1919 INVESTMENT COUNSEL
Complexity to Clarity

# Investment Review and Outlook

April 2018

## Introduction

2018 started off on an exceptionally optimistic note, with the S&P 500 Index rising more than 5%, hitting new highs on 14 of the first 21 trading days of the year. Bullish sentiment remained intact due, in part, to the passage of the tax bill in late 2017 and the belief that the resulting stimulus would boost corporate earnings and extend the US economic expansion. However, after hitting a high on January 26th, the first quarter came to an end with US stocks down for the year, marking the first negative quarter since 2015 and the worst start to a year since 2009.

A sharp selloff in early February, as rising yields and inflation fears rattled investors, continued through March. Headlines about tariffs, trade wars, increased scrutiny of technology firms and Federal Reserve rate increases further weighed on the markets, resulting in a drop of 0.8% for the S&P 500 Index. Surprisingly, the safe-haven sectors of telecom and consumer staples stocks fared the worst while technology stocks and those of the consumer discretionary sector outperformed all others: an unusual outcome in a quarter with a decidedly risk-off tone. Likewise, the bond market, as measured by the Barclay's Aggregate Index, did not provide any refuge, dropping 1.5% in the same period.

After one of the calmest years on record, it should be no surprise that volatility has picked up in 2018, a condition we believe likely will persist. However, with wage growth at a reasonable 2.6% level and other inflation indicators remaining tame, we believe the risk of an overly aggressive Fed remains low. Our long-term view of equities remains favorable, relative to other asset classes, but tempered by somewhat rich valuations. For now, our opinion of fixed income is that the return potential remains fairly limited.

## 1st Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 3/31/18

| | 1Q 2018 | YTD Return | Price / Value |
|---|---|---|---|
| Dow Jones Industrial Average | -2.0% | -2.0% | 24,103 |
| S&P 500 Index | -0.8 | -0.8 | 2,641 |
| Russell 2000 Index | -0.1 | -0.1 | 1,529 |
| MSCI EAFE Index | -1. 6 | -1.6 | 8,006 |
| MSCI EM (Emerging Markets) | 1.3 | 1.3 | 2,555 |
| Bloomberg Barclay's US Aggregate | -1.5 | -1.5 | 101 |
| Bloomberg Barclay's Municipal Bond | -1.1 | -1.1 | 107 |
| Gold – Continuous Contract | 1.4 | 1.4 | $1,327 |
| Light Crude Oil – Continuous Contract | 7.5 | 7.5 | $65 |

Source: Factset

## Economy

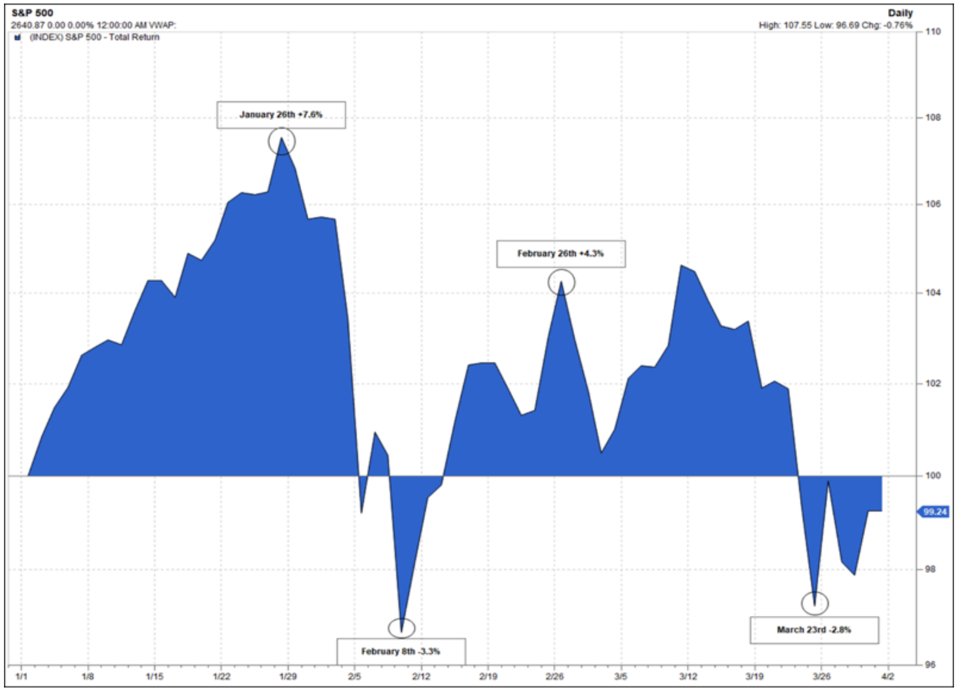
Following a sharp upward revision to fourth quarter GDP which drove domestic growth to a 2.9% annual rate, the economy downshifted slightly in early 2018, closer to a 2% rate. Despite the slightly softer tone, we believe the economy's prospects remain sound and expect readings to move closer to the 3% annual pace that prevailed much of last year. The anticipated shortfall thus far in 2018 likely is a byproduct of caution fostered by volatility in the equity markets, as well as within the political arena. President Trump's surprising steel and aluminum tariffs, while impacting only a small portion of the economy, nurtured fears of possible retaliation by major trading partners which could undermine trade and dilute recent gains in the manufacturing sector as protectionism sets in. The subsequent resignation of the president's top economic advisor, Gary Cohn, a highly-regarded primary architect of pro-growth tax policies, further fueled speculation that the fiscal stimulus measures coming online may become derailed. Meanwhile, the Fed continued slowly to raise interest rates under new Fed Chair Powell, and borrowing costs reached multi-year highs accordingly. The bottom line is that there was a lot of new information to digest; given the sturdy run of the US economy over the last year, a pause seemed in order.

We do not dismiss the aforementioned challenges but believe the chances of an acceleration in growth this year remain strong. Sturdy household spending, the driver of our consumption-oriented economy, seems entrenched and on solid footing. Following a 4% annualized rate of growth in the final months of 2017, we anticipate the consumer will remain active this year due to steady (albeit unspectacular) wage gains, as well as an uptick in after-tax pay as the "Tax Cuts and Jobs Act of 2017" takes hold. Although individual tax reform will be additive in the near-term, solid trends within the labor markets likely will have a greater impact on spending behavior in the long run. While the corporate tax cut is designed to be permanent, individual income tax provisions are scheduled to expire in 2025. By contrast, a robust employment environment that is supportive of wage growth and generates opportunity would appear to be more durable and provide a greater boost to consumer confidence. Clearly the data on labor are not disappointing. Layoffs decreased yet again in late March to the lowest level since early 1973. The unemployment rate resides at just above 4% and likely will fall into the mid-3s this year. The recent 2.6% annual increase in average hourly earnings remains lower than what we would expect at this stage of the recovery, but with manufacturing surveys reaching the highest levels since 2004 and strong retail sales, we expect wage inflation will pick up this year.

This economic expansion is long in the tooth but, given the extreme damage following the credit crisis and historically-slow recovery, asset utilization has yet to meaningfully strain the economy's resources and slack remains in both goods and labor. Globalization and weakness abroad have further supported these trends, resulting in deflationary pressures and low interest rates as the byproducts of the difficult environment. We seem to be at the point where the traditional economic playbook will be more relevant and believe the economic recovery will be more challenged in 2019 after a solid showing this year. Rising wages likely will pressure overall inflation higher, which in time will bring a more aggressive response from the Fed, although at this point the Fed probably would welcome a period of above-trend growth, tolerating an overshoot in price appreciation. Tariffs, while destructive to growth, are inflationary, as is a weaker dollar. It is rare to see a surge of stimulative fiscal policy, such as the recent tax bill, this late in the economic cycle; this may put the Fed in a position of raising interest rates to a greater extent than anticipated. Our biggest concern relates to increases in the deficit that seem inevitable due to recent tax policy and any infrastructure spending that actually materializes, especially if the increases are concurrent with a rise in interest rates. Most likely a recession would be the result, but we do not think this scenario plays out until mid to late 2019 at the earliest.

## Equities

The first quarter of 2018 began with a rush of investor enthusiasm for US equities stemming from the enactment of the "Tax Cut and Jobs Act." The S&P 500 posted its best return for January in 21 years. By the peak of the market on January 26th, the S&P 500 had returned 7.6%. Concomitant with this enthusiasm came an increasingly optimistic economic outlook and associated expectations for the Fed to accelerate its tightening schedule. The yield on the 10-year Treasury, which started the year at 2.41%, rose quickly to 2.85% by early February as bond prices dropped.

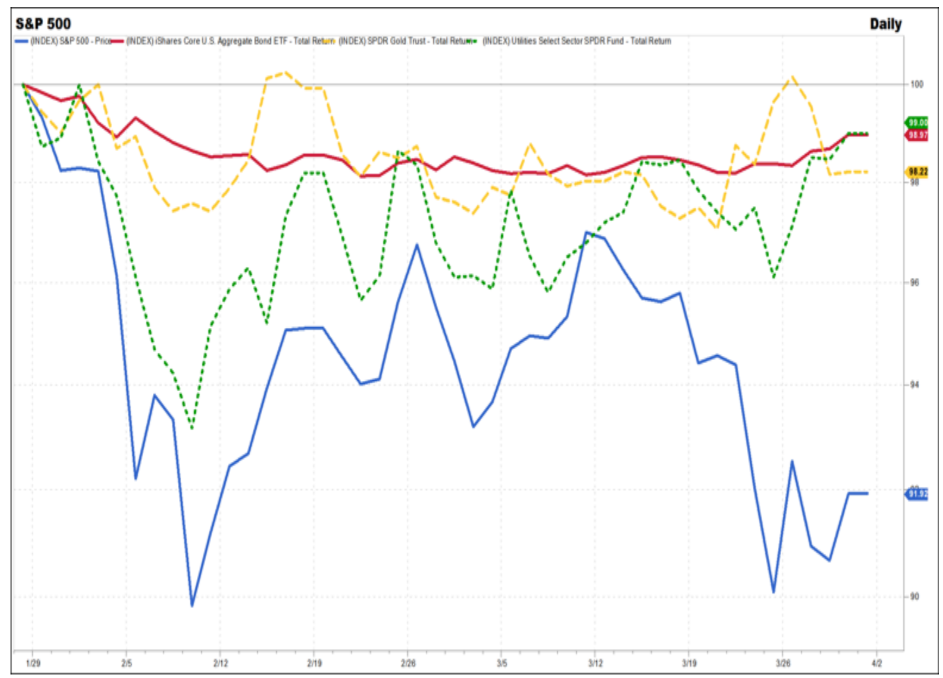



Source: Factset, 1919 Investment Counsel

The renewed volatility to the upside quickly inverted as stock buyers reevaluated and caution replaced enthusiasm. Concern over the potential impact of wage inflation and expanding budget deficits pushed rates higher and investor confidence lower. By February 8th, the S&P 500 had declined almost 11% from the January 26th high and was down 3.3% for the year. Volatility made a comeback and ended some noteworthy streaks:

- S&P 500 ended it longest streak without a 3% correction
- After only 8 days of 1% advances or declines in all of 2017, 23 of these events occurred in Q1
- US large cap stocks declined by 10% for the first time since Q1 of 2016
- First negative Q1 return for S&P 500 since 2009
- US Dollar fell to lowest level since December 2014

Markets returned to positive territory by late February and early March, but as the nor'easter storms arrived, so did tariff proposals, departures of key White House personnel and fears of a trade war. In addition, late quarter concerns arose in the technology sector regarding Facebook's use of personal data, an accident involving a self-driving car, and pressure on Amazon coming from the White House. Confidence was again eroded, and the markets headed back to negative numbers. For the quarter, the S&P 500 returned -0.8%, while small-cap stocks performed slightly better, down 0.1%. Developed international markets slumped -1.6% while emerging market equities bucked the negative trend, adding 1.3%. Surprisingly, in a period of broad equity weakness, bonds did not provide their normal refuge and by quarter-end had underperformed stocks due to rising interest rates. Additionally, bonds declined, as did other traditional safe havens such as gold and utility stocks, when stocks began to drop after the late January peak (see chart).




Source: Factset, 1919 Investment Counsel

Across the S&P 500, only two sectors, Technology (+3.20%) and Consumer Discretionary (+2.76), posted gains. Due to rising interest rates, stocks viewed as bond proxies performed poorly during the quarter as evidenced by Telecommunication (-8.69%) and Consumer Staples (-7.77%). As one might expect in volatile markets, stocks of higher-quality companies with good sales growth outperformed the market.

Company fundamentals continue to improve with a better economic backdrop and lower-tax rates. Free cash flow generation is strong and helps to fund companies' share repurchases and dividend growth plans. The earnings lift created by the corporate tax reductions has brought forward P/E multiples to a more palatable level but still above the long-term average.

Looking ahead, we believe that an increased level of volatility will continue and P/E multiples likely will contract modestly due to higher rates, geopolitical concerns and lower earnings growth expectations in 2019 and beyond. Sustainable and less-volatile growth in sales and earnings, combined with good profitability metrics, will be important factors to focus on for stock selection in the coming quarters. We favor companies in the industrial, healthcare and financial sectors with strong and stable growth characteristics as evidenced by earnings, cash flows and dividends. As interest rates continue to rise, we believe stocks will outperform bonds but expect equity market returns will be below their historical average.

Economic and Market Drivers

| Tailwinds | Headwinds |
|---|---|
| Strong Corporate Cash Flows | Fed Policy – rising rates and balance sheet runoff |
| Low interest rates | Protectionist Trade Policies |
| Fiscal Stimulus Package | Tight U.S. labor market – rising labor costs |
| Improving Real Household Income | Midterm Election Uncertainty |
| Low Inflation | Aging Demographics in Developed Markets |
| Animal Spirits rising - Business Optimism | China Slowdown / Deleveraging |
| Household Formation Increasing | Political Pressure to Regulate Tech |

## Bonds

After declining in both January and February, the Bloomberg Barclays Aggregate Index managed a positive return in March of 0.6%, which reduced the loss for the quarter to -1.5%. Whether the stock market was up or down, bonds did not necessarily move inversely as is the usual custom. March was more of a cautious month for credit, and performance was driven more by long-dated Treasuries, which nullified any other factors such as the March rate hike or strong employment data. While all points along the yield curve increased for the quarter, the 2-year Treasury yield rose by more than the 10-year Treasury, a situation known as a bear flattening of the yield curve. At the end of the quarter, the spread between the two was 0.50%, which is notable since when the differential between the 2-year and 10-year Treasury falls below that spread and approaches zero, it can be an indication that the prospect of a recession in the near future is becoming a greater concern. However, we do not foresee such an outcome until later in 2019, or beyond.

With the Fed continuing to raise rates in the short end and persistent demand in the long end, we do believe that more flattening, albeit at higher rates, could occur and thus favor purchases in the intermediate part of the curve (5-7 years). In addition to the Fed raising rates and tapering their bond purchases, the European Central Bank also is expected to end its quantitative easing program later this year. While these actions should put upward pressure on yields, there seems to be sufficient demand at the long end from pension and insurance funds to keep yields from moving significantly higher. Another area of concern is the sharp increase in Libor rates, which may signal a problem with short-term bank funding or a deterioration in financial conditions, as has been the case in the past. However, we expect Libor to settle in to a more normal range once we have moved past current short-term factors. One last risk to rates worth noting is the flows into or out of bond mutual funds and ETFs. Should there be a drastic increase in outflows, the selling could beget more selling.

In the corporate bond space, investors sold bonds either to reposition portfolios or reduce losses due to higher interest rates. Those sales, combined with near-record issuance and trade/geopolitical risks, kept investor sentiment soft. Heavy supply seen in the first quarter should slow down and become a positive catalyst going forward. We continue to believe that tax reform and strong corporate earnings support an overweight to corporate bonds. Even so, we do not anticipate adding to the current overweight and will strategically look for opportunities to lessen the exposure and/or boost the credit quality of the portfolios. With the narrowest spreads likely in the rearview mirror and event risk on the rise, we believe this is prudent.

The municipal bond market suffered its worst first quarter in two decades as rising rates within the Treasury market pressured all fixed-income markets. The Bloomberg Barclays Municipal Bond Index fell 1.11% during the period, which was in line with the 1.18% loss suffered in the Treasuries market. Municipal mutual funds experienced surprising inflows despite the negative press associated with rising interest rates, although much of these flows were parked in short maturities and cash equivalents. Longer maturities fared worse, but the damage could have been extreme if new supply had not been pulled into 2017 in advance of tax reform's 2018 effective date. Overall, first quarter new issue supply collapsed 31.9% versus last year's pace, leaving few bonds to buy despite the drop in prices.

We expect volume to rebound somewhat as capital needs and infrastructure improvements cannot be deferred forever. However, much of the volume may end up in the taxable municipal market. Tax reform eliminated the use of tax-free bonds being used for advance-refunding of outstanding, higher-yielding debt. In addition, there is the potential for more public/private partnerships to fund projects traditionally financed with tax-free bonds. Taxable muni bonds provide proceeds for development when a for-profit entity is involved in an infrastructure project. As we move beyond the April tax season, often marked by selling to meet tax obligations, we expect strong demand for new issues, particularly if deals are structured with more robust coupons than in recent years. Large coupons are considered defensive since they provide higher cash flows to invest in rising-rate environments, thus additive to total returns over time.

Despite our view that the worst is behind municipal investors for the time being, there remain challenges the market must navigate. First, as the Fed raises rates, Treasury yields likely will drift higher which will continue to be a headwind for tax-free bonds. Also, a lower corporate tax rate creates opportunities for traditional muni investors, such as banks and insurance companies, to invest outside of the tax-free market for competitive after-tax returns. While individuals remain the largest buyer base, primarily through mutual funds, banks and insurers traditionally soak up nearly a quarter of the market, and their fading influence is a negative. The fact that the top marginal tax rate for individuals dropped only slightly, to 37%, should keep individuals interested in tax-free bonds. As interest rates move higher, income-oriented investors likely will emerge. This is particularly true among the aging baby-boomer generation that may view the recent volatility within equities as a reason for a more defensive asset allocation following solid returns over the past few years.

## Conclusion

As was the case in the first quarter, we expect continued volatility in all markets as investors navigate trade rhetoric, geopolitical risk, and US politics, combined with an environment of additional Fed rate increases and rich asset valuations. However, with decent GDP growth in the 3% range and in the absence of a significant rise in inflation, we do not see a recession on the horizon. As we previously have written, we remain favorable to stocks relative to bonds, as a result of a decent employment outlook, moderate wage growth, and support for corporate earnings from tax cuts. However, given rich valuations and tighter monetary policy, future returns on stocks may be below their historical averages.