



The Power of Independent Advice

## Market Results as of the First Quarter of 2018

Selected Index Results for Q1 – 2018

<u>Index<sup>(1)</sup></u>	<u>%Growth For FY 2017</u>	<u>%Growth For FY 2018</u>	<u>%Growth For Q1 2018</u>
DJIA	25.08%	-0.88%	-0.88%
Leman Aggregate Bond Index (U.S. multi-sector bond)	1.18%	-1.50%	-1.50%
S&P 500 (large cap)	19.42%	-0.76%	-0.76%
S&P 400 (mid cap)	14.45%	-0.80%	-0.80%
Russell 2000 (small cap)	13.14%	-0.10%	-0.10%
MSCI EAFE Index (developed international)	21.79%	-1.41%	-1.41%
iShares MSCI Emerging Market Index	34.59%	1.38%	1.38%
iShares Dow Jones US Home Construction	59.10%	-11.51%	-11.51%
MSCI US REIT Index	0.11%	-10.89%	-10.89%
Amex Oil Index	5.33%	9.89%	9.89%
Barclays Global Agg ex-US Corp Bond Index	14.44%	0.59%	0.59%

These results do not include reinvesting dividends.

## Volatility Makes a Comeback, Swings in Bond Prices

Equity markets endured a long-overdue stumble in Q1. After recording its 15th-straight month of gains in January, a record, the S&P 500 Index closed sharply lower in February (-3.69%) and March (-2.54%). The Index finished the quarter down 0.76%. Meanwhile, the CBOE Volatility Index (VIX) mirrored the change in pattern and moved materially higher as stocks wavered. After recording all-time volatility lows in 2017 (9.14 on Nov. 3rd), the VIX Index spiked to a closing high of 37.32 in early February before sliding back to more palatable levels as we closed the quarter. We had been waiting for such a market development; warning the smooth market ride witnessed in 2017 had a limited shelf-life. The mean reversion or right-sizing of volatility and equity prices was perhaps jarring but Q1's activity was historically ordinary in terms of intra-year market activity. Outside of the U.S. both developed and emerging markets recognized the heightened volatility and equity drawdown as well. While the MSCI EAFE and MSCI Emerging Market indices could not claim the same month-over-month win streak as the S&P 500, both benchmarks were logging an impressive string of returns prior to the Q1 dust-up. The MSCI EAFE Index closed 1.41% lower for the quarter. Meanwhile, the MSCI Emerging Market Index managed to close up 1.38%, given a stellar January (+8.32%), but the index was not immune to the global equity drawdown in February and March.

## S&P 500 Index Sector Returns - Q1 2018

Source: Bloomberg

	Cyclical or Defensive			Cyclical or Defensive	
Consumer Disc.	Cyc	3.1%	Info Tech	Cyc	3.5%
Consumer Stpls.	Def	-7.1%	Materials	Cyc	-5.5%
Energy	Cyc	-5.9%	Real Estate	Cyc	-5.0%
Financials	Cyc	-1.0%	Telecom	Def	-7.5%
Health Care	Def	-1.2%	Utilities	Def	-3.3%
Industrials	Cyc	-1.6%			

In U.S. equity sectors, the Technology sector was featured most often in the Q1 headlines as the group lost some steam. However, Tech still led all other sectors (+3.5%). Consumer Discretionary followed with a 3.1% gain as retailers and apparel makers moved higher, due in part to the expectation of positive consumer spending outcomes resulting from new tax law. These were the only two sectors that posted gains for the period. Financials and Health Care followed-on with modest losses. Those that ended the period with material losses included Telecom and Consumer Staples. Both were likely affected by rising interest rates. Notably, staples have been buffeted of late as investors build in some expectation the group may see ongoing slowing from changing consumer spending habits. Energy also lagged notably (-5.9%) as investors may have questioned the sustainability of a rising oil price.

While issues such as U.S. trade disagreements with several global partners and rising interest rates were cited as key equity drivers late in the quarter, we believe the market largely just ran out of steam at the end of its historical run. We do not seek to downplay trade concerns as they could become serious. However, the uncertainty may have been a convenient tipping point in a market that had gotten notably overbought. Perhaps there was a bit of “sell-on-the-news” activity in Q1 as well. Analysts began raising their earnings forecasts, in earnest, due to the potential positives from the new tax plan. However, we believe valuations had already been positioned for this expectation. Regardless of the catalyst, we were overdue for a correction and thus, as anyone attending our annual update will attest, the activity came as little surprise (and there could be more).

Bond market performance also suffered in the first quarter as yields across the U.S. Treasury curve rose to new recent highs. Equity market volatility provided some solace for core fixed-income holders mid-quarter, but the late-period bond rebound was limited. The 10-year Treasury yield ended the quarter at 2.74%, after starting the period at 2.41%; and the benchmark bond did reach a yield high of 2.95% on February 21. In line with tighter Fed policy, the 2-year Treasury yield reached highs last witnessed in 2008 and closed Q1 at 2.27%. The 30-year Treasury bond yield rose 23 basis points and ended the period at 2.97%. The benchmark Bloomberg Barclays Aggregate

Bond Index fell 1.5% for the quarter; one of the worst quarterly performances since the index's inception.

### **Key Events in the Quarter**

**Jan 28:** A 6th round of NAFTA talks concluded with parties reporting some progress toward a new, modernized agreement.

**Mar. 1:** President Trump announces the first of several tariff measures. The initial announcement focused on tariffs for imported steel and aluminum.

**Mar. 8:** The European Central bank dropped its bias to ease policy but indicated its quantitative easing (€30B/month) could extend beyond Sept. 30, and its current policy rate is expected to be maintained for some time.

**Mar. 21:** Jerome Powell chaired his first FOMC meeting and authored a 25bps increase in the Fed funds rate.

**Mar 22:** The Trump Administration extended its tariff plans to cover approximately \$60B in imported Chinese goods. The announcement was aimed as a form of punishment for China's alleged theft of U.S. intellectual property. The measure drew condemnation from Beijing.

Investors found little shelter in corporate credit during Q1 as both investment grade and high yield spreads widened. Internationally, the Bloomberg Barclays Emerging Market Bond Index dropped 1.5%, leaving only developed market sovereign debt (S&P Citigroup International Treasury ex U.S. Index) to finish in the green (+3.5%). A modest uptick in U.S. inflation data and the expectation of tighter Fed policy contributed to the steep rise in U.S. yields mid-quarter. However, yields did manage to retrace some of the advance as bonds, in our view, became near-term oversold.

### **Global Economies - U.S. Growth Expected to Pick Up**

GDP growth in many global regions is expected to slow a bit in the quarters ahead but still maintain a healthy pace. In the U.S., however, current GDP forecasts show an economic pick-up in 2018: growth is expected, due largely to the revised tax plan. Bloomberg consensus forecasts place real GDP at +2.8% for 2018 and +2.5% for 2019. Both compare favorably to the +1.5% and +2.3% recorded in 2016 and 2017, respectively. There has been some reduced expectation, in terms of U.S. Q1 GDP growth on a quarter-over-quarter basis. However, we believe these dynamics may prove to be transitory and due in part to a particularly strong Q4.

Broadly, when it comes to the domestic economy, there is little to complain about as data on both the business and consumer side remains relatively strong. U.S. Industrial Production and Capacity

Utilization have trended up notably over the last 6 months and domestic manufacturing and services activity indicators are well into positive territory. On the consumer side, confidence readings are at levels last seen in the 1997-2000 period (but we should not lose sight of what happened next), and Retail Sales ex-Autos are growing at the fastest pace in eight years. U.S. Autos sales, meanwhile also continue at a robust pace, as do home sales. New Home Sales, for example, (600-700 thousand per month pace) are the strongest they have been since the financial crisis. While much of this is good news, it seems almost axiomatic that the best financial statistics are right before a severe economic stumble, which makes the pending event almost impossible to see coming.

Meanwhile, despite the low readings in the U.S. Unemployment Rate (4.1% in March), the Labor Force Participation Rate has been stagnant (62.9% in March) indicating some slack still left in the labor market. As a result, Average Weekly Hours has remained flat and U.S. Nominal Wage Growth has not returned to previous economic cycle highs. Consequently, U.S. inflation readings, while ticking up recently to 2.1% (CPI ex Food & Energy) still only match the long-term average (2.1% since 1995). Wage-push inflation, typically found at this stage of the business cycle, has yet to appear (and due to the ageing population, may not). We believe this still gives the Federal Reserve some flexibility to be measured in its policy.

#### **Real GDP (Year over Year%)**

Country	2017	2018E	2019E
U.S.	2.3%	2.8%	2.5%
Eurozone	2.3%	2.4%	2.0%
U.K.	1.4%	1.5%	1.5%
Japan	1.7%	1.4%	1.0%
BRICS	5.7%	5.7%	5.6%

Source: Bloomberg

E = Bloomberg consensus estimate

In other parts of the developed world, we are seeing favorable growth, but the pace is beginning to slow just a bit. What has likely been beneficial for the U.S., a weaker dollar, has been a recent drag on Europe and Japan. Goods exported out of Europe and Japan are costing a bit more due to a rise in the euro and yen, and this has been a slight drag in manufacturing indicators. Economic confidence in both Europe and Japan remain at or near post-crisis highs. Eurozone conditions look particularly favorable as the region has seemingly put its Greek/debt crisis in the rearview mirror. Conditions in the U.K. are not as attractive, given the Brexit overhang. U.K. consumer confidence and private consumption is trending lower, although this has been offset in part by rebounding investment growth and good export activity. While U.K. consumer demand could right size in 2H 2018, a rising trend in the British Pound and the approaching Brexit deadline is expected to translate into only a slight lift in 2018 GDP.

In emerging market economies, GDP growth is expected to improve through 2018, yet much of that improvement is expected to come from Latin America and India. Russia continues to deal with sanction pressure and China's GDP growth pace is expected to slow. The emerging world is indeed benefitting from a recovery, particularly in Latin America, but there are few signs we will return to the outsized growth pace of old. The story here can be told by a commodity market that has not definitively recovered from its multi-year trough (many emerging economies are dependent on commodity exports); and China continues to be a wildcard, in our view. Investors should not be surprised by the slowing pace of China growth, given Beijing's crackdown on excessive debt growth. This more-strict policy has been a drag on commodity demand and has squelched growth in many economic segments notable for their overcapacity. We believe the end result of a manufactured slowdown in China should cause investors to recalibrate their expectations for global growth (i.e. slower growth may be the new normal). In our view, China's economic trajectory has far-reaching implications for both the developed and emerging world.

### **Central Bank Policies**

Year-to-date, the tightening trend expected from some developed market central banks has perhaps been more subdued than expected. While the Fed has maintained its bias toward tighter policy (including a March rate increase) other developed central banks are not as quick on the trigger. The European Central Bank (ECB) has seemingly become a bit more cautious in its attitude toward policy tightening, as evidenced by recent speeches from ECB officials. This despite the ECB dropping its easing bias in its latest policy announcement (March 8). The Bank of Japan (BoJ), meanwhile is clinging to the expectation that inflation will reach 2% in FY 2019, and BoJ Governor Kuroda has stated that rates will remain unchanged until that number is reached. Notably, current expectations for Fed policy has the U.S. central bank raising interest rates two more times this year. New Fed Chair Jerome Powell seems steadfast in his intention to tighten policy, although we believe the current Fed outlook could be curtailed by further trade confrontations and/or turmoil in financial markets.

### **Outlook - Still Cautiously Optimistic**

While the global economy remains strong, Q1 serves as a reminder that volatility will likely remain heightened. Foreign equities may have the greatest upside, given more favorable valuations and non-domestic central bank policy that remains more accommodative. Risks to this view are focused on the dollar (and whether it strengthens, maintains or weakens relative to other global currencies).

Without major disruptions, earnings momentum in both the U.S. and foreign markets should be favorable, as will the phenomenon of continued synchronized global growth. The fundamental tailwind for equities and strong earnings is offset by valuations that are not cheap, trade talk that could be very unsettling, and continue Fed tightening.

On the bond side, long-term Treasury rates may be on the cusp of a definitive directional change many have expected for some time. However, we believe it is still too soon to call that directional change “sustainable”.

At this point, we are skeptical over talk of a prolonged lift in inflation (see below) that could further tip the yield scale in the upward direction. We have highlighted in the past inflation may be held down by structural factors (e.g., global aging populations).

Meanwhile, supply/demand in the Treasury market will remain a challenge as the Fed curtails its buying, but volatility could sustain more safe-haven demand than many currently expect. We still believe the 10-year Treasury yield could end the year in the 2.75% to 3.00% range, even with two more rate hikes.

## **Risks**

Investors should be aware of the risks associated with all portfolio strategies and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies (e.g., a trade war), global economic data, and other geopolitical events can have a substantial effect on portfolio performance.

## **Conclusions**

As odd as it may seem in the apparently endless stream of good investment news, our position is one of caution and measured expectations. As mentioned earlier, there is convincing evidence that over the next few years, investment returns will be lower and volatility higher. A moderately rising interest rate environment is hoped for even though it will include some negatives such as lower fixed income yields (compared to what we have experienced over the last couple of decades). Adding to the anxiety associated with a lower yield environment will be higher volatility; unfortunately, investors that choose to sit-out to avoid volatility will likely lose what investment yields are available, even if reduced. While there will be periods of negative returns, history tells us that equity and fixed income yields should still be positive (over time) and are highly likely the best alternative for the vast majority of investors (even at reduced levels).

If we enter a period of higher volatility, maintaining investment discipline within a lower overall yield environment will be more difficult emotionally. However, we need to remember that market timing as an investment strategy has never worked consistently (and results in lower longer-term yields). Trying to time markets in a lower yield environment has a high probability of creating permanent losses. Compounding the problem, a less favorable investment environment will increase the “sales pitches” of companies with

products and strategies purporting phony and distorted claims that appeal to our emotions. Avoid the temptation to act in an undisciplined and consequently damaging way— no matter how slick the advertisements trying to sell a strategy (or product) will claim. If a lower yield environment develops, no person or company is going to find a way around it – everyone is investing in the same lower yield environment. If someone appears to have found a way around it, be very wary – they are either not showing you all their “cards” or taking very high investment risk.

Fullen Financial is always available to help sort out false claims so don't be concerned about asking us.

As always – stay with a consistent and disciplined investment strategy – it is the only course of action with any track record of success (in any investment market). There is no reason to believe that with the changing economic dynamics that the disciplined approach to investments will be less effective than in the past at delivering the best possible relative returns.

At the most fundamental level, match your investment time horizon to your spending timeline – if you have short term cash needs then those funds should be in short term investments. If you have long-term spending needs (like 10 or more years into retirement) then this cash should be in long-term equity investments. These are simple asset/liability matching principles practiced by the most sophisticated investment managers every day (but far too complex to explain in sound bites and not conducive to selling products). Additionally, don't try to solve short-term financial problems with long-term equity exposure. If you try to chase returns, you may get lucky sometimes but, if pursued long enough, it always ends in extreme frustration and often with serious financial losses. The reality is that no one has ever consistently predicted investment markets and they never will - and there is always a consequence to continued unsound financial behavior.

As always, if your personal or family situation has changed (or is likely to) a discussion with us as to how this may impact your financial plan and your overall asset allocation is warranted. Or, if you simply feel a need to discuss any aspect of your portfolio and/or financial plan, or you haven't had a planning update within the last 12 months, please contact us to review your financial plan and investments.

**Your financial plan is the most important financial document that you possess! Keep it updated and use it.**

Please note that you are entitled to receive Fullen Financial's Form ADV whenever you would like to. This document outlines many details of who Fullen Financial is, their investment methodologies and their advisor's education and experience. You may do so by contacting Lisa Bushman at [lisa@fullenfinancial.com](mailto:lisa@fullenfinancial.com) and requesting such. Alternatively, you can go to the [www.fullenfinancial.com](http://www.fullenfinancial.com) website and under Resources, click on Client Forms, then on ADV (Firm Brochure).