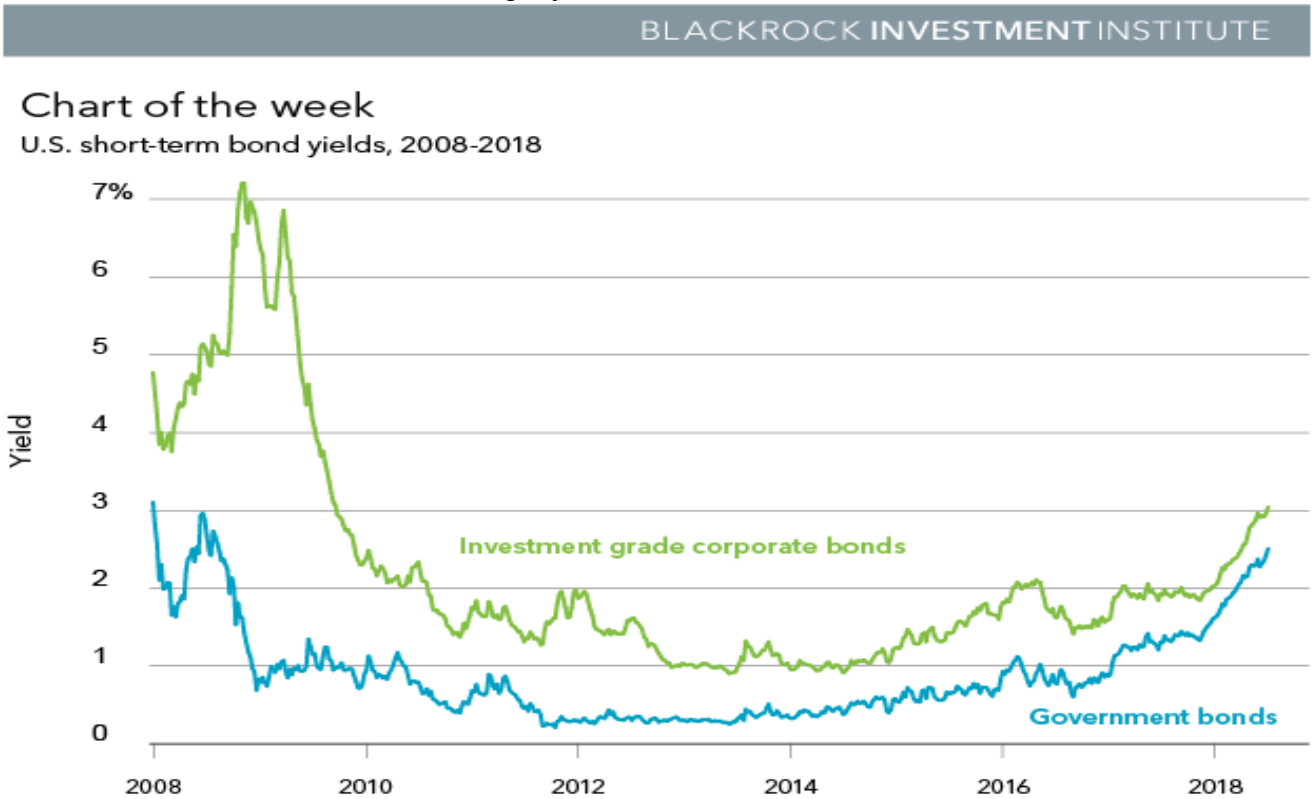
Market Insights for Week Ending April 27, 2018

The Yin and Yang of Rising Rates

"The Chinese use two brush strokes to write the word 'crisis'. One brush stroke stands for danger; the other for opportunity." This quote came from President John F. Kennedy during a speech delivered on April 12, 1959. While this quote has been used to describe many situations over the years, it describes the current situation in market yields quite well. Before we move on, a bit of a disclaimer. Our research found, according to Chinese Language Professor Victor H. Mair, the quote from Kennedy is inaccurate. Apparently, the error comes from a misunderstanding of how words are formed in Mandarin. Nevertheless, let us pretend just for today that what Kennedy said is accurate.

As longer term rates once again approached 3%, markets became nervous and volatility returned. Even a solid start to corporate earnings season wasn't enough to maintain the small bounce in equities. What was lost in all the noise was the fact that short-term investment-grade corporate bonds also hit 3%, which hasn't occurred in eight years.



Sources: BlackRock Investment Institute, with data from Thomson Reuters and Bloomberg, April 2018. Notes: Investment grade corporate bonds are represented by the Bloomberg Barclays U.S. 1-3 Year Credit Index, and government bonds are represented by the Thomson Reuters Benchmark 2-Year U.S. Government Bond Index.

The chart above depicts the yield for short-term investment grade corporate bonds in green and 2-year US Government bonds in blue. These yields have stayed below the 2% level since 2011, leaving very few options for investors who want a safer income stream that could keep up with inflation. And while

rates outside the US remain much lower, the increased income made available by higher US interest rates will have implications across almost all asset classes going forward.

Why Do We Care?

Going back to Kennedy's quote, how does the current situation present both danger and opportunity? To start, low short term rates over the past decade have forced income investors to consider riskier assets in search of higher yields. This has forced large amounts of capital into stocks and both high yield and emerging market bonds. High yield bonds remain at historically expensive levels and have remained uncharacteristically stable during the recent bout of stock market volatility.

The concern is, what will happen if higher interest rates persist? The need for income-oriented investors to use riskier assets for income will be diminished as investors will be able to find "safer" sources of income again. The ability to remove some price risk and still receive an acceptable level of income will lead some investors to begin to shift money from riskier assets and move it back into less volatile investments. While HCM hasn't yet reduced either our equity or high yield exposure, we did recently shorten the duration risk in our portfolios while taking advantage of higher yields on short-term fixed income. We see this as the opportunity side of rising rates.

As for the danger side, rising rates have certainly been a factor in the recent stock market volatility. Each time ten-year bond yields have approached the 3% level, equities have sold off. How long will investors hold onto riskier assets when they are gradually getting more income investing in "safer" assets? This is the danger side. A rapid repricing of riskier securities could cause a continuation or even an increase in selling pressure and a sharp drop in prices.

HCM continues to keep a close eye on this relationship and is prepared to adjust portfolios if we feel there isn't sufficient compensation for holding riskier assets. So far, we have seen strong earnings reports from US corporations. And global growth, while slowing somewhat, remains positive. Overall, we are maintaining our current portfolio positioning and our slight overweight to equities.

Weekly Focus – Think About It

Happiness is not something ready-made.
It comes from your own actions. – Dalai Lama

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Loss of .10%
- Developed Foreign Markets (EFA) – Loss of .22%
- Emerging Markets (EEM) – Loss of 1.03%
- Fixed Income (AGG) – Gain of 0.00%

(Note: performance is based on the change in net asset value

Last Week's Headlines

-US 10 year Treasury yields hit a four-year high of 3%. Strong equity earnings were initially met with a poor market reaction, though share prices rebounded later in the week

-US data confirmed a moderate pace of economic growth in the first quarter, while consumer confidence climbed to its second-highest level since 2000.

-The European Central Bank chose not to raise interest rates. The region's composite purchasing manager's index(PMI) held steady.

Eye on the Week Ahead

-US payroll numbers are expected to be solid, though the cold weather in April may cause the numbers be lower than usual.

-The Fed is expected to give an upbeat message about the economy and to defer any rate increases to future meetings.

If you have questions about how rising rates affect your financial situation, please contact a member of HCM's Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

Disclaimer

Any tax or other advice contained in this document, including any attachments, is not intended and cannot be used for the purpose of avoiding penalties under Internal Revenue Code. No action should be taken on any information contained in this message without first consulting with your tax/legal advisors regarding the tax/legal consequences for your particular circumstances.

Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

• • •