The Ten Themes of 1Q 2018

Global stocks declined in value in the first quarter of 2018. It marked the first time the S&P 500 and Dow Jones Industrial Average posted a quarterly loss since the third quarter of 2015. There were two major reasons that caused investors to become more cautious. The first occurred in late January 2018 when the Atlanta Fed came out and said 1Q 2018 GDP growth would be 5.4%. You might think this would be great news because we have not observed this kind of economic growth in a long time. However, markets took that positive forecast from the Atlanta Fed and grew concerned the economy would soon run too hot and it would lead to inflation. In turn, this would cause the Federal Reserve to raise interest rates more than expected, which would end up hurting future economic growth. Since the stock market is a discounting mechanism and reflects what is going to happen, stocks sold off on the fears of rising inflation and interest rates. Interestingly though, inflation data in February and March showed inflation being well contained. So, stocks rallied then, right? No

As inflation worries subsided, the Trump administration followed through with its campaign promises and threatened to place tariffs on imported goods from China. This caused China to hit back with proposed additional tariffs on U.S. goods. All the while, investors became very nervous that an escalating global trade war would adversely impact world economies. Some even began to bring up the R word (i.e. recession.)

We want to stress though the two major factors that caused stocks to sell off were based on fear and not reality. At least, they are not reality yet. Emotions can drive financial markets in the short term. However, in the long-run, stock prices always trade in-line with their intrinsic value based on their ability to grow earnings and generate cash flows above their returns on invested capital.

The fact is during the first three months of the year, we learned 4Q 2017 earnings among the companies in the S&P 500 index grew at a rate of +16%. This represented the best growth we have measured in any quarter in over five years. Even better, as companies were reporting their results for the final three months of 2017, they guided Wall Street analysts higher for even greater profit growth in 2018. This was the first time in any quarter since 2011 that we measured more companies in the S&P 500 raising their future earnings expectations than lowering it. The Tax Cuts and Jobs Act of 2017, which was discounted into stock prices last year, was a major reason why earnings expectations went higher as corporate tax rates dropped from 35% to 21%.

With the heightened stress in the market, stay tuned as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.**

1. Global stock rally ended
2. Spike in volatility
3. Fed wants to hike rates more
4. Flattening yield curve
5. Commodity prices flat
6. Tax reform
7. Trade War
8. Rising earnings expectations
9. Paying less for more
10. Global stock market performance

Global stock rally ended

For the first time since the third quarter of 2015, the S&P 500 index posted a quarterly loss during the 1Q 2018 period. The index only declined -1.18%. Not a huge fall, but still a loss nonetheless. The Dow Jones Industrial index, which represents only 30 stocks, declined a little bit more at -2.43% for the quarter. Shares of smaller companies, as measured by the Russell 2000 index only declined -0.40% in value in the first three months of 2018. We continue to favor smaller companies over larger companies as they will benefit more from last year's corporate tax rate cuts from 35% to 21%.

On the international front, stocks in developed countries such as Japan and across Europe, as measured by the MSCI Developed International index declined -0.90%. If there was one bright spot in the quarter, stocks in emerging market countries rose +2.46% in the quarter, as measured by the MSCI Emerging Market index. The continued drop in the decline in the value of the U.S. dollar against a basket of other major currencies is a major reason why emerging market stocks are doing so well.

Check out the returns during the 1Q 2018 period along with how they fared over the past three years. You will see lagging U.S. stock returns compared to the MSCI Emerging Markets index, which collectively is made of countries such as Brazil, China, India and Turkey, and the MSCI Developed International index, which is mostly Europe and Japan.

Name	Index	*1Q 2018	2015	2016	2017
Emerging Markets	MSCI Emerging Market	2.46%	-18.07%	8.76%	34.59%
Small Caps	Russell 2000	-0.40%	-5.71%	19.48%	13.14%
Developed International	MSCI Developed International	-0.90%	-3.48%	-1.69%	21.79%
Domestic U.S.	S&P 500	-1.22%	-0.73%	9.54%	19.42%

*As of March 31, 2018

Source: Bloomberg

Spike in volatility

Last year was marked by very calm financial markets. That changed significantly in January. According to the WSJ Market Data Group, the absolute daily percentage change for the Dow Jones Industrial Average was 0.31% in 2017. It was 0.30% for the S&P 500. On both instances, this represented the smallest absolute daily percentage since 1964. For the Nasdaq Composite Index, the absolute daily percentage change was 0.44%, the smallest since 1989. The average observed one-month volatility in the S&P 500 was lower than any other year since 1970 in 2017. To sum up, it was a very quiet 2017.

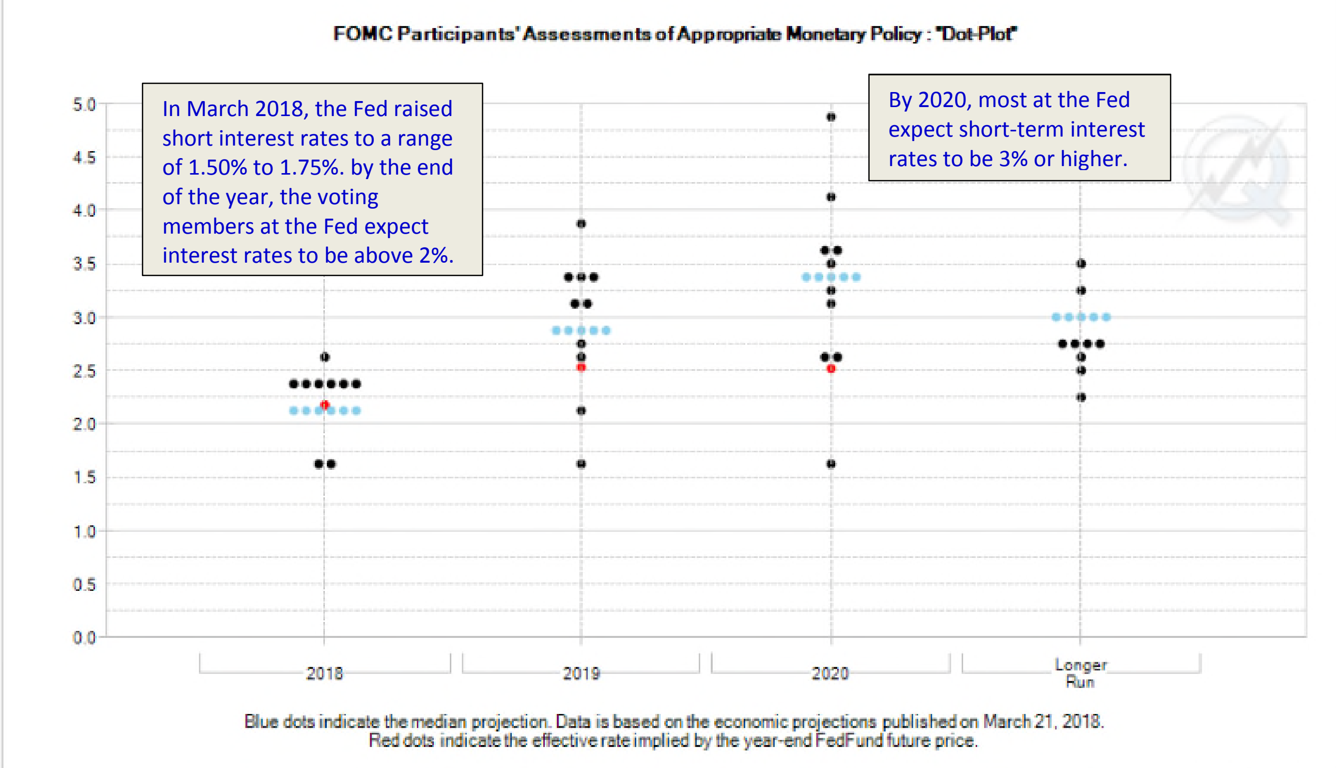
During the first three months of 2018, volatility exploded. Swings in the Dow Jones Industrial Average of 500 points in either direction started to become common. By our calculations, the S&P 500 index moved +/- 1% 40% of the trading days in the first quarter of 2018. The absolute daily percentage change for the index in 2018 jumped to 0.88% from 0.30% in 2017.

Another gauge many investors use to measure volatility is the Chicago Board Options Exchange (CBOE) Volatility Index, or VIX. During times of great economic uncertainty, the readings on the VIX will be at high levels, while calmer times will correspond with lower values. The average level of the VIX since it was created is 20. 47 of the 56 lowest readings in the history of the VIX occurred last year!

To put in perspective just how much more volatile markets have become on January 2, 2018, the CBOE VIX reading was 9, or almost half of what is normal for markets. By February 9, 2018, the VIX reading rose to 41, or almost 2X normal. By March 30, 2018 or the end of the 1Q 2018, the VIX was 20, right back to normal.

Fed wants to hike rates more

The Fed hiked interest rates in 2017. It wants to hike rates more in 2018. It did so by 0.25%, or 25 basis points, in March. It is expected to raise rates three more times in 2018. As of April 12, 2018, there is a 92% chance the Fed will hike short-term interest rates by +0.25% to a range of 1.75% to 2.00% at its June 13, 2018 meeting. By the end of this year, short-term interest rates should be above 2.00%. As the Fed raises rates, expect slightly more from your savings account, but also to pay more in interest on mortgages, auto loans, credit cards, etc. the key for stocks is how will higher rates impact corporate profits?



Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

Flattening Yield Curve

The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond.

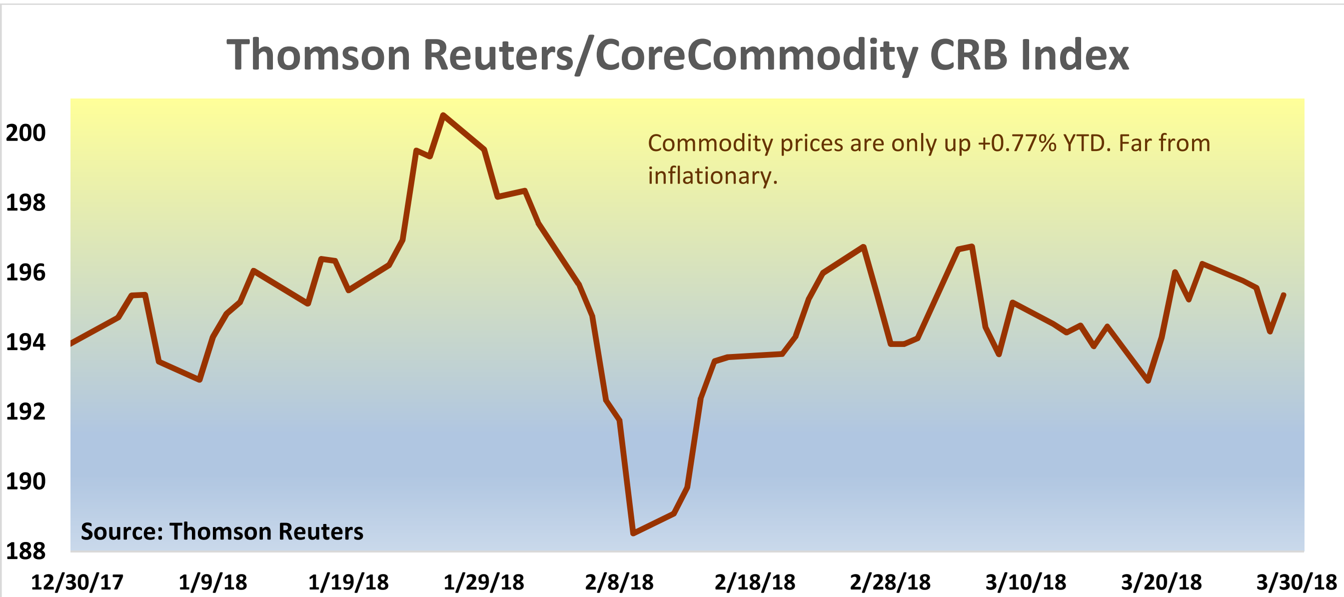
When the spread widens (i.e. steepening yield curve) between the rates on 2 and 10-year notes, it usually indicates an expanding economy. When the spreads narrows (i.e. flattening yield curve) it typically means less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

The rate on a 2-year note closed 2017 at 1.89% and the 10-year bond ended the year at 2.40%. Thus, the yield curve was 51 basis points. At the end of the first three months of 2018, the rate on a 2-year note rose to 2.27% the 10-year rate jumped to 2.74%. If you take a closer look at those numbers, you will see the rates on the short end of the curve (i.e. the 2-year note) rose more than on the long end (i.e. the 10-year note). As such, the yield curve narrowed another three basis points during 1Q 2018. Ideally, we would like to see this yield curve steepen so it would reflect better economic growth ahead. However, the bond market remains cautious.

Commodity prices flat

In addition to the U.S. bond market signaling caution, commodity markets have been equally cautious early in 2018. Specifically, commodity prices, as measured by the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities, from crude oil to orange juice, only rose +0.77% in the first three months of 2018. With some investors are worried about inflation rising, we are unlikely to see it any time soon given commodity prices are being held in check.

We also want to highlight that falling commodity prices are usually a sign of slowing economic activity. Therefore, as stocks struggled, bond and commodity markets indicated the same. However, our research on earnings trends paints a much different picture of an improving economy, which we will explain in more detail shortly.



Tax reform

Ever since President Trump was elected, the stock market anticipated his pro-business agenda of lower taxes, less regulation and increased infrastructure spending to boost corporate profits and lift the economy. This is one of, but certainly not, the only reasons stock prices hit all-time highs in his first year as President. In our opinion, this is the year that the baton is to be passed from the Fed, with its easy monetary policy to Trump's easy fiscal policy

Should markets be excited by tax reform? We say yes, but it is not without controversy. Naysayers will point out the potential the tax cuts have to balloon the U.S deficit. In the short-term though, major U.S. corporations will have hundreds of million, if not billions, more cash this year because of corporate tax rate moving from 35% to 21%. In particular, the average S&P 500 company will see about a $5 to $10 boost in earnings per share for fiscal 2018. Smaller cap companies will see even more of a boost given that they tend to have more domestically focused operations. This is one of the main reasons why we are slightly favoring small cap companies over large ones this year.

Trade Wars

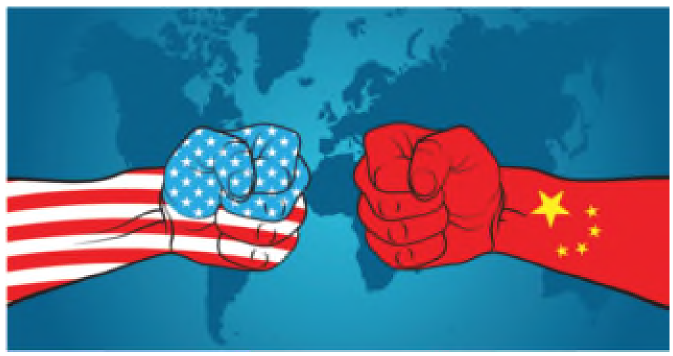
Just as inflation fears were subsiding as the 1Q 2018 period came to a close, the Trump administration proposed a 25% tariff on Chinese Steel and a 10% tariff on Aluminum. This caused more investor anxiety as the Chinese government came back with its own additional 25% tariffs on an equal amount of U.S. goods. Interestingly, the U.S. was just matching China with the 25% tariffs that it already imposes. So, China took it to 50% when Trump was just matching them at 25%. Trump has claimed for years of the unfair trade deal we have with China. In our opinion, it is hard to argue with him on this issue.

While the threats of an escalating trade war make great headlines, and Trump did up the ante at one point, the reality is the numbers on the total dollar value of goods to get hit with tariffs from both the U.S. and China are not going to have a material impact on either country's overall economy. In addition, the back and forth between the U.S. and China was akin to a spitting contest and nobody wins a spitting contest.

The truth is both countries need each other. Trump is just making trade a little fairer for U.S. companies. As such, trade war fears are likely overblown. We say that not because a trade war would not be bad. We say that because we know both sides understand it would be bad and concessions will eventually be made. Therefore, investors are best served not to overreact and hit the sell button.

Fear of a China / US trade war is a worry

A trade war is unlikely though because each side needs each other



Rising Earnings Expectations

While fears ran high during the first three months of the year, and it pressured stock prices, the main long-term driver of stock prices, changes in earnings expectations, kept rising. What's more, this was the first time in any quarter over the past seven years that we measured a majority of companies in the S&P 500 raising their earnings expectations after reporting quarterly results. We attribute most of those rising earnings expectations to the Tax Cuts and Jobs Act. In fact, in nearly 25 years of compiling earnings data, we have never measured this much growth this late in the cycle. The key question for markets is, "is this as good as it gets?"

How S&P 500 EPS growth estimates have changed in 2018: They are going higher!

Date	1Q18E vs. 1Q17A EPS Growth	2Q18E vs. 2Q17A EPS Growth	3Q18E vs. 3Q17A EPS Growth	4Q18E vs. 4Q17A EPS Growth
1/1/2018	9.12%	9.69%	14.69%	11.60%
2/1/2018	14.57%	15.77%	20.48%	13.19%
3/1/2018	16.31%	17.60%	22.62%	13.70%
3/30/2018	16.76%	18.13%	23.09%	14.41%

Source: The Earnings Scout

Paying less for more

As stock prices were rising last year, corporate earnings expectations were falling. This year, stock prices are falling as earnings expectations are rising. This has caused the market P/E ratio to drop. Remember, the P/E multiple is a valuation metric that represents just how much you pay for every dollar of expected earnings.

At the end of 2016 you had to pay 17.05x for every dollar of future earnings among S&P 500 companies. By the end of 2017, investors had to pay 18.09 x for every dollar of future earnings. This is why we stated last year stocks had become "expensive." Given this year's decline in stock prices, the P/E multiple has dropped to 16.45x. Therefore, there is more value to be found in stocks today than there was back in 2016 and 2017.

Date	*S&P 500 P/E ratio based on EPS Estimate over the next 12 months
12/31/2016	17.05x
12/31/2017	18.09x
3/31/2018	16.45x

As a rule of thumb, the higher the P/E ratio, the more expensive the overall stock market. The long-term historical P/E ratio for the S&P 500 (i.e. the market) is 15x.

Source: The Earnings Scout

Global Stock Market Performance Returns

Country	Stock Index	1Q18	FY2015	FY2016	FY2017
Brazil	Ibovespa	11.73%	-13.31%	38.93%	26.86%
Russia	MICEX	8.33%	26.12%	26.76%	-5.51%
Italy	MIB	2.55%	12.66%	-10.20%	13.61%
Taiwan	TSE	2.47%	-10.41%	10.98%	15.01%
Thailand	SET Index	1.29%	-14.00%	19.79%	13.66%
Hong Kong	Hang Seng	0.58%	-7.16%	0.39%	35.99%
Portugal	PSI	0.32%	10.71%	-11.93%	15.15%
U.S. Small Cap	Russell 2000	-0.40%	-5.71%	19.48%	13.14%
South Korea	KOSPI	-0.88%	2.39%	3.32%	21.76%
U.S. Large Cap	S&P 500	-1.22%	-0.73%	9.54%	19.42%
Turkey	BIST 30	-1.40%	-17.64%	9.23%	48.81%
Indonesia	JSE Composite	-2.62%	-12.13%	15.32%	19.99%
Greece	ASE	-2.73%	-23.58%	1.95%	24.66%
France	CAC	-2.73%	8.53%	4.86%	9.26%
India	SENSEX	-3.20%	-5.03%	1.95%	27.91%
China	Shanghai Composite	-4.18%	9.41%	-12.31%	6.56%
Spain	IBEX	-4.42%	-7.15%	-2.01%	7.40%
Australia	S&P/ASX 200	-5.10%	-2.13%	6.98%	7.12%
Canada	TSX Composite	-5.19%	-11.09%	17.51%	6.03%
Japan	Nikkei 225	-5.76%	9.07%	0.42%	19.10%
Ireland	ISE	-6.32%	30.00%	-4.04%	7.99%
Germany	DAX	-6.35%	9.56%	6.87%	12.51%
Mexico	Bolsa IPC	-6.54%	-0.39%	6.20%	8.13%
Philippines	PSEi	-6.76%	-3.85%	-1.60%	25.11%
U.K.	FTSE	-8.21%	-4.93%	14.43%	7.63%

Source: Bloomberg

Conclusion

Last year's global stock rally was built on hope and speculation that easy fiscal policy would lead to increased profits and higher stock prices. Mr. Market speculated and got it right. We do not guess or speculate. At a slight underweight to equities we participated in the rally but were not greedy.

Because of the reality of lower taxes, we are now more optimistic that CEO's will go out and spend those savings on property, plant and equipment. This should support further revenue growth for S&P 500 companies in 2018. The early 1Q 2018 reporting companies in the S&P 500 are showing strong results here in April that supports our view. Given that prices have now dropped to levels where we get to "buy more for less", we now have a more favorable view on U.S. stocks, especially since they lagged the returns of most international markets last year. With small cap U.S. based companies standing to benefit more from the tax cuts than large cap companies, and given the fact small caps underperformed last year, we are also favoring smaller U.S. companies over larger ones.

As always, we will be paying close attention to the U.S. Fed in 2018. It has taken steps to raise interest rates and reduce the size of its balance sheet. These moves are the opposite of the stimulus the central bank has provided markets for almost a decade. Will they derail the improving growth? Maybe, but our research indicates that it is not likely at this point.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Mark Klopfenstein, AIF® **Nick Raich, CFA®**