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Market Commentary
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Introduction

A healthy economic backdrop propelled stocks forward in the first month of the year, but after a long period of low volatility in 2017, the market took a sharp turn south in early February only to reverse course shortly after. Despite the wild ride in the first quarter of the year, the U.S. economy remains on solid footing. The labor market continues to strengthen with the unemployment rate at 4.1%, GDP growing at a modest pace annualized 2.9% for Q4, and inflation remains low with CPI up 2.2% over the past year. A few political headlines could bring uncertainty into the market as the year unfolds, namely talks of a trade war and the Fed raising the Fed Funds rate by 25 basis points to a range of 1.5 - 1.75. With an overall constructive view on today's economy, we continue to take risk in the equity market but acknowledge the importance of fixed income and alternative investments during a time when spikes in volatility will persist.

Domestic Equities

U.S. stocks endured a dramatic ride throughout the quarter ending with the S&P 500 returning -0.76%. The sell-off in February was due to a runaway stock market which crashed right into spiking interest rates signaling threats of inflation and this resulted in the worst month for the S&P 500 (-3.69%) in the last 2 years. Although February ended negative, it does not tell the whole story for the month. Stocks did pare some of their losses from the initial sell off with investors buying back in on expanding profits and strong economics. Earnings growth and sales growth for companies within the S&P 500 for Q4 2017 were 14.3% and 7.7% respectively. The most recent tax cuts should continue to support earnings in the years ahead. As long as the economy does not overheat and geopolitics do not rattle the market resulting in a significant correction, U.S. stocks should continue to push forward. Given this view, we remain overweight equities but recognize we are moving later into the business cycle and are prepared for more volatility.

International Equities

Despite global growth continuing to strengthen, international equities saw volatility alongside U.S. stocks, as the MSCI EAFE returned -1.53%. The Eurozone is experiencing an economic expansion with GDP growth year over year up 2.7% as of Q4 2017 along with a steady earnings outlook. Japan's economy grew at an annualized 1.6% rate in Q4 2017 mainly due to their easy monetary policy. From a valuation perspective, international equities look more attractive than U.S. stocks today as they are selling at lower price to earnings multiples. Additionally, aside from these solid fundamentals, a softer dollar could be additive to U.S. investors holding foreign investments. At more attractive valuations, international stocks should have more room to run than U.S. equities which is why we recently increased our allocation to this asset class (increased International Small Cap). If growth remains steady, profits continue to expand, currencies remain stable and geopolitics do not disrupt the region's growth, we would expect international stocks to be lifted as the rest of the globe continues to expand.

Emerging market (EM) equities outperformed developed market equities in Q1 2018 as the MSCI EM index returned 1.42%. EM equities continued to benefit from expanding profit margins and most importantly, a widening in growth versus developed markets globally. As some emerging economies rely heavily on raw materials and exports to support their growth, less trade activity could be a risk to these regions. Despite talks of tariffs from President Trump throughout the quarter, investors have yet to be scared completely out of Emerging Markets due to solid economics, a growing middle class and strong domestic consumption from some of these regions. Although Emerging Markets have their risks, which we will continue to monitor, the potential for upside remains greater than the U.S.

Fixed Income

For the first time since the fourth quarter of 2016, fixed income markets had negative performance during the first quarter of 2018. Rising inflationary pressures and the prospect of a more hawkish Federal Reserve drove rates higher, as the 10-year U.S. Treasury yield increased 0.33% from 2.40% to start the quarter, finishing at 2.73%. Though rates moved higher on the quarter, volatility in equity markets kept rates contained as demand for fixed income increased, pushing prices higher. Fixed income yields decline as prices increase. As expected, new Federal Reserve Chair Jerome Powell announced the first rate hike of 2018 during the March Federal Open Market Committee (FOMC) meeting. We believe the projected path for interest rates has shifted upward, but will stay range bound. If there is a meaningful pickup in inflation there could be two to three more rate hikes this year, representing further headwinds in fixed income. During a volatile quarter for equities, high credit quality bonds outperformed low credit quality bonds as investors searched for safety in fixed income. Despite the lower return potential in domestic fixed income, diverging global monetary policy and a softening dollar creates opportunities in other areas of fixed income such as international debt, as the Bloomberg Barclays Global Aggregate Bond index finished the quarter up 1.36%. Though there are headwinds for fixed income securities in a rising interest rate environment, being diversified within a fixed income allocation will continue to benefit portfolios.

Alternatives

Alternative asset classes lagged during a volatile environment for global equities this quarter. Oil prices rose higher as key OPEC members suggested that production cuts may continue beyond the end of 2018, allowing WTI crude to end the quarter at $64.94 per barrel, rising from $60.42 per barrel at the end of 2017. Commodities (as measured by the Bloomberg Commodity Index) were down -0.40% on the quarter as talks of free trade disruption have put pressure on the space. While rising energy prices can lead to inflation and reduce economic growth as the costs of producing goods increases, stable oil prices are a panacea as consumers are able to set expectations and corporations are able to remain profitable. Though tariffs have put upward pressure on commodity prices, we believe oil should remain range bound for the remainder of the year as more producers come on line to increase supply and regulate price levels.

Real Estate

Real estate has continued to be a positive contributor to the economy, and should continue to grow as Millennials buy homes. Buyers age 36 and below have become the largest share of home buyers, according to the National Association of Realtors. Recent data has been less positive, with housing starts declining -7% in February, down -4% from a year ago. The NAHB index, a leading indicator for the housing market, came in at 70 in March, representing developer’s optimism for continued growth. Though the data has been positive in nature, tight supply, rising home prices, and the rising cost of borrowing remain headwinds for housing in 2018.

Conclusion

2018 is off to a choppy start, but considering that this bull market is now 9 years old, some volatility is no surprise. The question on everyone’s mind is if this “grand experiment” of tax cuts to promote growth will support stocks higher and outweigh the threat of rising rates and a comeback in inflation. We believe current economic data provides hope for stocks to move higher but we acknowledge that risks remain. As a result, we continue to manage our portfolios with optimism, cognizant that absolute returns may be more muted going forward and keeping portfolios diversified across asset classes may be more important than ever.