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First Quarter 2018 Market Commentary

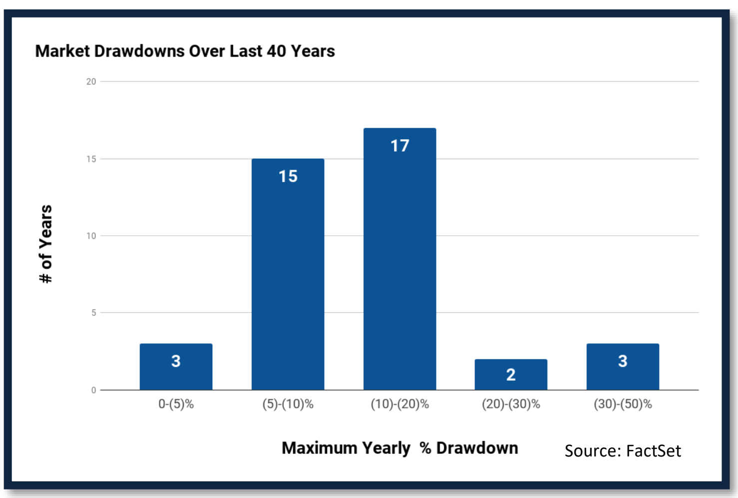
Index Performance and Analysis

The new year brought uncertainty and volatility back to the stock market in the first quarter. Investors exited positions in almost every corner of the market as they performed a reassessment of last year's slow, steady rally. The S&P 500 finished the quarter down -.76% with dividends while blue chips fared slightly worse with the Dow Industrials losing about -2%. The Nasdaq was able to post a weak gain of over 2% as technology company shares, last year's most crowded trade, began to falter mid-March. Small company stocks lost a half percent and bonds offered no safe harbor with the Bloomberg aggregate index losing -1.5%.

Market Correction Arrives

The year started off as a continuation of 2017's quiet but consistent stock rally. Since November of 2016 the S&P appreciated 34%. During that rise the market experienced historic calm; there were only eleven days in that 15-month span where the index moved at least 1% in either direction. It was only a matter of time, then, before investors pumped the brakes on this deliberate buying in order to reassess whether the economic environment, company fundamentals, and external risks justified the heights to which stock indexes had climbed. The reassessment arrived in February as consecutive bouts of selling resulted in the market's first correction in two years. A stock market correction is defined as a loss of at least 10% from a recent high, and it implies that stocks had been unreasonably bid up and wrongly priced. What brought this correction about, what are its consequences, and does it imply anything about the market in the year ahead? We consider these questions below.

The simplest explanation for the correction is the best: the stock market fell because it rose for so long. Corrections are an entirely normal occurrence for markets as investors periodically reevaluate the fair value of company stocks in response to a variety of changed circumstances. In fact the S&P 500 has averaged an intra-year drawdown, a loss, of 13% over the past forty years. The drawdown most likely to occur in a given year is between 10 and 20%; in other words, a correction. The extreme low volatility steady rise of 2017 is the true outlier. There is nothing unusual about this year's markets.



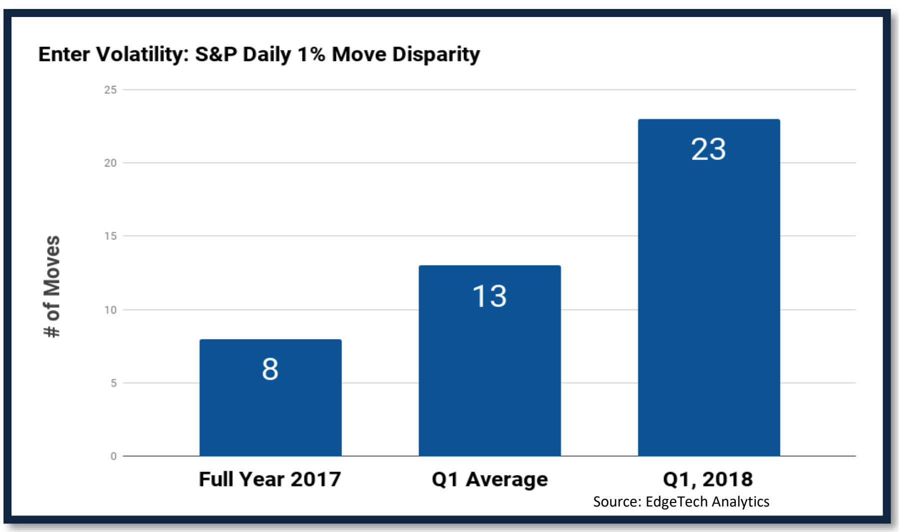
Nevertheless, there are always attempts to assign blame, to rationalize and create a dire narrative for why the market experienced a correction. Soon after February's sell-off there were widespread warnings of runaway inflation simply because supervisory worker wages rose a little more than what was predicted. Never mind that stagnant wages have been a consistent drag on our economic expansion and workers earning more tend to spend more, an undeniable good. In any case, subsequent wage and inflation reports returned to their normal rates of modest growth in March. Well, if it wasn't inflation then it must have been rising interest rates that spooked investors and shattered the market calm. Higher rates, this thinking goes, mean more expensive financing and thus businesses will be discouraged from investing further in themselves in the future. To be sure, interest rates are up this year, but they remain at historic lows, and domestic businesses will be flush with savings from the new tax legislation. It seems unlikely, then, that modest increases in rates will have significant effects on corporate capital spending let alone have been a catalyst for investor fears and the correction. So, despite the doom and gloom of the financial media and the ominous red number losses quoted on the nightly news, corrections are a normal part of a healthy market, they're events to be suffered through rather than surrendered to.

Tariff and Tech Turbulence

Unfortunately, the normal markets entail a certain amount of irrational investor behavior. Whereas last year investors were able to ignore the sensationalism surrounding the President and focus on fundamentals, this year investors are treating every Trump tweet as a buy or sell signal. Hence the first quarter's erratic volatility. Already in the first quarter the S&P 500 has experienced almost three times as many daily moves of 1% or more in both directions than in all of 2017. And the number is almost double the first quarter average going back to 1957. This chart shows the divergence.

Volatility has persisted post-correction because uncertainty has crept back into the minds of investors. Uncertainty breeds volatility and volatility only breeds more volatility.

First, what had seemed a remote possibility last year became a reality in the first quarter as President Trump announced his tariff plan in order to make trade fair again. Steel and aluminum tariffs were followed closely by a plan targeted specifically at that global trade malefactor, China. In true Trumpian fashion and much to the chagrin of skittish investors—these announcements were made post-correction—the tariffs came with caveats and carve-outs, i.e. plenty of room to negotiate. And so, Canada and Mexico, our closest trade partners and significant sources of imported steel, were exempted from the metals tariffs. Members of the Trump administration, in apparent attempts to calm the markets, are adamant that discussions with China are ongoing, and that some sort of bilateral accord will be reached which will sufficiently address all of the President's concerns about unfair trade practices. Be that as it may, continuing negotiations only serve to prolong volatility in the stock market as the prospect of a trade war looms thus feeding into the growing sense of uncertainty.



Aside from the tariff issue, the other source of uncertainty this year has been the high-flying technology sector of the stock market. For the past two years the sector has risen dramatically as investors have plowed money into the most familiar tech stocks. Until their peak in mid-March, technology company shares had risen almost 12% for 2018 coming off the heels of a nearly 40% rise last year. The time was ripe for a reevaluation of this crowded trade and pessimistic investors looking for a reason to sell found one in the privacy crack-up at Facebook. Abuse of the social network's user data by a political consulting firm instigated congressional hearings and a new call for government regulation of websites in regard to their collection and appropriation of their users' personal data. Government regulation, however well-intended, tends to stifle innovation as resources formerly allocated to productivity and development are transferred to compliance. The uncertainty accompanying the threat of the government regulating the best performing segment of the market rankled investors and helped to sustain volatility through the end of the quarter.

Key Economic Indicators

Gross Domestic Product

Fourth quarter GDP grew at a decent clip, coming in at 2.9%. The final number shows an economy growing at a moderate pace, neither too fast nor too slow. Bullish observers were disappointed in not seeing the third straight quarter of 3% growth and bearish observers found no evidence of an overheating economy. 2017's annual growth rate was 2.6%, mild to be sure, but a marked improvement over the past two years. Our economy is expanding thanks in part to the persistence of last year's synchronized global growth. With businesses now enjoying the benefits of the Republican tax cut—recall that the corporate rate fell from 35% down to 21%—and factoring in the softer regulatory touch of the Trump administration, we expect a boost to the current expansion this year. The elusive 3% growth rate (not seen since 2005) is a possibility and could finally put an end to this slowest economic expansion since World War II.

Consumer Sentiments

Measures of consumer sentiment and consumer comfort were elevated through the first quarter and reached record levels in March. This despite the stock market's erratic behavior, the never-ending drone of the media/Trump back-and-forth, and the real potential for a trade war. Confidence was dinged last month but remains near a 15-year high.

Such elevated consumer animal spirits bode well for the economy in the year ahead. Confident and comfortable Americans are more likely to spend, thereby adding to GDP and necessitating expanded production. The sentiments of consumers are a "leading indicator" meaning that they can be relied upon, to a certain extent, to foretell future economic conditions. Declining sentiments, thus, will precede economic downturns. The continuing rise in consumer attitudes in the face of significant market volatility indicates to us that the average American sees the economy as resting on firm ground and bolstered by a business-friendly government.

Labor Market

The defining aspect of this economy the past two years has been the good health of the labor market. The unemployment rate sits at 4.1%, where it has been the past six months. Total unemployment, a broader measure that includes those marginally attached to the workforce, is now at pre-recession levels. Prime-age (25-54) participation which was anomalously falling until it bottomed in 2015 continues to increase as more Americans fill jobs to accommodate our expanding economy. Notwithstanding the pace and breadth of recent job creations—we've gone 90-straight months without a net loss of jobs—wage gains remain tepid. While not ideal for workers, mild wage growth has helped to keep inflation in check and prevent the growing economy from growing too fast.

Looking Forward

As we have shown, the first quarter's volatility was nothing out of the ordinary. It feels like a "frightening deviation" because, as the *Wall Street Journal's* Jason Zweig explains, "the pain of a market drop depends not only on its size, but on its steepness relative to recent experience." It is important, then, that we not ascribe excessive significance to the correction and that we maintain the long view of the market. Market moves in the short term are more often volatile than calm, driven by reactive investor behavior focused more on the 24-hour news cycle than ongoing economic trends. Remember that the stock market is not the economy and not even a healthy growing economy will prevent corrections or volatility.

We expect more volatility the rest of the year, if the first quarter is any indication. Our quantitative investment software enables us to see through this volatility and helps us to create and manage proactive portfolios. These portfolios allocate based on an unemotional analysis of underlying price trends and market movement so that they are less susceptible to the volatile whims of this year's uncertain investors.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk includes the uncertainty and volatility of potential returns for a portfolio or an individual investment over time. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk. A computer modeling program may not reflect actual risk and return parameters applicable to any particular portfolio or investor. Actual investment decisions made on the basis of a computer-generated model or modeling program may be materially different from expected or intended results, and any computer modeling program is subject to errors in the program and system failures at any time.

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