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MARKET REVIEW & OUTLOOK
FIRST QUARTER 2018

The Return of Volatility: A First Quarter Timeline

After a calm and lucrative 2017, market volatility returned with a vengeance in the first quarter of 2018. The S&P 500 and Dow Jones fell by -0.8% and -2.0% respectively. The Nasdaq rose by 2.6% during the quarter. International developed equity markets fell by -1.6% while Emerging Markets rose by 1.2%. While interest rates were quite volatile, they ultimately rose by 0.3% as measured by 10-year Treasury yields, and the Barclays Aggregate Index fell by -1.5%. Gold prices rose by 1.7%, energy prices rose by 7.5%, and the U.S. dollar fell by -2.2% relative to a basket of global currencies. These relatively meager performance figures do not do justice to the ups and down of the first quarter. It was a wild ride!

Global stock markets rose in a rapid and linear fashion in January, a continuation of the trend that was in place in 2017. The S&P 500 rose nearly 6% in January alone as fourth quarter 2017 earnings proved very strong and corporate guidance around the new tax policy was issued. Equity fund inflows were considerable, and the environment was euphoric. There was evidence that retail investors were finally coming back into the market.

The early February jobs report showed the fastest acceleration in wage growth since 2009 and was the catalyst for a long overdue market correction. The first official testimony by new Federal Reserve chief Jay Powell was perceived as hawkish, and the 10-Year Treasury yield began to rise rapidly. Inflation was suddenly the topic du jour. In a relatively short amount of time (eight trading days), we finally had a proper market correction (defined as a market pull-back of at least 10%). Worth noting is that half of the retail funds flows that were recorded in January became outflows in February. The unwind of isolated volatility financial instruments had been a long-time coming and is healthy for the markets in the long run.

After a recovery at the end of February and beginning of March, we were hit by news about compromising data usage by Facebook and trade tariffs targeted at the Chinese by President Trump. U.S. markets declined by about -6% during the week of March 19th. Unlike what we saw in February, this decline was more traditional in nature in that Treasury yields fell and defensive sectors held up relatively well. Lost in the news-flow was that the Federal Reserve hiked interest rates for the sixth time in this cycle to 1.75%. The Technology sector became a point of negativity as Google lost an important legal battle with Oracle, Trump made comments about regulating Amazon and squelched the merger between Broadcom and Qualcomm, and Mark Zuckerberg was called upon to testify before Congress.

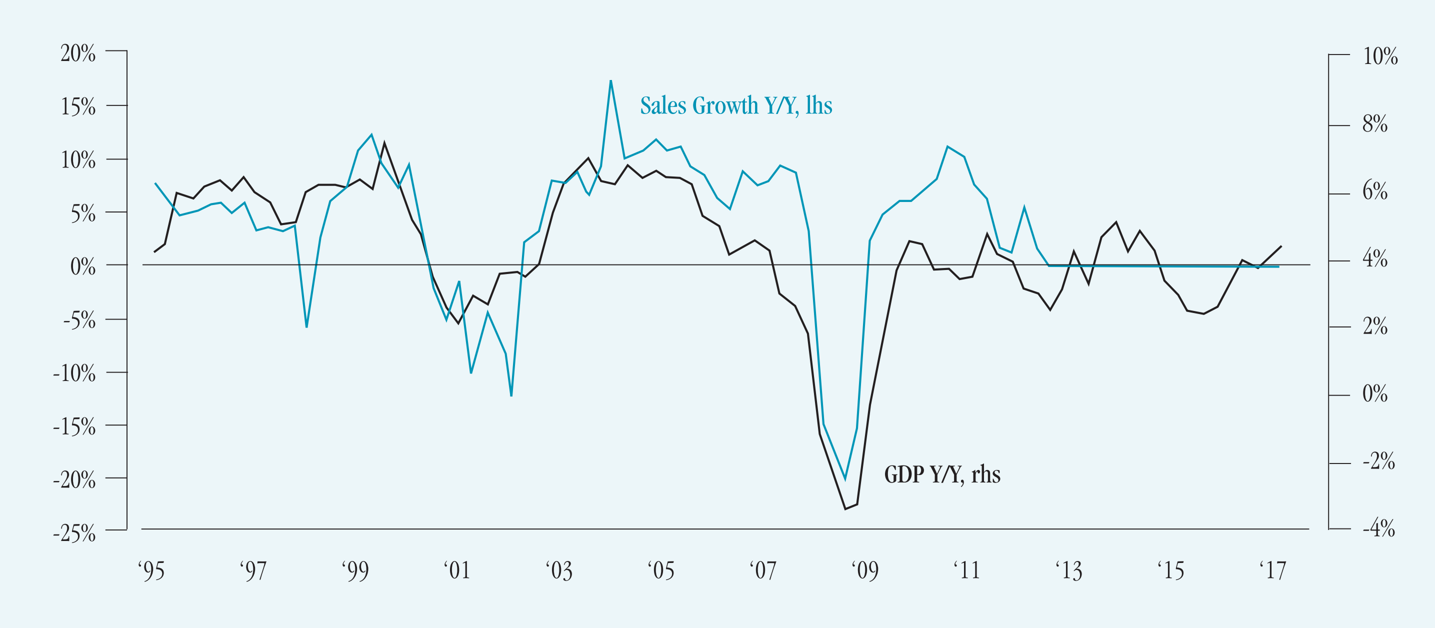
Politics versus Corporate Fundamentals:

Corporate fundamentals remain quite strong. 2018 and 2019 should be record years for buybacks and dividend yield increases thanks to repatriation of foreign cash, lower tax policy uncertainty and record corporate earnings. Repressed demand for capital expenditures plus the newest tax reform incentives have driven economic data even higher – U.S. Manufacturing PMI and Consumer Confidence hit cycle-highs in February.

We acknowledge that mean-reversion oriented P/Es (like the Shiller/CAPE) remain expensive for the U.S. market. However, the more traditional 12-month forward P/E is now quite reasonable. The S&P 500 is trading at 16.3xs 12-month forward earnings versus a 30-year median of 15xs. Valuation looks even more reasonable if taken within the context of lower global interest rates. Over the past 30 years, interest rates have averaged almost five times higher than the current global level.

The political environment, however, is

S&P 500 Sales Growth Y/Y vs. GDP Pct Chg Y/Y



Source: Strategas Research Partners

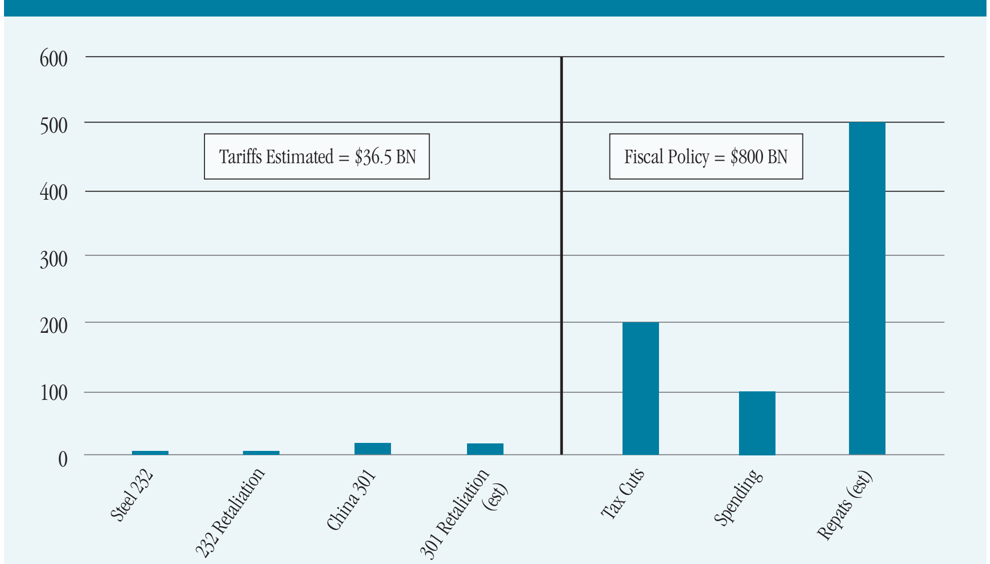
fraught with uncertainty. The market appears to be overreacting to sequential negative narratives (inflation scare in February, rising yields, a hawkish Fed, rising deficits and a potential trade war). There is indeed a reasonable case that U.S. trade with China was not fair over the last few decades. But it is difficult to imagine that tariffs are the solution. While our absolute trade deficit is large, our trade deficit as a percentage of GDP has decreased by a great deal over the last five years. Round one between the U.S. and China on aluminum and steel tariffs saw numerous exemptions. Separately, NAFTA negotiations look to be proceeding with some key agreements in recent days.

The market's response to Trump's declaration of 25% tariffs on $50-$60bn of Chinese imports led to investors erasing $4 trillion in global market capitalization which is 100xs the total value of goods affected by tariffs. In the U.S., we are looking at $200bn in new tax cuts, $100bn in new federal spending, and $500-$700bn in repatriation vs. $37bn in thus-far announced tariffs. In retaliation, the Chinese are reportedly imposing a levy on $10bn of U.S. imports that range from 25%-15%.

We believe that our President's negotiating style has become apparent, and we believe that what began as "tough talk" will moderate as negotiations proceed.

Inflation versus Deflation:
Today's economy remains characterized by "Goldilocks" growth, rising corporate earnings, easy monetary policy, less regulation, lower taxes and massive fiscal stimulus. Economic slack as measured by capacity utilization rates, unemployment rates, etc. has been exhausted so, going forward, additional growth should generate modest inflation. At this stage, a bit of inflation is good for equity markets. As the "Goldilocks" growth of late 2016 and 2017 starts to fade, this could be problematic for traditional bond allocations.

Comparing The Size of Tariffs With Incremental Fiscal Policy, CY 2018, $BN



Source: Strategas Research Partners

Ironically, the timing of the Tax Cuts and Jobs Act combined with the massive expected increase in government spending agreed to in the budget deal may accelerate the end of the business cycle. These policies are, of course, well intentioned. Trump hopes to expand economic growth to portions of the country that have been left behind and attract more jobs and manufacturing back to our country. Normally, massive fiscal policies are implemented when times are tough. Times are not tough, and we are sitting at full employment. Trump's fiscal spending budget is nearly as large as Obama's during the Global Financial Crisis.

This oddly timed fiscal policy may temporarily boost economic growth which is likely to increase inflation. In response, the Fed may raise interest rates more aggressively, prematurely ending the current business cycle. If we are right, this cycle will end as they generally do – with the aggressive tightening of monetary conditions causing an inverted yield curve.

The current deficit is expected to get much worse. Many economists now forecast a federal budget deficit of more than $1 trillion as early as 2019. To fund this massive deficit, the U.S. Treasury will have to issue more debt in the form of Treasuries at a time when the Fed has committed to reducing its balance sheet. To meet its future debt obligations, the U.S. will eventually have to raise taxes, cut spending, borrow more money or print more U.S. dollars.

The optimistic argument is that if the U.S. tax cut performs as envisioned, it will likely be because capital expenditures finally rise after years of stagnation, boosting productivity and wages. Growth in the economy will run hot and make up for lost tax revenue.

Since the late 1990s, when stocks have sold off, bond yields have moved lower. This diversification has been useful to investors and asset allocators and is the premise behind the traditional balanced portfolio. This pattern has not always held, however. For instance, in the 1970s when inflation was rising, bond and interest rate sensitive sectors provided little safety while hard assets like commodities performed well. The outlook for inflation versus deflation is THE most important economic factor today. We believe that it will take a few years to have a definitive answer on the subject. There are many structural factors that are deflationary, but the massive monetary stimulus of the last nine years should prove inflationary at some point.

In Conclusion:

At the risk of sounding like a broken record, we do not feel the end of the business cycle is imminent. Market volatility in the first quarter may have bought us some time. Today, valuations are reasonable (the S&P 500 is trading at 16.3xs forward earnings while corporate earnings are supposed to grow by 18% this year). Any euphoria from 2017 has been washed away. Funds flows have been negative, and the put/call ratio is reaching negative extremes. Investors are again pessimistic in the face of record manufacturing, consumer confidence and corporate earnings data. Our business cycle indicators remain benign. While a true trade war would be problematic, we believe that President Trump has dealt his opening hand and is using his characteristic bluster as a negotiating tool. We believe that the first quarter earnings season will be very strong, and that investors will focus on strong company fundamentals once again.

MARKET DATA					
Index		*Q1 2018*	*2017*	*2016*	*2015*
S&P 500	*U.S. Large-Capitalization Stocks*	-0.76%	21.83%	11.95%	1.37%
S&P 400	*U.S. Mid-Cap Stocks*	-0.77%	16.24%	20.73%	-2.18%
S&P 600	*U.S. Small-Cap Stocks*	0.55%	13.23%	26.46%	-2.01%
Russell 1000	*U.S. Large- and Mid-Cap*	-0.69%	21.69%	12.04%	0.91%
Russell 1000 Growth	*Growth Stocks broken out*	1.42%	30.21%	7.07%	5.67%
Russell 1000 Value	*Value Stocks broken out*	-2.83%	13.66%	17.33%	-3.84%
MSCI EAFE Index	*Established International Markets*	-1.58%	25.62%	1.59%	-0.28%
MSCI Emerging Markets	*Developing International Markets*	1.24%	37.75%	11.27%	-14.61%
		3/31/18	12/31/17	12/31/16	12/31/15
90 day T-Bill	*Short-Term Interest Rate*	1.72%	1.39%	0.51%	0.17%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.74%	2.43%	2.45%	2.28%
VIX Index	*Risk Measurement*	20	11	14	18
Corporate Bond Spread	*Risk Measurement*	110 bps	93 bps	120 bps	165 bps
TIPS Spread	*Inflation expectations*	196 bps	198 bps	197 bps	171 bps

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