MARKET REVIEW & COMMENTARY

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TELEMUS®

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MARKET REVIEW

FEBRUARY

January's seamless continuation of 2017's bull run ended abruptly in February. Volatility spiked to the highest level since the third quarter of 2015 with the S&P500 falling almost -10% in the first ten days of the month, before rebounding to finish down only -3.69% for February. 'Growth' continued its outperformance over 'value', losing half as much in the month as its value brethren. Capitalization mattered little as far as performance went, everything fell. U.S. stocks outperformed international and emerging markets, while more speculative frontier markets lost the least. Most categories of fixed income experienced modestly negative returns as interest rates continued their slow ascent. Alternative investments like hedge funds generally lost less than stocks, real assets declined across the board, the dollar rose a bit and soft agriculture rose convincingly.

Specifically, the S&P500 fell -3.69% while high dividend payers lost -4.59% as they continued to get painted with the 'fixed income' brush. Large cap growth was down -2.62% while large cap value was down -4.77%. Small cap growth was down -2.85 while its value counterpart lost -5.00%. Across the pond, Europe lost -5.88%, EAFE closed down -4.51%, emerging markets fell -4.61%, while frontier markets lost only -1.49%.

Fixed income return patterns were identical to January; the longer the duration, the worse the return. In a reversal of January, municipal securities outperformed their taxable counterparts across the curve. Riskier bonds reversed their January outperformance and fell in February. 10-20 year Treasuries dropped -1.62%, the Bloomberg Barclays long credit index lost -3.31%, 10 year municipals were down -0.43% and TIPS lost -0.97% in February. 3-5 year Treasuries lost -0.26%. 1-5 year credit lost -0.35% while T-bills gained a skinny +0.09% and 3 year municipals eked out a +0.04% gain. World bonds lost -0.68%, emerging market bonds were down -2.23%, and high yield paper fell -0.85%.

Alternative investments and real assets were generally down. The HFRX Global Hedge Fund Index lost -2.42%, global natural resources fell -7.13%, the Bloomberg Commodity Index was down -1.73%, global real estate lost -6.36%, U.S. real estate fell -7.20% and precious metals fell -8.90%. The dollar reversed its down trend, gaining +1.66%

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YEAR-TO-DATE

This has been a volatile year as markets blazed in January only to fall hard in February. The disparity between the returns of 'growth' and 'value' stocks is remarkably large. U.S. growth stocks are up between +4.72% (large cap growth) and +0.94% (small cap growth). U.S. value stocks are down, between -1.09% (large cap value) and -3.83% (small cap value). The S&P500 has gained +1.83% while high dividend payers are down -0.91%. EAFE is up +0.28% and Europe is down -0.79%. Emerging and frontier markets however maintain a lead; up +3.34% and +4.16% respectively.

Fixed income returns have become mostly negative across-the-board but are not nearly as bad as the rhetoric would imply. Corporate bond returns have slightly underperformed Treasury and municipal bonds. Returns generally followed duration lower. Short Treasuries are up +0.22%, 3 year municipals are up +0.19% and 1-3 year corporate paper is down -0.38%. The 10-20 year Treasury Index is down -4.24%, Barclays Intermediate Corporate Bond Index fell -1.56% and the Bloomberg/Barclay Municipal 10yr Index has lost -1.95% year-to-date. TIPS fell -1.82% which is surprising given the growth of inflation-aware sentiment, emerging market paper (EMBI) is down -2.72% and high yield bonds lost -0.26% through February.

Alternatives have held up but real assets have experienced mostly negative year-to-date returns. The HFRX Global Hedge Fund Index is down a modest -0.04%, while agriculture is up +0.74% and industrial metals are up +0.91%. On the other hand, precious metals are down -8.55%, energy is down -7.42%, the dollar has given up -1.64%, and world real estate is down -5.82%.

World markets started 2018 like a rocket, corrected even faster in the beginning of February and ended up with mixed YTD returns by the end of February.

We are finally seeing what we have long posited, the volatility which comes with a reduction of quantitative easing and a global debt build-up. We anticipate more of the same. In the U.S., reduced government revenues are leading to larger bond issuance adding additional pressure to the markets.

Wages and goods prices have begun to firm albeit at very low levels. Should growth in the U.S. and global economies remain intact, we could see the green shoots of inflation in wages and goods' prices. Finally, interest rates in the U.S. are nearing levels that might indicate, in the months ahead, an actual reversal in the downward trend that has been in place for so long.

INDEX RETURNS AS OF 2/28/2018

BASIC INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
BALANCED INDEX (25% ACWI, 60% US Gov. Cr 1-5, 5% HFRX, 5% commodity, 5% bill)	-1.38%	-0.08%	-0.08%	7.70%	14.84%	28.29%
HFRX GLOBAL HEDGE FUND INDEX	-2.42%	-0.04%	-0.04%	2.88%	8.33%	-3.79%
CPI - SEASONALLY ADJUSTED	0.00%	0.54%	0.54%	5.98%	7.08%	17.22%
S&P 500 COMPOSITE	-3.69%	1.83%	1.83%	37.29%	98.34%	153.07%
LIPPER LARGE - CAP CORE	-3.78%	1.50%	1.50%	33.42%	87.47%	129.46%
WISDOM TREE LARGE CAP DIVIDEND	-4.59%	-0.91%	-0.91%	32.48%	84.33%	135.88%
MSCI ALL COUNTRY WORLD INDEX NET	-4.20%	1.20%	1.20%	27.15%	61.96%	73.18%
MSCI EAFE NET	-4.51%	0.28%	0.28%	17.94%	41.78%	32.00%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	-0.30%	-0.53%	-0.53%	3.82%	7.91%	40.89%
BLOOMBERG BARCLAYS US AGGREGATE	-0.95%	-2.09%	-2.09%	3.46%	8.76%	42.42%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.09%	0.22%	0.22%	1.45%	1.56%	3.54%

EXTENDED INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
RUSSELL 1000 GROWTH	-2.62%	4.27%	4.27%	46.26%	119.02%	199.16%
RUSSELL 1000 VALUE	-4.77%	-1.09%	-1.09%	26.05%	76.32%	113.59%
RUSSELL MIDCAP GROWTH	-3.14%	2.34%	2.34%	30.67%	94.15%	169.74%
RUSSELL MIDCAP VALUE	-4.92%	-2.74%	-2.74%	22.76%	76.50%	151.71%
RUSSELL SMALL CAP COMP GROWTH	-2.69%	2.42%	2.42%	32.36%	100.80%	188.84%
RUSSELL SMALL CAP COMP VALUE	-4.60%	-3.33%	-3.33%	23.06%	65.14%	132.81%
MSCI EM (EMERGING MARKETS) NET	-4.61%	3.34%	3.34%	29.40%	27.89%	29.93%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.08%	0.20%	0.20%	2.08%	2.41%	6.54%
BLOOMBERG BARCLAYS US AGENCY	-0.36%	-1.09%	-1.09%	2.63%	5.54%	27.65%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	-2.23%	-2.72%	-2.72%	16.08%	16.96%	86.84%
CITI GROUP WORLD GOVERNMENT BOND	-0.68%	0.94%	0.94%	7.83%	4.64%	23.60%
BLOOMBERG COMMODITY	-1.73%	0.22%	0.22%	-13.43%	-33.99%	-57.78%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	-10.71%	-8.21%	-8.21%	1.73%	-41.28%	-60.18%
LIPPER GLOBL NAT RES	-7.13%	-5.23%	-5.23%	1.94%	-2.23%	-24.89%
LIPPER PRECIOUS METAL FUND	-8.90%	-8.55%	-8.55%	4.14%	-33.75%	-46.73%
MSCI WORLD REAL ESTATE	-6.36%	-5.82%	-5.82%	6.42%	25.56%	40.31%
LIPPER REAL ESTATE FUND	-6.51%	-9.29%	-9.29%	3.27%	27.43%	58.96%

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MOOD CHANGE...

A confluence of events has awakened investors from their slumbering complacency marking a meaningful change in investor psychology. Equity and bond market valuations have increased over the past few years to levels that many consider historically rich, if not over valued. However, the move up, especially over the past 18 months has been accompanied by historically low volatility, so investors have been lulled into calmly accepting meaningful valuation-creep. However, a 10% drop in the broad equity markets from January 26th to February 8th woke investors up to the fact that the equity markets are volatile and that equity risk should command a bit more respect than recently shown by investors.

The initial catalyst was the January jobs report on February 2nd, which appeared on the surface to be a sound beat with nonfarm payrolls rising by 200,000 compared to the median estimate of 180,000 and the jobless rate holding at 4.1%. This matched the lowest rate since 2000. However, the spark that lit the fire was the fact that average hourly earnings (AHE) rose a more-than-expected 2.9% year over year, which happened to be the highest reading since June 2009. Taken in a vacuum the increase in AHE may have been celebrated as the well-earned tick up in hourly earnings for workers who haven't had an inflation-adjusted earnings increase in nearly three decades. However, the jobs data does not exist in a vacuum and the AHE increase surfaced coincident with the Fed holding firm on normalizing interest rates (read increases) and shrinking their balance sheet (read increased supply of bonds). In addition, the upswing in global economic activity has the other major central banks leaning towards normalization over time as well and a potential shift to quantitative tightening over the longer term.

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Those of us who have been around for awhile know that "bond vigilantes" are bond market investors who protest monetary and fiscal policy that they consider inflationary by selling bonds, thus increasing yields. Global central bank monetary policy has taken money printing to gargantuan extremes and now there are meaningful discussions about fiscal stimulus, which typically comes when the economy needs a boost, not when GDP is on the rise and unemployment is at its nadir. It's no wonder that the bond vigilantes have returned. Even before the AHE number sparked inflationary fears, the bond vigilantes seemed to have been at work pushing yields higher. The 10-year Treasury yield began the year at 2.46% and rose to 2.94% on February 21st, the highest level since January 2014. The current rise in interest rates seems to be a clear manifestation of the confluence of monetary policy normalizing, central bank balance sheets on the cutting block, green shoots of inflationary pressure, and now protectionist trade policies that risk an inflationary trade war.

Fed Chairman Jerome Powell's stated in his recent Capitol Hill testimony the following: "We've seen some data that will add confidence to my view that inflation is moving up to target." Powell went on to reiterate the Fed's intention to continue on its path of interest rate hikes and left open the possibility of four rate hikes in 2018. The Powell Fed will likely strengthen its resolve to raise rates to the extent inflationary pressures continue to mount. The current Fed interest rate policy seems to have made the "Fed Put" a fond memory and "buy the dip" advice less prudent.

While even a sustained move up in inflation beyond the targets of global central banks can be problematic to both equities and bonds, the embedded deflationary pressures of aging demographics and ever-improving technology make runaway inflation very unlikely. The domestic and global economies continue to show improvement, if not strength and corporate earnings continue to move up, especially considering the benefits derived from the new tax law. Corporate tax savings have flooded trading desks with corporate buybacks, which bodes well for future corporate earnings as long as revenues and margins hold steady. Ironically, it seems that a tax law named the Tax Cuts and Jobs Act of 2017 could likely result in far less jobs than happy shareholders.

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CONCLUSION

As noted last month, the current financial market environment is enigmatic as synchronized global growth and improved corporate earnings face the headwinds of a monumental monetary unwind occurring in uncharted waters, along with geo-political confrontations that appear to have shifted from military to economic. Stronger economic growth and low unemployment are sparking nascent signs of wage growth, which is the single largest contributor to inflation. The variables involved in solving the current financial/geo-political equation are endless. Fortunately, we don't have to solve the equation. What we do have to do is recognize that much of the easy money has been made over the past several years and that the return prospects for the next nine years are considerably lower than the past nine. Accordingly, we believe that prudence dictates the more conservative allocations we have recommended over the past months. This thinking is reflected in our current asset allocations, which we continue to rebalance consistently.

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