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2018
1st QUARTER

Sarah Swan,
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The Equity Market

Out of Hibernation?

By Sarah Swan
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As we finally say goodbye to winter in Rochester, will we welcome back the bear after a long, long hibernation? This feels like a possibility, as the bull market run may have hit highs in January that we won't be seeing again for a while. The extreme volatility we've seen in the past three months could be a symptom of an underlying shift in the market cycle from a bull to bear market, as opposed to just some normalizing and correcting. Just two months into the new year, the market had seen 15 days in which it moved one percent or more in either direction. That number has only increased throughout March and the start of April. In the couple of weeks bookending quarter-end, the S&P 500 index rose or fell more than one percent eight times, the same number as in all of 2017. You may have heard a reference to "Charlie Brown's shirt" by pundits, suggesting the rapid upward and downward intraday movements by the market. The CBOE Volatility index (known colloquially as a "fear gauge" of investors) has been moving accordingly, gradually rising since the beginning of the year with a spike during February's correction.

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Vince Russo,
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The Bond Market

1st Quarter Overview

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By now, everyone should be reacquainted with the term *volatility.* For the first month of the quarter, it seemed as though the trajectory of interest rates was up, up, up in almost a straight line. No sooner had I written my fourth quarter newsletter highlighting how the yield on the 10-year U.S. Treasury note had finished 2017 lower than where it began the year than I was surprised by an increase in the yield by 30 basis points by the end of January. It did not stop there. By February 21, the yield on the 10-year Treasury had climbed to 2.95%, more than 50 basis points higher than we ended the year. The 10-year Treasury yield closed at 2.74% at quarter-end. The chart on page 3 illustrates how rates across the entire Treasury yield curve have moved since the end of 2017.

We have discussed the shape of the yield curve and its significance many times. The chart illustrates how the curve has flattened over the quarter and where the rise in interest rates is most noticeable. While the very short end of the yield curve has risen the most, the focus for the capital markets remains on the longer interest rates. The reason is that longer-term capital investments play a larger role in economic growth and development. So, the current difference between the 2-year and 10-year Treasury yield stands at 0.47% (47 basis points), the lowest spread since the financial crisis of 2008.

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The Equity Market *continued from page 1*

This is the market attempting to correct for the inflated optimism that we talked about last quarter. Even companies that are beating earnings estimates (which is normally a large predictor of stock prices at least in the short term) are seeing their stocks decline or sell off. Corporate earnings have been notably robust for several months now, and expectations are for continued positive results going forward, but shakiness is really starting to take over after many months of resilience (or in our opinion, complacency). That resilience in 2017, as we intuited, was based on optimism surrounding the election and deregulation, the overhaul of the tax code, and comfortability and familiarity with Fed Chair Janet Yellen. Although the fundamentals of our economy haven't changed much from 2017, those three factors certainly have. President Trump's rhetoric has proven powerful in moving the market in both directions (but negatively as of late), tax reform has been coupled with a sizable increase to the government's spending deficit, and the new Fed Chair is anything but familiar in a time of newly rising rates, neutralizing policy, and general uncertainty surrounding the effects of such monetary policy.

Headlines Add to Turbulence

If no news is good news, this quarter has been one for the books. Political and company-specific headlines (and the intersection of both—i.e., Trump's public criticism of Amazon and its discounted shipping prices through the United States Postal Service, and Facebook's data breach and CEO Mark Zuckerberg's subsequent testimony before Congress) have been testing investors' confidence on a near-daily basis, resulting in huge intraday swings in the market. This has only reinforced our "Jenga" reference in that the stock market is very prone to tumbling in this environment of volatility and turbulence.

Concerns over a possible trade war have colored market swings the past few weeks. What began with President Trump's aluminum and steel tariffs has progressed with a couple of rounds of tariff leveling from some of our allies, as well as China. The newest development was the US and China unveiling plans to impose tariffs on billions of dollars of exports. The US listed over a thousand items that will be subject to penalties while China retaliated by targeting hundreds of goods, including nearly $23 billion worth of soybeans and other products from the Midwest. Several economists have said that these developments, along with the possibility of retaliatory tariffs by other countries on American exports, could drive up consumer prices and reduce trade overall. Despite advice and concerns from economists and advisors, President Trump seems committed to reinforcing protectionism. We will continue to look out for the effects of these policies over the coming months as China and the US attempt to establish a new normal in trade relations. This week's developments helped quell some fears; in what's being seen as an act of conciliation, China's President Xi Jinping pledged to open China's markets further for trade and investment. However, at the same time we've moved away from fears of a trade war, we've apparently moved onto fears of a real war.

Over 40 Syrian civilians were killed (and several more injured) over the weekend in a chemical attack on Douma, a rebel-held town in war-torn Syria. The attack is being denied by President Assad, who is backed by Russia. To make matters worse, President Trump then tweeted threats of firing missiles into Syria. Russia responded equally aggressively, leading many to fear imminent escalation of, and involvement in, an already dangerous situation that has been going on for over seven years. We will be following the development of this state of affairs very closely.

Fundamentals Remain Stable

Despite such geopolitical commotion, our domestic economic fundamentals remain strong, evidenced by the Labor Department's jobs report released in early April. While March's hiring slowed slightly, the unemployment rate, a seasonally adjusted 4.1%, held steady at its lowest level since December 2000 for the sixth straight month. The labor market remains relatively positive. Consumer-price increases are edging toward a healthy level consistent with solid demand, and manufacturing and industrial production are growing. According to the Fed's most recent Federal Open Market Committee meeting minutes, all participants see the economy continuing to grow and inflation continuing to edge higher, supporting the notion that the Fed will likely stick to its planned path of interest rate hikes. Members approved another .25% increase in the target range, and expectations are for an additional 2-3 hikes this year (in June, September, and possibly a third before year-end). Sentiment about the economy seemed generally positive, albeit it with some reservation about the same potential issues we've touched on here.

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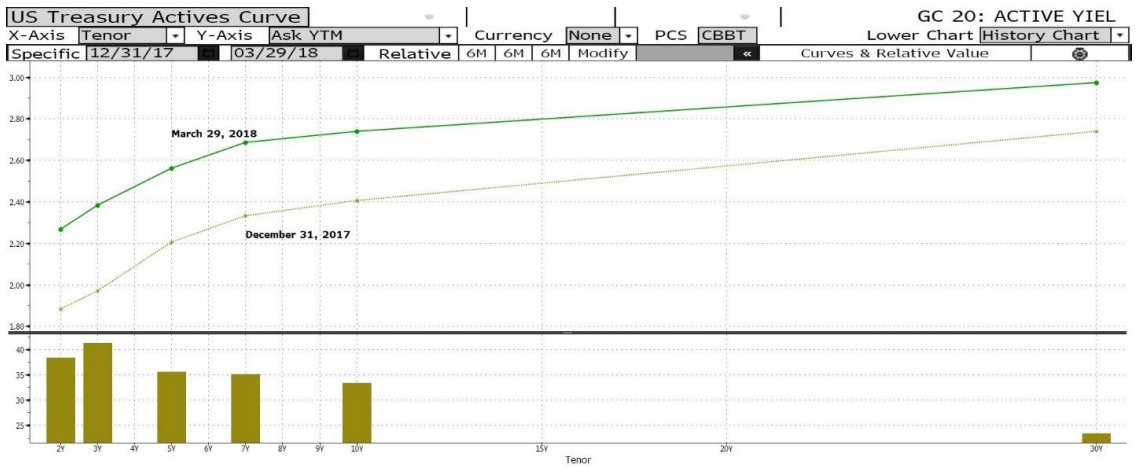

Source: Bloomberg

Notwithstanding the flatter yield curve, every sector of the Bloomberg Barclays Aggregate U.S. index was negative for the quarter. The Aggregate index is the broadest of the U.S. bond market indices. It had a total return of -1.46%, while the Government/Credit Intermediate index (our benchmark) was at -0.98%. Even the U.S. Corporate High Yield index had a negative return of -0.86%. Performance favored shorter, high quality bonds. As such, the bond market was not able to offset the negative performance of the volatile equity markets. There are times when both asset classes can come under stress and perform negatively. The future uncertainties have more to do with the direction of asset prices as of late than underlying economic conditions. The uncertainties that contributed to bond market performance have been monetary policy, fiscal policy and, most recently, the rhetoric surrounding trade policy.

Monetary Policy & Inflation Expectations

The Federal Open Market Committee, the policy voting members of the Federal Reserve Board, met in January and March. At each meeting, the members voted unanimously to increase the overnight bank lending rate by 0.25%. This fed funds rate is expected to be targeted within a range with lower and upper bounds (now between 1.5% and 1.75%). This latest increase is the sixth since the Fed started tightening interest rates in December of 2015. All the increases have been widely anticipated by the capital markets. The expected trajectory of the fed funds rate is slow and steady increases of 0.25% reaching a peak of 3.5% by the end of 2020, and settling longer-term between 2.8% and 3.0%. We're about halfway through this tightening cycle based on the median forecasts of the Fed. Additionally, the assets that were purchased by the Fed after the 2008 crisis are being allowed to mature and are not being reinvested. This is another form of tighter monetary policy that reduces the supply of money within the banking system. It is unclear what the appropriate amount of excess reserves should be in the future. We know that prior to the emergency liquidity programs that were put in place to stabilize the banking system, the Fed's balance sheet had about $900 billion of liquid assets that grew to $4.5 trillion during the asset purchase programs. However, monetary policy tightening does not fully explain why we have seen a shift up in longer interest rates.

We've also seen a weakening of the U.S. dollar, which normally helps by making our goods and services relatively cheaper in the global market but also makes foreign investment in our financial assets less attractive. In early January, there was worry about decreased demand for our Treasury notes as the BOJ signaled its intent to buy less of our long-dated debt. This increased the sell-off of our currency versus other reserve currencies. Then we had inflation expectations taking a firmer hold in anticipation of improving domestic growth and expectations that central bank asset purchases around the world may have peaked. There was also the notion that deficit spending as suggested by the new tax policy, along with higher private capital investment, should lead to higher real interest rates. Inflation expectations have indeed increased since last year. Breakeven rates between inflation-protected Treasury notes and nominal Treasury notes have increased by about 20 basis points in 5- and 10-year maturities.

Protectionism & Inflation

The first signs of the Trump Administration making good on campaign promises regarding "fair trade" appeared in February. The potential for disrupting current global supply/demand dynamics sent shock waves through the capital markets. I want to emphasize the unintended consequences of protectionist policies.

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Our Game Plan

We are not surprised by the recent movements in the market (the market has been overdue for a correction and cyclical shift for a long time), and instead are poised to take advantage of the current environment. When appropriate, we're using the volatility to get into new names or add to our current positions at an undervalued price. Furthermore, we are aware of our tactical exposure to different kinds of risk and are positioned to hedge such risks where possible. That's why stock picking is so important in this kind of market environment. We're favoring value and income stocks slightly in situations where it's appropriate, especially when prices seem to materially exceed fundamentals (making growth more difficult to achieve). As we've mentioned in other communications, our expectations are for a mostly flat or slightly down market for the second half of the year. We continue to believe that complacency is the real enemy of the bull, not the bear, so we posture ourselves every day to attempt to stay on top of market currents.

End

Protectionism limits the supply of goods and services by either banning and limiting imports or imposing tariffs on them. In either case, it raises costs to consumers. One of the factors in keeping inflation low has been reducing the cost of goods and services through competition and technological advancements. For quite a while, there has been abundant supply of goods and services to satisfy demand. If there is no scarcity of goods and services for a given level of demand, prices cannot rise in an open market. If supply is suddenly cut, demand will need to adjust downward to keep prices stable. That is the dilemma facing U.S. consumers if protectionist policies significantly affect supply.

Consider the mid-70s when OPEC voluntarily reduced the supply of crude oil. The resulting shortage of refined gasoline and other petroleum products led to huge increases in the price of petroleum-based products and crude oil. That was the intent of OPEC. Since there were no substitutes, consumers had no choice but to pay higher prices or curtail demand. The unintended consequence of this action was economic stagflation (high unemployment with high inflation) that ultimately reduced demand for crude oil in the longer term. Subsequent OPEC policy ensured that it was in the cartel's best interest to keep the supply of oil fairly stable. This example should be noted by proponents of protectionist policies. There is a reason why the capital markets are concerned by the mere talk of potential disruptions to global trade.

The trade deficit in the U.S. is offset to a great extent by creating a capital account surplus, or positive foreign investment in the U.S. It is extremely important for the U.S. economy to encourage foreign investment, especially to offset our domestic budget deficits and our national debt that needs to be refinanced as Treasury obligations mature. So, while we cannot foresee what the risks are, we can safely say that the negative potential impacts are greater than any specific benefits to those industries that the policies are intended to protect. These policies could have dramatic unintended consequences, so we remain cautious and on alert for the potential risks.

End