MARKET REVIEW & COMMENTARY

MARCH 2018

TELEMUS®

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MARKET REVIEW

MARCH

The last were first. The year's volatility continued into March as stocks rose and then swooned, bonds rallied slowly and alternatives fell less than stocks. Small cap U.S. stocks outperformed their larger brethren and international and emerging markets generally lost less than U.S. markets. Most categories of fixed income experienced modestly positive returns as interest rates topped and began their leisurely descent. Alternative investments like hedge funds generally lost less than stocks, the dollar lost a bit and real assets were generally positive.

Specifically, the S&P500 fell -2.54% while high dividend payers were close behind, falling -2.31%. Large cap growth was down -2.24% while large cap value was down -1.76%. Mid cap growth was +0.40% and mid cap value eked out a +0.10% return. Small cap growth gained +1.79% while its value counterpart grew +0.70%. Across the pond, Europe lost -1.20%, EAFE closed down -1.97%, emerging markets fell -1.99%, but frontier markets gained +0.79%.

Despite a cacophony of voices predicting higher interest rates/lower bond values, interest rates peaked and then began a leisurely descent. Consequently, fixed income was a bright point in March as bonds served their anchor-to-windward portfolio purpose. In a reversal of February, municipal securities underperformed their taxable counterparts across the curve. The yield curve continued to compress as long rates fell more than short. 10-20 year Treasuries gained +1.84%, the Bloomberg Barclays long credit index was up +0.75%, 10 year municipals were up +0.35% and TIPS gained +1.05% in March. 3-5 year Treasuries were up +0.53%, 1-5 year credit gained +0.08%, while T-bills gained a skinny +0.13% and 3 year municipals were down -0.07%. World bonds were up +1.53% and emerging market bonds gained +0.70%. High yield paper fell -0.60%, perhaps presaging a nascent investor preference for less risk.

Alternative investments and real assets were generally positive with a few exceptions. The HFRX Global Hedge Fund Index lost -0.98% and the Bloomberg Commodity Index fell a modest -0.62%, but global natural resources gained +0.62%, global real estate was up +2.00%, U.S. real estate gained +3.88% and precious metals rose +1.33%.

MARKET REVIEW

YEAR-TO-DATE

Going nowhere fast! As we have predicted, the slowing of quantitative easing (money printing) has resulted in more volatility. Stock markets blazed in January only to fall hard and then rise in February, and rise and then fall in March. The disparity between the returns of 'growth' and 'value' stocks remains wide, despite narrowing a bit in March. U.S. growth stocks are up between +3.54% (small cap growth) and +1.94% (large cap growth). Midcaps are following this playbook with midcap growth +2.75% and mid cap value -2.65%. U.S. small cap value stocks are down, -3.15% and large cap value stocks lost -2.83%. The S&P500 is now negative year-to-date, down -0.76%, while high dividend payers, being treated as a bond surrogate, are down -3.20%. International is closing in on U.S. returns as EAFE has lost -1.70% and Europe is down -1.98% but emerging and frontier markets maintain their lead; up +1.28% and +4.98% respectively.

Fixed income returns remain 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. Although March reversed this trend, returns year-to-date generally followed duration lower. Short Treasuries are down -0.38%, 3 year municipals are up +0.11% and 1-3 year corporate paper is down -0.31%. The 10-20 year Treasury Index is down -2.47%, Barclays Intermediate Corporate Bond Index fell -1.50% and the Bloomberg/Barclay Municipal 10yr Index has lost -1.61% year-to-date. TIPS fell -0.79%, which is surprising given the growth of inflation-aware sentiment, emerging market paper (EMBI) is down -2.04% and high yield bonds lost -0.86% through March.

Alternatives have held up but real assets have experienced mostly negative year-to-date returns. The HFRX Global Hedge Fund Index is down -1.02%, precious metals are down -7.33%, energy is down -11.12%, the dollar has given up -2.14%, and world real estate is down -3.94%.

We continue to experience what we have long posited, the volatility which comes with a reduction of quantitative easing and a global debt build-up. Without the salubrious opiate of easy money we are returning to normal levels of volatility. We anticipate more of the same. However, the global economy is experiencing synchronous slow growth and the U.S. economy continues on a slow growth trajectory. S&P 500 corporate profits are expected to log a 17% increase in the first quarter; partially assuaging valuation concerns. Interest rates have pulled back somewhat despite U.S. issuance of more short term debt and recent economic indicators reflect a slight loss of momentum. It is unusual to experience tax cut stimulus near the end of a long growth cycle but that is exactly the situation now. This is the time to make sure your asset allocation is right for you. Our allocations lean to conservatism and we have been rebalancing regularly.

INDEX RETURNS AS OF 3/31/2018

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)	-0.49%	-0.57%	-0.57%	7.70%	14.75%	28.29%
HFRX GLOBAL HEDGE FUND INDEX	-0.98 %	-1.02%	-1.02%	1.54%	6.61%	-2.33%
CPI - SEASONALLY ADJUSTED	0.00%	0.69%	0.69%	6.14%	7.24%	17.40%
S&P 500 COMPOSITE	-2.54%	-0.76%	-0.76%	37.29%	98.81%	153.07%
LIPPER LARGE - CAP CORE	-2.66%	-1.20%	-1.20%	33.42%	87.87%	129.46%
WISDOM TREE LARGE CAP DIVIDEND	-2.31%	-3.20%	-3.20%	32.48%	84.57%	135.88%
MSCI ALL COUNTRY WORLD INDEX NET	-2.21%	-1.03%	-1.03%	27.15%	61.60%	73.18%
MSCI EAFE NET	-1.97%	-1.70%	-1.70%	17.94%	40.64%	32.00%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	-0.04%	-0.57%	-0.57%	3.82%	7.97%	40.89%
BLOOMBERG BARCLAYS US AGGREGATE	0.64%	-1.46%	-1.46%	3.46%	8.85%	42.42%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.13%	0.35%	0.35%	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	-2.24%	1.94%	1.94%	46.26%	119.55%	199.16%
RUSSELL 1000 VALUE	-1.76%	-2.83%	-2.83%	26.05%	76.56%	113.59%
RUSSELL MIDCAP GROWTH	0.40%	2.75%	2.75%	30.67%	94.51%	169.74%
RUSSELL MIDCAP VALUE	0.10%	-2.65%	-2.65%	22.76%	76.46%	151.71%
RUSSELL SMALL CAP COMP GROWTH	1.09%	3.54%	3.54%	32.36%	101.25%	188.84%
RUSSELL SMALL CAP COMP VALUE	0.48%	-2.87%	-2.87%	23.06%	65.01%	132.81%
MSCI EM (EMERGING MARKETS) NET	-1.99%	1.28%	1.28%	29.40%	27.72%	29.93%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.15%	0.34%	0.34%	2.08%	2.41%	6.54%
BLOOMBERG BARCLAYS US AGENCY	0.56%	-0.53%	-0.53%	2.63%	5.61%	27.65%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	0.70%	-2.04%	-2.04%	16.08%	17.13%	86.84%
CITI GROUP WORLD GOVERNMENT BOND	1.53%	2.49%	2.49%	7.83%	4.13%	23.60%
BLOOMBERG COMMODITY	-0.62%	-0.40%	-0.40%	-13.43%	-34.38%	-57.78%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	3.64%	-4.87%	-4.87%	1.73%	-41.69%	-60.18%
LIPPER GLOBL NAT RES	0.62%	-4.65%	-4.65%	1.94%	-2.81%	-24.89%
LIPPER PRECIOUS METAL FUND	1.33%	-7.33%	-7.33%	4.14%	-34.47%	-46.73%
MSCI WORLD REAL ESTATE	2.00%	-3.94%	-3.94%	6.42%	25.84%	40.31%
LIPPER REAL ESTATE FUND	3.10%	-6.48%	-6.48%	3.27%	28.04%	58.96%

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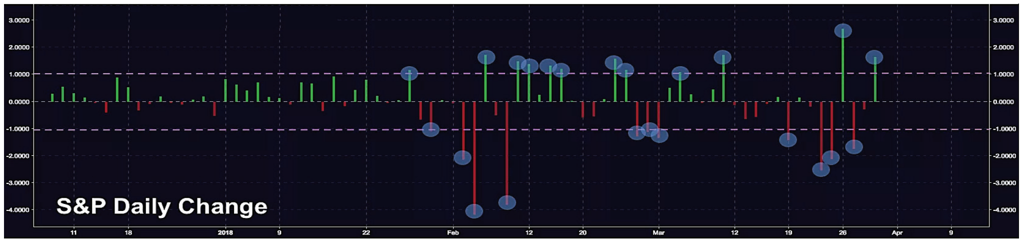
COMPLACENCY NO MORE…

Last month we noted that investors appeared to have awakened from a slumbering complacency as volatility spiked in early February. The chart below encapsulates the change in investor psychology and market action since early February and continuing through March. While market participants that came to the party in the last 10 years may find the pickup in volatility something new, those of us who have been investing longer find the recent volatility a return to normalcy. In fact, the S&P 500 moved up or down 1% or more on 23 separate occasions during the first quarter, a stark contrast to the run-up in the market in January and the precedent set in 2017.

The end of March marked the end of Q1 2018, which was unique because the S&P 500 had its first quarterly loss since 2015. To be clear, the S&P fell less than 1% for the quarter. However, the drawdown from the January 26th high was 7.7%. Domestic markets weren't alone in the move down as European shares had a bad stretch as well in Q1, falling 4.5% as the headwind of a strong currency continues. The market action in February and March is indicative of a changing narrative in which the benefits of synchronized global growth are being met by the pressures of the shift in central bank monetary policy (tightening) and renewed inflationary concerns.



MARKET REVIEW

We do well to remember that we are in uncharted territory as developed market central banks unwind nearly 10 years of zero-bound interest rates. Inflationary concerns have become front-of-mind for many investors as the Fed continues to withdraw liquidity from the market and other central banks contemplate the same. What appears to be stoking further inflationary concerns is the unprecedented late-cycle fiscal stimulus in the U.S., which is adding to an annual deficit that was already widened by recently enacted tax cuts. The result is a flood of new issuance of U.S. Treasury debt at the same time that the Fed has ceased new purchases and appears on track for another two, if not three, quarter-point interest rate hikes this year.

Indeed, short-term interest rates have moved up, but long rates have moved down after testing resistance levels just weeks ago. This occurred despite the onslaught of new bond issuance and reflects skepticism about the new inflation narrative and the fact that U.S. rates remain at competitively attractive levels. The yield curve as expressed by the spread between the two and ten-year Treasury notes (see below), has fallen to just 47 basis points, which represents the flattest reading since the financial crisis and, historically, has signaled some caution relative to the health of the economy.

Reflective of the dual market narrative noted above, corporate earnings continue to reflect the synchronized global growth that has pushed global share prices higher. During the first quarter analysts increased earnings estimates for companies in the S&P 500 for both Q1 and Calendar Year (CY) 2018. Q1 EPS estimates for the S&P 500 were increased by 5.4% to $36.24, while CY 2018 EPS estimates have been increased by 7.1% to $157.77. The Q1 increase in analysts' estimates is the largest increase in 15 years, while the FY increase is the largest since FactSet began tracking this metric in 1996. It is important to note that these upward revisions in EPS estimates were made in January and have since come down a bit. However, if analyst estimates prove accurate, forward S&P 500 valuation levels fall from their historically high levels. What remains to be seen if the S&P 500 continues its march up on the back of improved earnings or whether the market pauses as EPS catch up to extended valuations.

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CONCLUSION

Though inflation remains a budding concern in the face of the sea-change in monetary policy, the embedded deflationary pressures of aging demographics and ever-improving technology make runaway inflation seem unlikely. The current financial market environment is enigmatic as synchronized global growth and improved corporate earnings face the headwinds of a monumental monetary unwind. We don't see the geo-political landscape as being meaningfully worse than it has been historically. We do expect financial markets to experience more volatility; returning to historical performance patterns. Further, we think that future returns will be lower than they have been since 2008; as the opiate of QE is removed.

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