AS VOLATILITY RETURNS
Following a placid 2017, U.S. stock market volatility had one of its highest quarterly rises ever. The CBOE Volatility Index, or VIX, rose 80 percent during the first quarter. Investor concerns about inflation and rising bond yields collided with extreme bullish sentiment in January causing stocks to enter correction territory in February. A more hawkish Federal Reserve, political turmoil in Washington, and trade tensions with China added to investor concerns as both stocks and bonds fell in the first quarter of 2018. This despite the fact that U.S. GDP showed signs of accelerated growth in 2017 and corporate tax cuts were expected to significantly boost corporate earnings this year. Price swings in February were so strong that it caused the demise of a couple of exchange traded funds that short the VIX, a trade that had been very profitable during the past three years. Dovish central bank policies and a synchronized global recovery had suppressed volatility to levels below normal.

STOCKS: BREAK THEIR WIN STREAK
The U.S. equity market ended a volatile first quarter lower, following an impressive eight consecutive quarters of positive returns. The Standard & Poor’s 500 Index fell 0.8 percent and the Russell 2000 Index of small stocks was down 0.1 percent. Small companies derive a larger proportion of their earnings from domestic markets compared to large multinationals and are expected to benefit more from the territorial tax-reform package passed by Congress in December 2017. International developed markets fared worse than U.S. stocks, while emerging markets such as Brazil and Russia benefited from a rally in oil prices. A weaker dollar also helped emerging markets deliver positive returns for the quarter. A stronger euro and investor fears over potential tariffs drove relative underperformance of European stock markets.

Within the U.S. market, growth stocks continued their outperformance over value stocks. Small growth had the best returns for the quarter while large value did the worst. The technology
sector continued its strong momentum delivering a positive return of 3.5 percent for the quarter. Despite concerns about data privacy that affected companies like Facebook and Google, strong ongoing business fundamentals, robust consumer demand, and a favorable tax rate incentivizing technology companies to repatriate some large off-shore cash balances helped technology stocks. The consumer discretionary sector also posted a solid 3.1 percent return for the quarter due to strong performances by ongoing secular disruption companies such as Amazon and Netflix. Amazon now makes up about 2.5 percent of the Standard & Poor’s 500 Index and approximately 20 percent of the consumer discretionary sector.

Higher interest rates put pressure on high dividend yielding sectors, such as utilities and real-estate, telecommunications, and consumer staples. During a period of unusually low bond yields, investors gravitated to these sectors in search of yield. As bond yields rose, these stocks became relatively unattractive. Both telecommunications and consumer staples are also grappling with secular and competitive headwinds.

**BONDS: NEGATIVE RETURNS ACROSS ALL SECTORS**

Rising interest rates, a more hawkish Federal Reserve, and widening credit spreads pushed all fixed income sectors into negative territory for the quarter. Concerns over inflation, growth, and a rising level of Treasury issuance to finance increased federal deficits contributed to higher rates. The 10-year Treasury yield rose 34 bps to 2.74 percent and the two year U.S. Treasury rose above 2 percent for the first time since 2008, finishing the period at 2.27 percent. The Bloomberg Barclays Aggregate Index returned -1.46 percent in the first quarter. The Federal Reserve raised interest as anticipated by 25 bps in March FOMC bringing the Fed Funds target to 1.50 percent - 1.75 percent. The Fed’s updated rate forecast continued to project two more rate hikes in 2018 but added a third hike in 2019. The market took that as an incrementally hawkish monetary policy.

Of all major sectors, corporate bonds fared the worst with the Bloomberg Barclays U.S. Credit Index returning -2.13 percent. Credit spread widened during the quarter prompted by trade policy concerns, increased equity market volatility, and tempered investor demand. Investment grade credit spreads widened by 16 bps for the quarter to 109 bps. The Bloomberg Barclays High Yield Index return -0.86 percent, outperforming investment grade bonds due to higher yield support. High yield spreads were as narrow as 311 bps in January, widened by quarter end to 354 bps amid a flight to quality and decreased appetite for risk.

The Barclay Municipal index returned -1.11 percent for the quarter outperforming the broad taxable market. Municipal new supply was down nearly 50 percent year-over-year because of the overhang from the issuance wave last December however ratios did not tighten as one might expect. This was due to seasonal weakness from municipal sellers that use the proceeds to make tax payments. The European Central Bank kept rates unchanged and will conclude its quantitative easing program only when it is satisfied prices are on a sustained trajectory toward its inflation objective. Emerging market local currency bonds offered investors the best return in the first quarter — up 4.71 percent. A weaker dollar and higher yields helped local currency bonds.

**OUTLOOK 2018: GLOBAL GROWTH, STRONG EARNINGS ARE POSITIVE FOR EQUITIES**

The U.S. economy ended 2017 with positive momentum, and we expect it to further benefit from fiscal stimulus through tax cuts, regulation rollback, and a positive shift in business and consumer confidence in 2018. Over 2 million jobs were created in 2017, and the unemployment rate ended the year at a low of 4.1 percent. Labor markets appear to be at or near “full employment” and the probability of upward wage pressure has increased. Increased Treasury issuance to finance the tax-cuts and the $1.3 trillion spending bill passed by Congress should put upward pressure on bond yields. However, secular headwinds of aging populations and displacement of labor due to technology will likely continue to restrain inflation and central bankers will be slow in reducing monetary accommodation. The probability of a recession in 2018 is low.

The tailwinds which underpinned equity markets in 2017 (low interest rates and inflation, steady earnings growth across sectors, and global growth) will now be joined by the additional benefit of successful U.S. tax reform in 2018. We believe equities will continue their relative outperformance given the entrenched nature of the aforementioned tailwinds. In
particular, earnings growth appears poised to continue its key role in driving equity outperformance. However, we acknowledge that risks to equity markets are also on the rise. In particular, rising inflation and interest rates, political theater in the U.S., and the potential for trade and real wars have increased. The Federal Reserve is expected to raise rates two additional times in 2018. The European Central Bank and even the Bank of Japan are moving toward either reducing or ending their asset purchase programs and preparing financial markets for eventual rate hikes. Monetary policy will become a headwind to financial markets and equity valuations in the U.S. are also high.

We continue to look for exposure to quality companies within sectors and geographies that would benefit from higher interest rates and sustained synchronized global growth such as financials, technology, and consumer. We believe there may be more value in international equities, particularly emerging market equities since the end of the financial crisis. Idiosyncratic issues in market-leading stocks such as Facebook and Amazon have also contributed to a rise in overall volatility and dimmed the luster of their respective sectors. However, we expect such issues to wane going forward and, as technology continues to play an ever-increasing role in daily life, we fully expect technology stocks to regain their allure and continue to imbue other industries. In summary, the trends that have driven equity outperformance over the last several months remain in effect. But, external political variables have hampered their effect. While fears that such variables could outright reverse global economic momentum are valid, we don’t believe they will be realized. Risks to our current outlook include political actions unfriendly to businesses, an unforeseen rise in interest rates, or an increasingly inflationary environment.

We anticipate fixed-income returns in 2018 will likely be more muted than last year’s results and maintain an underweight position in bonds. The Federal Reserve projects two more rate hikes in 2018 and an additional three in 2019. This will put pressure on the front end of the curve, keeping the yield curve flat. Spreads have reached pre-crisis levels meaning there is less room for spread compression to drive performance, leaving investors with the carry, which is low.

We maintain an underweight position in government bonds such as U.S. Treasurys and government mortgages in favor of sectors that offer spread and interest income. We are tactically underweight mortgages because of the Fed’s plan to reduce its balance sheet. We continue to be overweight investment grade credit and high yield bonds. With no recession in sight, we expect credit fundamentals to continue improving. We continue to see value in municipal bonds. Demand from buyers should remain strong given the small reduction in the higher marginal tax brackets. Diminished supply as a result of tax reform should be supportive of municipal bond prices.

We expect oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, higher oil prices are also likely to increase U.S. shale production and cap prices around $60 per barrel. We have no position in commodities, but maintain positions in material and energy stocks and energy pipelines.

KEY RISKS:
- **Interest Rates** – inflationary pressures and Fed balance sheet unwind cause interest rates to move up faster than the market expects.
- **Trade War** – escalation with China, NAFTA countries, and European allies.
- **Geopolitical** – North Korea, Middle-East, cyber-attack, or increase in terrorism.