Ginsburg Financial Advisors, Inc.
Personal Financial Planning & Investment Management
Larry P. Ginsburg, CFP® **Adele Ostomel, CFP®**

phone: **(510) 339-3933**
fax: (510) 339-1611
LGinsburg@GinsburgAdvisors.com
AOstomel@GinsburgAdvisors.com

FIRST QUARTER 2018 MARKET RECAP

Tariffs, Rates and Scandals, Oh My!

"Put 'Em Up, Put 'Em Uuuuuup!"

So said the Cowardly Lion to the Tin Man and the Scarecrow. The same can be said for the trade rhetoric between the U.S. and China and Mexico and, well, the rest of the world. Like the Cowardly Lion, the threats of President Trump levying $60 billion worth of trade tariffs on China or pulling the U.S. out of NAFTA may be more bravado than actual action. Interest rates are also going "uuuuuup," but inflation measures, much like the Cowardly Lion, remain relatively tame and portend an environment conducive to a continued steady increase in global economic growth. In addition, special counsel Robert Mueller's investigation is heating up and the Federal Trade Commission's inquiry into Facebook's user privacy protections suggest more fireworks are yet to come. These events combined with the ongoing tensions with Iran, North Korea, and Syria, were enough to test the mettle of both stock and bond investors during the first quarter of 2018. While the perceived level of "event risk" remains high, especially as we enter midterm elections later this year, we still see the Yellow Brick Road to positive portfolio returns over the course of 2018 driven by encouraging economic trends in both the U.S. and foreign economies.

What? U.S. Stocks Were Only Down 0.8%?

The S&P 500 Index ("S&P 500") began the quarter in euphoria amid optimism over President Trump's tax cut plan, pushing the index up over 5.6% in January. This optimism quickly faded in February though after the Labor Department reported a 2.9% annualized increase in average hourly wages stoking fears that the U.S. Federal Reserve ("Fed") would accelerate the pace of monetary tightening (in the form of higher interest rates) to combat a perceived sign of accelerating inflation. Market fears further intensified after the U.S. imposed new tariffs on steel and aluminum imports and President Trump's threat to enact additional tariffs on up to $60B worth of Chinese goods. These events combined with the uncertainty over the outcomes of special counsel Mueller's investigation and the Facebook-Cambridge Analytica data scandal and heightened geopolitical risks pushed the S&P 500 down 13.4% from its peak price in January marking the first official correction for the index in 2018. U.S. stocks did manage a late quarter rally after the Fed raised interest rates but commented that economic conditions do not warrant more interest rate hikes than its previous guidance of three increases for all of 2018. This helped to bolster investor confidence in the continuation of the U.S. "Goldilocks" economy; a state in which U.S. economic activity is "just right", not growing too fast nor too slow, with low unemployment, low inflation, and low interest rates.

Within the S&P 500 Index, technology (+3.4%), consumer discretionary (+3.1%), and financials (-1.0%) sector stocks outperformed during the quarter, while telecom (-7.5%), consumer staples (-7.1%), and energy stocks (-5.9%) underperformed. Growth stocks once again outperformed value (dividend paying) stocks (+1.9% versus -3.6%) during the quarter driven by cyclical, economically-sensitive stocks outpacing defensive-oriented stocks.

Foreign Large Company Stocks Decline Not Surprising; Foreign Small and Emerging Markets Stocks Buck The Trend

The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures developed foreign markets, large cap stock returns outside of the U.S. and Canada, declined 1.5% (on a U.S. dollar basis) in 1Q 2018. The nominally greater loss in foreign market stocks relative to U.S stocks was not surprising given the substantial outperformance of these assets in 2017 (S&P 500 returned +21.8% vs. +25.0% for the MSCI EAFE) and the desire for investors to take some profits off the table. Fears of a trade war between the U.S. and China also weighed on investor sentiment given the deep economic linkages between China and developed foreign market economies (namely Japan and the European Union). Unlike their large cap peers, foreign small cap stocks, as measured by the MSCI EAFE Smallcap Index squeaked out a +0.2% return (on a U.S. dollar basis) in the first quarter. Foreign small cap stocks continue to benefit from easy monetary policy measures, which disproportionately aides domestically-focused, non-multinational companies.

The MSCI Emerging Markets Index once again led the pack and returned +1.4% (on a U.S. dollar basis) for the quarter even though Chinese-domiciled stocks, which account for roughly 30% of the index, were down 0.2% (in U.S. dollars) during the same time frame. Investor demand for emerging market stocks remains strong driven by more attractive valuations, favorable currency trends, rising commodity prices, and the broad based economic recovery within this group of countries.

What Are Our Expectations For Stocks Going Forward?

While the challenges discussed above may appear daunting, the U.S. economy still enjoys strong fundamentals, including robust and accelerating corporate earnings, expanding business investment, a healthy labor market, and the highest level of consumer confidence since 2004. A positive economic backdrop combined with more reasonable stock valuations, supports continued ownership of U.S. stocks but just not at the same levels we have generally advocated in the past. The U.S. economy, while very healthy, is much closer to the end of its current business cycle than its beginning. We do not expect a recession to occur over the next 12-18 months, but we do expect the U.S. equity market will more meaningfully factor in the potential for a contraction in economic activity towards the end of this year and into next. This may result in higher volatility, as U.S. stock prices become more sensitive to economic data releases and non-economic events that may foretell increasing growth headwinds, and ultimately stock price declines.

We also expect the increase in volatility that occurred in first quarter 2018 to continue going forward. The U.S. equity market had gone on an unprecedented length of time with abnormally low volatility. The recent increase in the breadth and frequency of price fluctuations is actually a return to normal market conditions. The recent (13.4%) drop in the S&P 500 from an intra-day peak level of $2,872.87 on 1/26/18 to an intra-day low of $2,532.69 reached on 2/9/18, was nearly in line with the average peak-to-trough downdraft of -13.8% typically experienced in any given year over the past 38 years.

We are much more excited about the prospects for foreign stocks, both developed and emerging markets, as compared to U.S. stocks. Foreign stocks are not only cheaper but the underlying economies of many major foreign markets tend to be earlier in their business cycles relative to the U.S., thus provide a longer runway to compound returns. Within key developed markets, such as Japan and the European Union, central banks remain highly accommodative, which benefits stocks via increased demand. The increase in demand is driven by direct government purchases as well as increased investor demand for assets that can generate meaningful returns in a low interest rate environment. Low interest rates also disproportionally benefit domestically focused companies, which tend to be small-to-mid sized companies, via cheaper access to capital. These companies also tend to have much lower exposure to foreign currency movements thereby providing more stable revenue and earnings streams relative to domestically domiciled multinational corporations. For these reasons, we continue to expect small-to-mid sized foreign developed market stocks to outpace their larger capitalized peers.

Emerging markets remains the most attractive sector within the universe of stocks. The prolonged recovery in the U.S. and the accelerating recovery in many developed markets have benefited a broad swath of emerging market economies through increased export activity and stabilized demand for commodities. The growing middle class within China and many other emerging economics has also broadened the base of economic activity within these countries to include more consumer-centric industries (e.g. healthcare, travel & entertainment, and information technology). This has reduced the reliance of these countries on just a handful of sectors (banks, telecommunications, and utilities), which has improved their fiscal positions and stabilized economic activity.

The long-term outlook for emerging market stocks is promising due to their attractive valuations relative to U.S. and foreign developed market equities. We expect demand for these assets to also increase over time as U.S. investor ownership of these stocks remains relatively light, which is surprising considering emerging markets now account for about one third of global output, and the market capitalization has increased 15 times over the last 20 years to around $15 trillion. With that said, the substantial outperformance of emerging markets, which are up 25% over the past 12 months vs. +14% and +15% for U.S. and foreign developed markets, and a red-hot initial public offering ("IPO") market, suggest the potential for some performance headwinds over the near-term as "hot money" investors look to exit their positions. We also anticipate the continued rhetoric surrounding a trade war between the U.S. and China to weigh on U.S. investor demand for these assets until there is better visibility into the outcome of this situation.

Real estate sector assets have underperformed the broader markets last year and in first quarter 2018, primarily due to investor concern over the potential impact rising U.S. interest rates will have on domestic real estate activity. While this is a valid concern, the underlying fundamentals for this sector remain healthy and the breadth and pace for which rates will rise should be manageable. Nonetheless, we look for opportunities to broaden our clients' ownership of these assets to include investment opportunities in international real estate and global infrastructure (e.g. airports and seaports, rail systems, electricity distribution/transmission, water supply and treatment). Real estate assets continue to provide a viable proxy to owning bonds to generate lower volatility returns without meaningfully increasing exposure to primary bond risk factors, namely duration and credit spreads. (Duration measures the sensitivity of bond prices to interest rates. Credit spreads relate to the higher yield of riskier bonds compared to U.S. Treasuries.)

We generally recommend maintaining tactical exposures to technology, healthcare, and financial stocks as we expect these sectors to outperform the broader U.S. stock market. Technology and healthcare stocks will disproportionately benefit from the repatriation of foreign-domiciled corporate earnings, primarily in the form of increased share repurchases, while financial stocks will see a meaningful benefit from a reduction in the corporate tax rate and continued industry deregulation. Financial sector companies also benefit from expanding economic activity (via increased loan activity) and rising rates (they will earn more on the loans they make).

Alternative assets and strategies provide an effective means to lower overall portfolio volatility (i.e. reduce the breadth and frequency of fluctuations in portfolio returns) due to their lower correlation with traditional stocks and bonds. These assets are performing in line with our expectations this year by delivering flat-to-slightly positive returns with volatility patterns similar to investment grade bonds of all types. These assets were beneficial to stabilizing portfolio returns during 1Q 2018 given the broad decline in most stock and bond indices.

We remain encouraged regarding the long-term prospects for midstream energy multi-limited partnerships ("MLPs") given the continued buildout of the U.S. energy pipeline infrastructure. Not only have innovations in drilling and surveying methodologies increased the supply and storage of oil, natural gas, and natural gas liquids, but increased demand for U.S.-derived energy products both domestically and abroad is consistently rising. Unfortunately, this asset class has once again been a drag on returns during first quarter 2018 primarily due to a change in tax law that eliminated a certain type of tax allowance. Since the true impact to both midstream "C" corporations and MLP industry revenues will be nominal, the latest sell-off served as a capitulation event for many retail investors whereas more stable institutional investors, such as pension funds, have been actively increasing their ownership of midstream sector assets. The fact of the matter is that current valuation levels do not reflect the continually improving operating and financial fundamentals of these companies. We expect market sentiment to turn positive over the course of 2018 as operating results reconfirm the positive secular trends and underlying health of these companies. Given the ubiquitous selloff of midstream companies, we are adjusting client investments within this asset class to include C corporations as well as MLPs, as way to capture the larger opportunity set and to provide more flexibility for the underlying managers to generate positive returns.

Bond Yields Are Readjusting To Reality

U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Government Bond Index, were down 1.2% in first quarter 2018. During the quarter, the yield on 10-year Treasury bonds rose from 2.40% to as high as 2.94% before moderating to 2.74% on 3/31/18. The last time this yield was above 2.94% was in late 2013/early 2014, when the Fed began tapering its bond purchase program ("Quantitative Easing"). Investment grade bonds of all types, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, underperformed safe-haven U.S. government bonds, declining 1.5% in 1Q 2018. Investment Grade bond results was weighed down by the decline in corporate bonds falling 2.2% in 1Q 2018. Municipal bonds, which typically provide a higher (non-tax adjusted) rate of return relative to U.S. Treasury bonds for assuming additional credit risk, were down in the first quarter 1.2%. Global investment grade bonds of all types, as measured by the Bloomberg Barclays Global Aggregate Index, outperformed U.S. investment grade bonds generating a +1.4% return in 1Q 2018 due in large part to the index's exposure to foreign market government bonds, which were up 2.9% during the same period.

As mentioned above, an upward surprise to average hourly earnings in January sparked fears that the U.S. economy may finally be overheating, which triggered a 0.54% rise in interest rates between 1/1/18 to 2/21/18. However, those fears did not align with subsequent data readings in other inflation measures (e.g. core consumer price inflation, core personal consumption inflation) or the Fed's latest projections for inflation released on 3/21/18. We view the upward "recalibration" of interest rates during 1Q 2018 as a healthy development for the market. Prior to 2018, Treasury yields remained artificially low and did not appropriately reflect the 150 basis point (1.50%) rise in the federal funds rate since the Fed started raising its target rate on 12/16/15. In other words, market rate expectations have reset to better reflect the U.S. economic backdrop and the potential for at least two more 25 basis point (0.25%) interest rate hikes this year, which would bring the federal funds rate up to a range of 2.00%-2.25%.

The market strategists we speak with tend to agree that the “big move” in interest rates has occurred. They also agree that while U.S. economic growth will rise from an annual rate of 2.6% at the end of 2017 to just under 3.0% by the end of this year, driven by the temporary boost provided by the recent tax cuts, 2018 represents a peak in growth after which the rate of growth is expected to slowly decelerate. Given these views, we maintain our expectation that runaway inflation is unlikely and the Fed’s slow-and-steady approach to monetary policy tightening (i.e. rising interest rates) will continue. This also includes the continued “unwind” of the Fed’s $4 trillion balance sheet holdings of government securities of which the agency will sell $420 billion of U.S. Treasuries and mortgage backed securities (“MBS”) by the end of 2018 and $600 billion of these securities in 2019 and every year going forward until the balance sheet has been “normalized.” The modest glide path forward in interest rate hikes and the predictable nature of its balance sheet reduction program will help investment grade bond prices adjust in a more orderly fashion as U.S. interest rates continue to rise. This provides the opportunity for investment grade bonds to deliver nominal-to-flat returns going forward as the yields generated from interest payments can offset the incremental declines in bond prices.

How Are We Positioning Your Bond Investments?

Even though interest rates are rising, market yields remain relatively low compared to historical levels. Thus we prefer to use stocks as the primary means by which clients assume risk to grow the value of their portfolios over time. The primary goal for bonds is to provide a ballast to portfolios by stabilizing returns and serving as a buffer during times of extreme market stress. This means we continue to advocate owning a largely diversified mix of domestic and global investment grade bonds that do not have excessive sensitivity to rising interest rates. We also continue to avoid direct exposure to non-investment grade bonds of all types considering the U.S. is in the late phase of its business cycle when credit risk typically rises as a result of rising default rates. For this reason, we continue to reduce direct exposure to investment grade corporate bonds while maintaining an emphasis on “structured notes” such as MBS and asset backed securities (“ABS”) as a low-correlated way to assume credit risk, thus the potential for excess returns, while carrying a lower sensitivity to the overall U.S. credit environment.

We have also shifted some credit exposure into emerging market bonds, where we see both an opportunity to further reduce volatility and to enhance the future return potential of clients’ bond holdings. Emerging market bonds are not only benefiting from improving economic activity, but the underlying health of both government and private issuers has also dramatically improved. A much larger supply of “local-currency” debt reduces the overall correlation of these assets to U.S. interest rate moves. Many key emerging market currencies also remain meaningfully undervalued relative to the U.S. dollar, which provides a "carry" opportunity in terms of earning a higher yield while providing the potential to realize positive currency appreciation.

Prudent Asset Allocation May Be The Best Way to Minimize Risk

At this point in the market cycle, where both bond and stock prices are trading near historical highs, it is prudent for our clients' fixed income holdings to serve as a "shock absorber" to potential downdrafts in the financial markets. We want to be cautious with the bonds owned in client portfolios. Another way of saying this is that we prefer to assume higher levels of risk, thus the potential for higher levels of returns, within the equities or stocks portion of your portfolio, rather than with fixed income or bonds. Not only do equities generally deliver higher levels of returns over time, but minimizing the volatility within your fixed income holdings helps moderate overall return fluctuations enabling your portfolio to compound returns more efficiently over time.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.