2018 First Quarter Review of the Markets

Index	1st Qtr Return
S&P 500	-0.76%
MSCI ACWI Ex USA	-1.18%
Barclay’s Bond Index	-1.46%
Consumer Price Index	0.63%

Investment Commentary

Volatility is back. The first quarter of 2018 reminded investors that markets do not always go up, and that high valuations can make markets more sensitive to bad news. January returns were strong, picking up right where 2017 left off. February and March, however, were considerably more volatile with global markets experiencing the first correction (defined as a peak-to-trough drop of at least 10%) since early 2016. The S&P 500 ended the quarter down 0.8%. International stocks fared similarly, ending the quarter down 1.1%.

Bonds did not provide relief as the Bloomberg Barclays Aggregate bond index performed worse than global equity indices, losing 1.5%. Losses came primarily as a result of rising interest rates, but credit spreads also widened on corporate bonds as they typically do during equity market selloffs.

Economic Outlook

It is our estimation that the selloff that began at the end of January progressed as follows. The Bureau of Labor Statistics released their employment report for the month of January which showed wages increased more than expected. This led to fears of increased inflation. Worries about increasing prices had two effects: they increased the interest rates on longer term bonds, and increased the probability that the Fed would tighten monetary policy at a more aggressive pace than originally expected. The two forces of cheaper bonds and more aggressive monetary policy made stocks relatively less attractive and prices fell.

It seems counterintuitive that stocks should drop solely as a result of Americans earning *more* money. More aggressive tightening of monetary policy, however, would be of concern. The Fed’s current forecast of rate hikes already incorporates inflation that has hovered around 2% for the past year, and we do not believe that there have been material developments that will drive inflation much higher at this time, perhaps with the exception of our next topic - tariffs.

International trade was another important topic in markets during the quarter. The protectionist stance taken in Washington has raised questions about the impact of trade tariffs on markets. From a purely economic perspective, tariffs create pricing inefficiencies globally. Imposing tariffs increases prices to purchasers and decreases consumption, both generally negative for the economy. However, tariffs increase income to the government and decreases competition for domestic producers, which could create jobs for these firms. The final outcome of trade talks remains to be seen, but as with most policy changes there will be winners and losers. We are confident that increasingly aggressive rhetoric with regards to trade and tariffs resulting in a full-blown trade war would have negative implications for both the domestic and global economy. At this point, we are hopeful that the rhetoric is merely a negotiating tactic and thus not have a significant economic impact.

Investment Strategy

The quarter did not bring about significant changes to our asset allocations. The economic outlook seems stable enough to remain invested at a neutral allocation to equities. We continue to watch the employment picture as well as corporations' access to debt markets to make sure that remains the case. With this as a backdrop, news during the quarter was not sufficient for us to decrease the risk allocation in the portfolio. Also, the decrease in valuations was not sufficient for us to increase risk in client portfolios, as it was simply a return to multiples seen at the end of 2016. At that time, interest rates were much lower, making stocks slightly less attractive now than they were at that time.

Growth stocks (as opposed to value stocks) have fueled much of the performance in U.S. stocks over the past 15 months. Growth companies can be categorized as stocks with higher price to book value ratios and higher expected earnings growth rates. Generally speaking our equity allocation has been more skewed towards growth than value for most risk profiles over that time, which has been helpful. However, historically periods where growth has outperformed value (or vice-versa) have not been persistent. It is for this reason, as well as elevated sentiment and revenue growth expectations in sectors like technology, that we are weighing a partial transition from growth stocks into more value-oriented equities.

As noted, fixed income did not provide a meaningful safe haven against declining stocks for the first quarter of the year. We do believe that in the event of a truly adverse stock market event or a recession, investment grade fixed income with some duration (interest rate risk) will provide meaningful portfolio protection. Since the timing of such events is uncertain, we continue to hold these bonds in client portfolios where appropriate.

We are within 18 months of the longest economic cycle on record and we would like to remind clients that our expectation is for continued volatility as opposed to the relative calm of 2017. We would also encourage clients to revisit their risk profiles and ensure they are still in line with long-term goals. As always, we welcome such discussions.