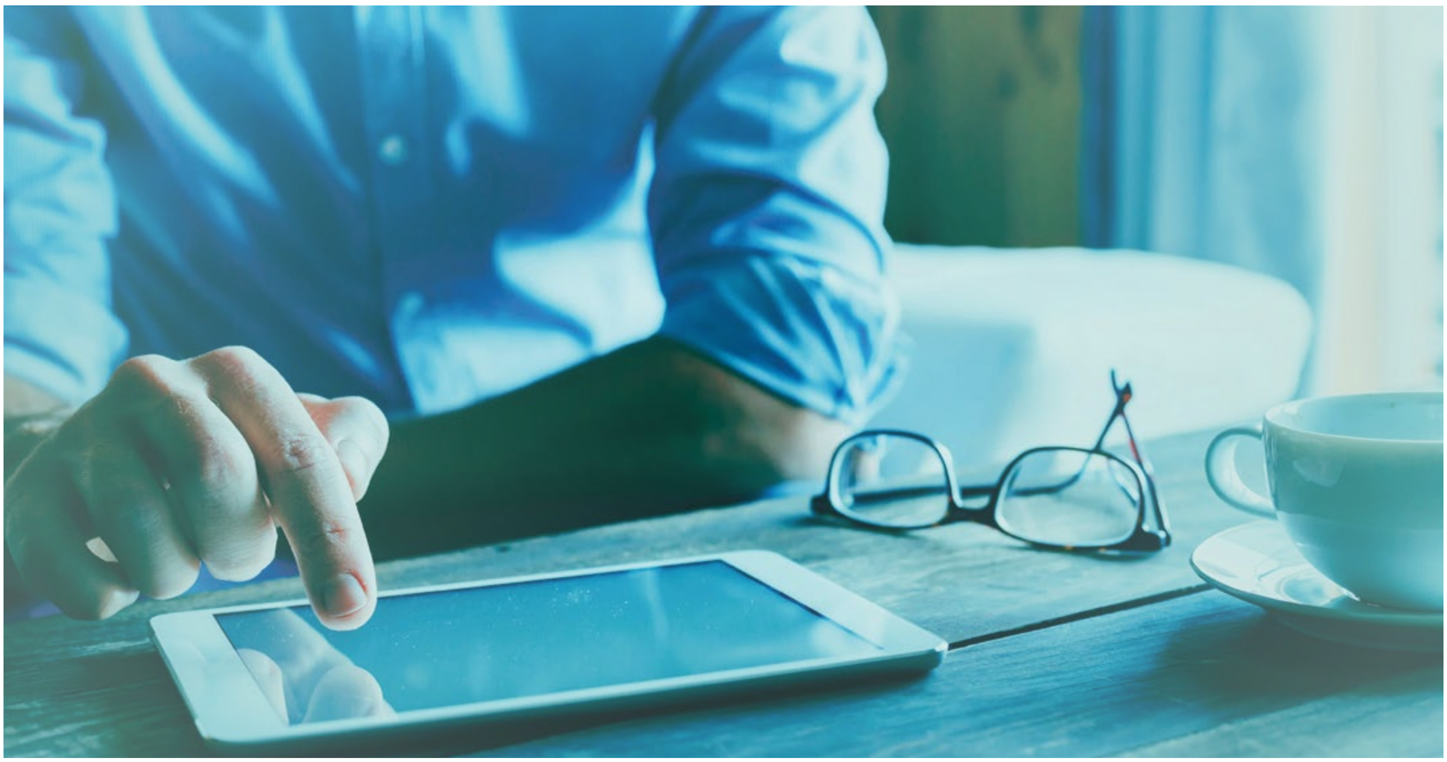
Tompkins Financial Advisors

Investment Committee Update

Q1 Review ■ 2018



THE QUARTER IN BRIEF

Stocks rallied in January, corrected in February and slumped in March as volatility and economic policy changes took some of the enthusiasm out of the market. The Trump administration announced tariffs on foreign steel, aluminum and assorted products from China; China soon said that it would reciprocate with excise taxes of its own. The Federal Reserve adjusted the federal funds rate upward and welcomed a new chair; the White House appointed a new chief economic advisor. An orderly process was outlined for the Brexit. The Nasdaq Composite advanced for the first quarter, but the Dow 30 and S&P 500 did not; most major Asian and European benchmarks also retreated. Among commodities, oil and gold improved. The placid market climate of 2017 vanished, giving way to trading sessions marked by significant ups and downs.[1]

DOMESTIC ECONOMIC HEALTH

A protectionist trade strategy emerged from the nation's capital in March. The Trump administration declared that a 25% tariff would be instituted on imported steel and a 10% tariff on imported aluminum. Some countries were given short-term exemptions from these excise taxes: Argentina, Australia, Brazil, Canada, Mexico, South Korea, and members of the European Union. Additionally, up to $60 billion in Chinese imports would soon face excise taxes. China retaliated at the end of the quarter, imposing import charges of either 15% or 25% on 128 U.S. products, including pork and fruits.[2]

Elsewhere in Washington, the Janet Yellen era gave way to the Jerome Powell era at the Federal Reserve. Weeks after Powell took over as Fed chair, the central bank made its first interest rate adjustment of the year, a 0.25% hike that set the target range for the federal funds rate at 1.50%-1.75%. The Fed's updated dot-plot forecast, reflecting the consensus opinion of its policymakers, projected two more hikes this year: three in 2019 and two in 2020. All that would leave the benchmark interest rate around 3.4%, according to the dot-plot. The Trump administration hired former Reagan administration official and CNBC commentator Larry Kudlow as its new chief economic advisor, following the resignation of Gary Cohn.[3,4]

Business growth looked good in the first quarter; correspondingly, so did hiring. The Institute for Supply Management's factory Private Mortgage Insurance (PMI) went from 59.1 to 60.8 to 59.3 across three months; ISM's service sector gauge was also very high at readings of 59.9 in January and 59.5 in February. January saw a net job gain of 239,000 hires by the Department of Labor's estimation, and February brought an even more impressive net gain of 313,000. The headline jobless rate stayed at 4.1% in January and February, and the U-6 rate, counting the underemployed, remained at 8.2% in both those months.[5]

Inflation became a worry during the quarter, but fears that it was running away subsided. There was a half-percent spike in the headline Consumer Price Index in January, plus a 0.3% gain for the core CPI. A month later, both the headline and core CPI moved but 0.2%. By February, annualized consumer inflation was running at 2.2%, core inflation at 1.8%. Wholesale inflation pressure was greater: the year-over-year advance in the Producer Price Index through February was 2.8%. Speaking of production, industrial output was up 4.4% in the 12 months ending in February; durable goods orders rose 3.1% in February after a 3.5% January decline.[5]

Consumer incomes rose 0.4% in both January and February, paralleled by consecutive 0.2% gains in consumer spending. Another indicator from the Department of Commerce seemed to show consumers were saving rather than buying: overall retail sales fell 0.1% in February following a 0.1% January increase. The Bureau of Economic Analysis showed real consumer spending at 4.0% in the fourth quarter, a major factor in the 2.9% expansion of the economy. (That number was an upgrade from the BEA's second estimate of Q4 GDP, which was 2.5%.)[5]

Consumer confidence indices posted very high readings. The successive marks for the University of Michigan's monthly index in the quarter: 95.7; 99.7; 101.4. The Conference Board's index hit an 18-year peak of 130.0 in February before dipping slightly to 127.7 a month later.[6,7]

GLOBAL ECONOMIC HEALTH

Things looked better for China's economy as the quarter ended. The nation's official manufacturing PMI rose 1.2 points to 51.5, marking the twentieth straight month of expansion for China's factory sector. That reading was a point higher than the consensus in a Reuters survey. Economists, polled by Reuters, forecast China's growth rate to decline slightly to 6.6% in the quarter; the Chinese government projected Gross Domestic Product (GDP) of 6.8%. Vietnam looked like the star of Asian economies in the quarter; its GDP reached 7.4%, and its exports were up 22% year-over-year.[8,9]

The European Central Bank shifted policy slightly in the quarter. In its March policy statement, it removed references to the possibility of increasing its €30 billion-per-month bond purchase program if the global economic outlook worsened. It forecast euro-area growth of 2.4% in 2018, 1.9% in 2019, and 1.7% in 2020. In January, the Markit manufacturing PMI for the eurozone reached a 12-year peak of 58.8. Economists worried about Italy's sharp swing toward nationalism, as voters embraced two radical-right parties, the Five-Star Movement and the League, in its latest national election. The fear was that renewed populist sentiment might build and lead Italy to vote to abandon the euro and head back to the lira.[10,11]

WORLD MARKETS

Next to the Nasdaq Composite, Hong Kong's Hang Seng had the best Q1 of any notable stock benchmark: it rose 0.58% in the first three months of 2018.[12]

The FTSE 100 took the hardest fall: the United Kingdom's Marquee index plunged 8.21%. Germany's DAX tumbled 6.64%, and the Nikkei 225 had a quarter almost as poor, dropping 5.76%. Canada's TSX Composite lost 5.19% in Q1, and Australia's All Ordinaries retreated 4.84%. In China, the Shanghai Composite finished the quarter 4.18% lower. France's CAC 40 lost 3.43%, and India's BSE Sensex slumped 3.20%. MSCI's two closely watched benchmarks rode through the turbulence without much damage: the MSCI World index fell 1.80%, and the MSCI Emerging Markets index, 0.93%.[12,13]

COMMODITIES MARKETS

S&P 500 VIX futures led the commodities pack in the quarter, rising 41.26%.[14,15]

Other notable commodity and currency gains and losses in Q1: cocoa, +35.02%; soybean meal, +19.96%; lumber, +18.82%, the Mexican peso, +10.17%; corn, +8.01%; WTI crude, +7.83%; soybeans, +7.37%; cotton, +3.17%; wheat, +2.44%; orange juice, +2.39%; the U.S. Dollar Index, -2.01%; silver, -5.12%; coffee, -8.09%;

palladium, -9.64%; #11 sugar, -17.78%. Gold gained 0.81% for the quarter; unleaded gasoline, 1.33%. Platinum retreated 1.17%. On March 29, WTI crude settled at $64.94 per barrel on the NYMEX; gold and silver respectively closed at $1,327.30 and $16.27 on the COMEX.[14,16]

REAL ESTATE

In the first quarter, home loans certainly became more expensive. On March 29, Freddie Mac's Primary Mortgage Market Survey showed the interest rate on a conventional mortgage at 4.44%, up from 3.99% on December 28. Rates also climbed for 15-year Fixed Rate Mortgage (FRMs)and 5/1-year Adjustable Rate Mortgage (ARMs). Average interest on the 15-year fixed rose from 3.44% to 3.90% in the same time frame, and from 3.47% to 3.66% for the 5-year adjustable-rate home loan.[17,18]

After falling for two straight months, existing home sales improved 3.0% in February – even as some serious headwinds threatened to hold sales back. The median house price had risen 5.9% in a year (to $241,700); mortgage interest rates were climbing and there was a distinct shortage of affordable properties for buyers – but demand overruled all of that. Economists surveyed by Reuters had forecast that the National Association of Realtors would announce a February sales gain, but just one of 0.5%; NAR said that resales were up 1.1% year-over-year through February. New home buying, according to the Census Bureau, declined for a third consecutive month in February. The 0.6% dip occurred even with new home supply at a 9-year high, and the median price, down 0.9% from a peak reached in November. Through February, new home sales had strengthened 0.5% in 12 months.[19,20]

The NAR's pending home sales index partly reversed its 5.0% January retreat with a 3.1% February advance. Building permits improved 5.9% in January, then slumped 5.7% a month later; housing starts were up 10.1% in January, then fell 7.0% in February. The 20-city S&P CoreLogic Case-Shiller Home Price NSA Index rose 0.3% in its January edition, taking its yearly gain to 6.4%.[5]

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LOOKING BACK… LOOKING FORWARD

At the end of Q1, the Nasdaq Composite had managed a decent YTD advance, unlike the Dow Jones Industrial Average, S&P 500 or Russell 2000. (The Russell also had a negative quarter, losing 0.40%.) The PHLX Oil Service index brought up the rear among U.S. equity indices during Q1, retreating 9.27%. Volatility sent the CBOE VIX jumping: the "fear gauge" of the stock market climbed 80.89% for the quarter. On March 29, the Dow settled at 24,103.11; the S&P, at 2,640.87; the Nasdaq, at 7,063.44; the Russell, at 1,529.43; the VIX, at 19.97.[1]

As a tough quarter for stocks becomes history, signs of a trade war have surfaced. What could the second quarter hold? All three major indices (and oil futures) sold off significantly as Q2 began. Investors hope that the March jobs report and the start of a new earnings season will restore some optimism to the market. Housing and retail sales aside, fundamental economic indicators have looked good for the most part. The anticipation (and results) of this coming earnings season could take investors' minds off recent headwinds, but a continuation of the market volatility we witnessed in the first quarter would not be a surprise. If earnings can distract Wall Street away from concerns about trade, the slump in tech shares and the Fed's plans for tightening; then, the tone might be set for a better month and quarter than some investors expect. For now, the feeling that a promising year for equities might turn into a poor one persists.[25]

% CHANGE	Q1 CHG	2017	1-YR CHG	10-YR AVG
DJIA	-2.49	+25.08	+16.67	+9.73
NASDAQ	+2.32	+28.24	+19.77	+21.24
S&P 500	-1.22	+19.42	+11.85	+10.08
REAL YIELD	**3/29 RATE**	**1 YR AGO**	**5 YRS AGO**	**10 YRS AGO**
10 YR TIPS	0.69%	0.41%	-0.64%	1.13%

Sources: wsj.com, bigcharts.com, treasury.gov – 3/29/18[1,21,22,23,24]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

The material above was prepared by MarketingPro, Inc.

In Like A Lamb, Out Like A Lion: Volatility Returns In Q1

The market environment in 2017 was not normal. Volatility was abnormally subdued while risk appetite among investors soared to all-time highs. The S&P 500 broke records, including going more than 33 consecutive sessions without a 0.5% daily decline, going more than 244 consecutive sessions without a 3% drawdown, and going more than 400 consecutive sessions without a 5% drawdown. While 2017 was a Goldilocks year of strong returns and record-setting low volatility, investors need to realize that 2017 was an outlier year and should prepare for a return of volatility to historical norms.

All of the low volatility records set in 2017 came to an end during the first quarter of 2018. Markets got off to a strong start with a near 7% advance for the S&P 500 in January. However, a return of volatility eroded all of those gains, pushing markets into the red as investors began to worry about the potential for an accelerated rise in interest rates and the potential for a full-blown trade war.

A combination of **trade war concerns** and a **selloff in the technology** sector led investors to flee U.S. equities.

Trade War Concerns

Trump has continued to apply pressure internationally through an array of tariffs. The president is also threatening to dismantle NAFTA, further fueling market uncertainty. China has since retaliated with its own set of tariffs. The Chinese imposed a 15% - 25% tariff on 128 U.S.-made goods, mostly focusing on agricultural products, such as beef, pork and almonds. China's concentration of tariffs on U.S. agricultural products is an effort to hurt Trump's core base of voters and put pressure on him to halt the implementation of additional tariffs. A breakthrough on a NAFTA deal could help shore up concerns of a deteriorating U.S. position in global trade; the Trump administration is pushing for a NAFTA deal in principle to be announced at the Summit of the Americas in Peru in April.

Tech Selloff

The FANG stocks – Facebook, Amazon, Netflix, and Google – which have been the market leaders since 2015, have fueled the recent market selloff. While there were a number of company-specific headlines (Trump feuding with Amazon via tweet, Tesla auto crash fatality and inability to meet Model 3 production targets, and Apple ditching Intel for in-house computer chips), the broader market implications stemmed from a combination of the longstanding outperformance of the growth and momentum factors, the sector's outsized weighting in the S&P 500.

Portfolio Shift

Tompkins Investment Committee shifted from a sizable overweight in growth stocks to a slight overweight in value stocks in mid-February. This move

Closely Monitoring Market Technicals

The S&P 500's recent close below its 200-day moving average was the first since BREXIT in June of 2016. We are closely monitoring market technical and keeping an eye on a number of indicators.

In the chart above, the market uptrend established in March of 2009 is still within the one standard deviation channel line from the central regression line (red line.) We will be more concerned if the second standard deviation line (lower green line) is disrupted.

lowered our exposure to the technology sector, which was a timely move given the recent weakness in tech, with technology mega-caps dragging down the performance of major indices.

Silver Lining

Improved valuations are a positive for the market. The S&P 500 Index's latest decline has made it the cheapest since the global selloff that followed BREXIT. Lower valuations combined with expectations of positive first quarter earnings is likely to slow further declines.

Conclusion

Investors should prepare themselves for a return of volatility, especially after an abnormally quiet 2017. At Tompkins Financial Advisors, we focus on structuring diversified portfolios that protect against market volatility. We not only include stocks and bonds, but also alternative strategies that have low correlations to equities and fixed income. While bonds don't offer fool proof protection in sell-off scenarios, due to their rising correlations during periods of market stress, alternative strategies can offer another avenue of portfolio diversification.

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