUMBERS

| Name | First Quarter Performance (%) | YTD Performance (%) |
|---|---|---|
| DJ Industrial Average TR USD | -1.96 | -1.96 |
| S&P 500 TR USD | -0.76 | -0.76 |
| S&P MidCap 400 TR | -0.77 | -0.77 |
| S&P SmallCap 600 TR USD | 0.57 | 0.57 |
| NASDAQ Composite TR USD | 2.59 | 2.59 |
| MSCI EAFE NR USD | -1.53 | -1.53 |
| BBgBarc US Agg Bond TR USD | -1.46 | -1.46 |
| Wilshire US REIT TR USD | -7.48 | -7.48 |
| IA SBBI US 30 Day TBill TR USD | 0.34 | 0.34 |

## FORECAST IN BRIEF

While much of the volatility from the first quarter can be traced back to computer models triggering sell-offs at various points (this is known as technical trading), we are hopeful that markets will return attention to the strong fundamentals that are present in the U.S. and abroad. Analysts are expecting a strong earnings season. According to FactSet, the first quarter 2018 earnings estimated growth rate for the S&P 500 is 17.3 percent. In fact, estimated earnings growth, which historically sees declines from the beginning to end of a given quarter, has risen by 5.4 percent in the first quarter. This represents the largest positive change in estimated earnings during a quarter since FactSet began tracking this data point in 2002. Another anomaly that occurred during the quarter is the increase in earnings estimates but a decrease in the price of the S&P 500; this has not occurred since Q2 2010. In addition to earnings growth, revenues are expected to increase at a rate of 7.3 percent for the quarter. It is possible that as analysts begin to factor in the consequences of tariffs and a possible trade war, earnings expectations may be lowered.

The Fed will conduct two meetings during the second quarter, one in May and one in June. Current expectations are for a 25 basis point rate hike coming from the June meeting. As economic data rolls out, analyst views could change; however, the Fed has been deliberate to set expectations so as to not surprise the markets, so unless something dramatically changes, a 25 basis point rate hike is expected during the second quarter.

While the short end of the yield curve is driven by Fed policy, the long end is influenced by other factors. Inflation is one factor that influences the long end of the curve; another factor is supply and demand of Treasury bonds. Inflation readings have been in focus over the last several years and will continue to be. Since the inflation readings are backward looking, the price impact of the tariff talks may not be seen in readings released in the coming months. Additionally, any movements may be based on rumors since many of the discussed tariffs have not been codified into law yet. The supply and demand dynamics of yield curve movements may also be affected by the trade war developments. China is a significant purchaser and holder of U.S. Treasury bonds. If they decide to use this as leverage, China may be able to move the long end of the yield curve by slowing its purchase, or even selling, long-dated treasury bonds. When you consider that the Fed is decreasing demand for long-dated U.S. Treasuries by unwinding its balance sheet, and that the U.S. government is increasing supply due to the tax bill's effect on the deficit, conditions are becoming ripe for the long end of the yield curve to rise.

Over the relative short-term, emerging markets have been an attractive investment, but like the U.S. and other developed markets, emerging markets may be negatively impacted if a trade war ensues. Unless and until that happens, we expect that the trend of synchronized global growth, which in 2017 drove the revenues of multinational corporations and much of the global economy, will continue. Emerging markets also enjoy more attractive valuations compared with developed markets. The weakening dollar and the expectation of future weakening has, and should continue to, benefit investors in these countries.

The geopolitical landscape, though it didn't produce any market moving developments in the first quarter, is still set for potential flare-ups and more serious crises. At the time of this writing, news broke of a new chemical weapons attack in Syria. President Trump, dealing with a host of issues at home, may sharpen the U.S. response to a point that could further complicate relations with Russia. The Trump-Kim summit that will allegedly take place this spring will also draw a lot of attention from market observers.

The current market environment can be summed up as "fundamentals are strong, but markets are highly sensitive." Higher volatility can be expected to continue. 2018 is shaping up to be a year that separates those investors who have a plan and stick with it from those who succumb to short-term market movements driven by headlines. If you haven't reviewed your asset allocation recently, we recommend you do so soon to ensure that your current investment risk is aligned with what you can tolerate.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

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