Trumbower Financial Advisors, LLC
1st Quarter 2018
Investment Market Commentary

March Madness

First quarter US equity indexes resembled the UVA Cavaliers in the first round of the NCAA basketball championship. After scoring 7.55% and setting a new record January 26th, the S&P 500 fell into correction territory on February 8th. A subsequent 8% rebound was shut down by the bears' tight defense during early March. For the first time in 9 quarters US Equities finished in the red. Developed Foreign Markets followed suit giving back -2.2%. Emerging Market equities pulled a buzzer-beater that shoved them up 1.42%.

The starting line-up featured Technology and Consumer Discretionary sectors, up 3.5% and 3.1%, even though Tech stocks fouled out in March. Energy and Consumer Staples warmed the bench posting declines of -5.9% and -7.1%. Investors once again favored Growth stocks that maintained an average spread of 4.6% over Value.

Treasury yields edged higher – more so on the short end of the curve. The spread between 2 and 10-year yields narrowed to just 0.47%. The curve is at its flattest since the advent of the 2008 Financial Crisis. Chasing Fed Funds hikes, short term rates have jumped up 1% since March 2017. Yield on the 10-year is up just 0.32% and the 30-year a mere 0.03% from this time last year. Fears of inversion echoed around the locker-room giving investment market players the jitters.

The January jobs report showed a 2.9% increase in wages – the largest

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1st Quarter Equity Market Results

	1st Qtr. % Chg.	12-mo. % Chg.
S&P 500	-0.76	13.99
S&P 400	-0.77	10.97
Nasdaq	2.59	20.76
Russ 2000	-0.08	11.79
MSCI EAFE	-2.20	11.86
MSCI Emg MMkt	1.42	24.93

Selected Benchmark and Category Average Returns

Large Cap Equity

*Benchmark Indx & Category Average**	(Total Return) **1st Q 2018**	**12 Mos.**
S&P 500 Growth	1.93	19.69
Large Cap Gr Avg	2.81	21.45
S&P 500 Value	-3.57	7.69
Large Cap Val Avg	-2.62	8.64
S&P 500 Index	-0.76	13.99
Large Cap Blnd Avg	-1.23	12.42

Mid Cap Equity

*Benchmark Indx & Category Average**	(Total Return) **1st Q 2018**	**12 Mos.**
S&P MC 400 Growth	1.35	15.66
Mid Cap Gr Avg	3.06	20.02
S&P MC 400 Value	-3.01	6.12
Mid Cap Val Avg	-2.18	6.85
S & P 400 Index	-0.77	10.97
Mid Cap Blnd Avg	-1.60	9.35

Small Cap Equity

*Benchmark Indx & Category Average**	(Total Return) **1st Q 2018**	**12 Mos.**
Russell 2000 Growth	2.30	18.63
Small Cap Gr Avg	2.63	18.44
Russell 2000 Value	-2.64	5.13
Small Cap Val Avg	-2.66	5.67
Russell 2000	-0.08	11.79
Small Cap Blnd Avg	-1.32	8.46

International Equity

*Benchmark Indx & Category Average**	(Total Return) **1st Q 2018**	**12 Mos.**
MSCI EAFE	-2.20	11.86
Intl Equity Avg	-0.91	15.82

* **Category average** calculated using *Morningstar Direct*. Fund universe screened to include funds that meet the following criteria:

A. M-Star Category consistent with designated asset class and management style.
B. M-Star Style Box consistent with designated management style.
C. Fund's Objective consistent with asset class.
D. Excludes Index Funds.

We have not independently verified *Morningstar* data.

Thank you to everyone who participated in our Client Satisfaction Survey. Your input is invaluable to us. We welcome your questions and the opportunity to discuss your portfolio and investment philosophies at any time. Please do not hesitate to contact us.

What's Up With the Dollar?

During three short weeks following the November 2016 election the US dollar shot up sharply most likely prompted by expectations that tax cuts and infrastructure spending would rouse interest rates. And rise they did, although the initial spike subsided pending subsequent action by the Fed. The dollar ended 2016 up 40% from a 2011 low but spent 2017 losing ground. At the end of February 2018 the USD was down -8.24% from a year earlier against a basket of major currencies.

Softer dollars are a bonanza for US investors holding securities denominated in foreign currency, give US exporters a shot in the arm and energize Emerging economies who finance growth with borrowed USDs. However welcome, the turn of events comes as a surprise during a time when the Fed has been more or less committed to increasing rates and US Treasury yield premiums over other gold star sovereign debt expanded. According to Commodity Futures Trading Commission data, hedge funds and speculators are betting on further deterioration – but the reason is far from clear. This mystery has inspired much conjecture and motivated us to re-examine the complex relationships between currencies – the dollar in particular.

Define Value

When speaking about the strength or weakness of the USD commentators are usually referencing an index that measures the value of a dollar relative to a basket of major foreign currencies, the most common of which features: Canadian dollar, Japanese yen, euro, British pound, Swiss franc, Australian dollar and Swedish krona. Day-to-day index fluctuation tends to be modest, but major geopolitical events can cause extreme disruption. The USD, for example, gained 8.2% against the UK pound the day after passage of the "Brexit" referendum.

The actual relative value of most currencies (those that trade freely) is determined by exchanges. On average, $1.5 trillion changed hands in the global currency markets every day during 2016 dwarfing the $312 billion average daily volume of equity trades around the world. Roughly one-third of the activity is in the spot market. The rest involves derivative contracts to buy or sell at a future date. Swaps, forwards and options are used by all sorts of entities to hedge against fluctuation in the value of amounts to be paid or received in the form of foreign currencies and to protect against losses in the value of their assets denominated in non-functional (foreign) currency. As a simple example, a US enterprise that has agreed to purchase foreign goods or services over a period may want to lock in a current spot exchange rate to hedge the risk that the USD will continue to weaken against the seller's currency.

Another source of currency exchange volume is "carry trade" that arises when investors speculate on interest rate differentials between 2 countries. Again, stated simply, the currency of a country with lower interest rates is borrowed for investment in the currency of a country that offers higher yields. The profit on the interest rate differential is only realized if the exchange rate remains the same or moves in the borrower's favor. The laws of supply and demand, however, make this unlikely as the currency offering higher returns becomes more attractive driving up its price. Investors can sometimes insure against devaluation on future conversion by purchasing currency derivatives.

Meddling!

And then there is plenty of meddling by central banks seeking to further their own agendas. Some countries peg their currency to the US dollar, euro or a basket of currencies to moderate disturbances created by wild gyration. Pegging can be costly, however, as the home country has to buy the foreign currency. That is one reason China holds so much of its reserves in US Treasuries (a meaningful source of demand that has helped keep the USD on an upward trajectory). Switzerland infamously scrapped its short-lived peg to the euro in 2015 when the central bank decided it was no longer willing to pay the price. The decoupling shot the Swiss franc up by ~ 29% against the euro overnight (+15.8% vs USD) triggering a stock market panic attack and stalling economic growth. China has gradually loosened its peg to the USD by adding

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the currencies of other trading partners to its target mix. That doesn't mean the value of the yuan is a freely floating market-driven phenomenon. The same might be said of the yen and euro as central banks have continued to stifle interest rates yet bid up the price of their currencies by buying their own bonds.

What's Driving the Dollar?

The level of US interest rates should influence its appeal. When the Fed raises its base rate the dollar tends to strengthen – although as we have seen recently the correlation isn't perfect. The staggering ascent of the USD from 2011 to 2016 is partially attributable to the Federal Reserve's announcement that it would begin to unwind the unprecedented level of monetary stimulus that has artificially kept the lid on US interest rates while European and Japanese counterparts remained exceptionally accommodative. Higher economic growth rates relative to other countries is another positive force. As US GDP accelerates capital flows into the US at a faster rate and cranks up global demand for dollars. Prospering Emerging Market economies borrow profusely when dollars are cheap augmenting demand until strengthening dollars make debt service more expensive and credit tightens sometimes resulting in considerable financial distress.

Bleaker financial conditions have also elevated the dollar as US market interest rates plummeted. In times of global financial turmoil the US government's taxing authority and relatively stable political environment are viewed as a safe haven. This helps explain stubbornly low yields on longer-term US Treasuries that have prevailed in spite of recent Fed Fund hikes. When the yield on other iron clad sovereign debt is negative even a nominal return on the greenback draws a crowd.

There are many reasons the dollar has backtracked noticeably in spite of ramped up yields. Perhaps investors are looking for more confident reassurance that US interest rates will continue to "normalize"? Financing the burgeoning US budget deficit releases a flood of new Treasury debt that has recently been met with tepid foreign demand – a double whammy since the Fed isn't buying any more as it unwinds quantitative easing. Foreign shoppers may be concerned about buying into a longer-term cycle of dollar devaluation. Thankfully, the US dollar remains the world's reserve currency and as long as this is the case there will be a core level of support. Without it, the US Treasury would be forced to print money instead of borrowing it.

Trade Deficit vs Trade Tensions

It has been noted that wider US trade deficits generally accompany periods of dollar weakness, but historical comparisons are muddied by extenuating circumstances. The dollar slid precipitously during the 1970's as trade surpluses evaporated and deficits deepened - accompanied by the end of the gold standard and persistent inflation. In the 1980's the US joined several other countries in coordinated efforts to "fix" trade imbalances by devaluing the dollar.

Recent financial commentators have pointed fingers not on the US trade deficit but on troubling trade tensions emerging from the administration's attempts to close the gap by taxing foreign imports. The invigorating effects of cheaper dollars on US exports could be more than offset by headwinds wafting of retaliatory tariffs on our products. It seems ironic. The dollar's retreat should in and of itself go a long way toward narrowing the trade deficit while hostilities surrounding negotiating tactics designed to force it closer make it harder to sell US goods abroad AND might scare off some of the foreign investment we need to finance our massive budget deficit.

The forces that drive demand and hence the value of our currency are multifaceted. In some respects, we are fortunate that the dollar hasn't rocketed back up in response to the Fed's efforts to revive interest rates. A weaker dollar is not to be feared. It fosters more robust global growth and benefits our companies operating in multinational markets. We just need to be sure we don't rub too much luster off its allure or rob ourselves of its advantages.

March Madness

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since June 2009. Long awaited signs that economic recovery is being passed along to consumers should have been met with cheers. Instead, positives were shrouded by visions of inflation. Bond yields spiked along with the VIX (Volatility Index). Speculative short volatility bets began to unwind sparking a massive selloff ending with the S&P 500 down more than -6% in two days. The VIX had its largest single day advance since it was created in 1990 and smacked short volatility ETFs down more than 90%. Two were ejected from the game leaving fans empty handed.

Rumors of a comeback were quelled when new Fed Chairman Powell noted a lack of strong evidence supporting wage inflation during the March meeting. The Fed's preferred inflation metric, the Core PCE deflator, remains below target at 1.5% so it seems the FOMC remains posted up for three 2018 rate hikes.

Corporate fundamentals are encouraging another forward press. Analysts' consensus project a 19.8% increase in 2018 earnings for S&P 500 companies. Estimated first quarter year-over-year growth rate for the index is 18.5%, a 7-year record. Healthy profits coupled with the recent retreat in prices took some of the hot air out of valuation multiples and should ease concerns that stocks are intrinsically over extended.

In 2009 the Tech sector represented 18% of the S&P 500. Propelled by the FANGs, the tech team constituted 26% of the Large Cap US index in January 2018. They have since been taken down a notch. Facebook shed $75 billion in market cap after news of involvement in the Cambridge Analytica data harvesting scandal broke. Both Facebook and Alphabet face prospects of tighter regulation while Amazon contends with a negative tweet-storm. Government intervention is not generally considered a growth stimulus.

Stock market volatility during the first quarter was also rooted in escalating tensions over trade. Tariffs were first announced in January and ramped up in March adding steel (25% tariff) and aluminum (10%). Exemptions for the EU, Australia, South Korea, Canada and Mexico clearly exposed the principal opponent. China retaliated with $3 billion in tariffs on US imports. Trump then threatened to tax 1,300 different Chinese products and accused the Chinese of stealing intellectual property through subterfuge. China lobbed back another round of threats targeting US exports of soybeans, passenger planes, automobiles and perhaps a boycott of US Treasuries.

None of this posturing has taken effect. The President could rely on a rarely invoked section of trade law to impose his will, but there is still plenty of time for negotiation. Companies have until May 22nd to weigh in and the US has 180 days thereafter to make final decisions. Stock market investors, however, reacted violently - recalling past trade wars gone wrong.

Barron's columnist Randall Forsyth described the contradiction that has investors all worked up. Even if efforts to shrink the trade deficit with tariffs produce desired results, fiscal policies such as tax reduction and increased spending have the opposite effect. Higher budget deficits deplete domestic savings and will be financed by borrowing from abroad. According to Forsyth "double entry accounting" principles mandate that external capital inflows must widen the trade deficit, all else being equal.

Trade deficits are not entirely bad and often broaden during periods of domestic economic prosperity because US consumers have more money to spend on foreign goods. Spending overseas generates profits that find their way back to the US through foreign investment that helps keep long-term US rates low allowing us to finance budget deficits inexpensively. Trade barriers, on the other hand, can chip away at GDP siphoning off gains in productivity promised by tax cuts and stifling global economic activity.

The whistle has been blown. Strong earnings growth, moderate wage increases, low unemployment, easing dollar and restrained increases in the cost of borrowing dribble down the court hoping to escape being double teamed by a jump shot of inflation and extreme protectionism. It is anybody's game.