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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Reversion to the Mean

The stock market began 2018 on a strong note. Between January 1st and its peak on January 26th, the S&P 500 rose 7.4%. Since the long term annual return for stocks has averaged 8.9% over the past 90 years, the stock market achieved almost a year's worth of return in a very short time period. It was not to be. Over the next 2 months several investor concerns came to the fore: a strong January employment report led to an uptick in interest rates, the Trump administration announced tariffs on steel and aluminum imports, and there were several high-profile departures from the administration. In response to these developments, stocks corrected over 10% from their January high to their low in early February. Although stocks rallied in late March, the S&P 500 finished the quarter slightly negative with a total return, including dividends, of -0.8%. Value stocks trailed growth stocks in the quarter. The S&P Value Index returned -3.6% while the S&P Growth Index gained 1.9%. Stock markets outside the U.S. also declined during the quarter, as the MSCI All Country World Ex U.S. Index had a return of -1.3%.

Following a strong performance in 2017, a correction in stock prices is not all together surprising. Indeed, coming into year-end 2017, conditions were ripe for a change. The popular stock market averages were near all-time highs and investor sentiment, a contrarian indicator, had reached bullish levels. Amidst the strong economic picture, robust employment and surging consumer confidence, a sense of complacency had set in.

It is a rare year when the annual return for stocks matches the long-term average of 8.9%. More often the market overshoots on the upside or the downside, with the long-term average reverting to the mean return of 8.9%. The stock market behavior in early 2018 is emblematic of this process.

Stock market corrections are part and parcel of investing. However, corrections are unnerving for even the most seasoned investors. This is especially true given the extended period of low stock market volatility from 2016 through 2017. During 2017 the S&P 500 experienced a total of 8 days when the market had a daily move of +/- 1%. In contrast, during the first quarter of 2018 the S&P 500 experienced 23 daily moves of +/-1%. What is behind the increased volatility? We have touched upon several of the factors above and we have also discussed them in recent quarterly letters. Prominent considerations include:

- A reversal of the extraordinary central bank policies of 2008-2017, including ultra-low or negative interest rates as well as open market purchases of government and corporate bonds. Policies that were unprecedented in recent financial history.
- Above average valuations for stocks and narrow stock market leadership. Bianco Research estimates that the ten largest stocks in the S&P 500 contributed 45% of the year-to-date performance of the index in the first quarter.
- Elevated geopolitical risks covering a wide range of topics from Russian election meddling and global populism to protectionist trade policies and increased military tensions in Asia, the Middle East and Europe.
- Growing U.S. federal budget deficits, which, combined with an expanding global economy and less accommodative central bank policies, have the potential to place upward pressure on interest rates.

Finding True North

During the first quarter many of the factors above combined to produce a modest decline in stock prices *and* a decline in bond prices. The Bloomberg/Barclays U.S. Aggregate Bond Index had a return of -1.5%.

In early April, the administration proposed additional tariffs and concern grew about a potential trade war with China, the world's second largest economy. Other factors that weighed on the stock market included controversies surrounding potential privacy violations by major social media companies (Facebook and Google) and increased tensions with Russia over espionage and the conflict in Syria. The weakness in stock prices occurred against an otherwise constructive backdrop: the global economy enjoys synchronized growth, the U.S. economy is at full employment and inflation remains at low levels.

How should investors respond to the recent market weakness? Are trade frictions and other geopolitical risks reflected in stock valuations? What is the outlook for stocks, bonds and other assets for the remainder of 2018? These questions are top of mind. Amidst the intense media coverage of daily events, it is easy for investors to become disoriented, not unlike losing one's bearing during a hike in the woods. In both instances, gaining perspective and the correct orientation is critical to choosing the right direction. Finding true north is as helpful on the hiking trail as it is in managing investment portfolios. With that thought in mind, we are guided by the following:

- Global economic growth continues to demonstrate strength in virtually all regions. The latest World Bank estimate for 2018 global GDP growth is 3.1%. Barometers of industrial activity and consumer confidence are generally healthy across continents. Inflation remains subdued.
- Interest rates, while still low by historical standards, face upward pressure from direct and indirect central bank tightening, growing U.S. budget deficits and robust industrial activity.
- Geopolitical risks, including trade frictions, remain elevated in many regions of the globe. Russia continues to demonstrate more assertive behavior in the Middle East, Europe and beyond. In the U.S., upcoming mid-term elections will have the potential to alter the balance of power in Washington.
- Equity valuations remain above average and, as mentioned above, stock market leadership continues to be narrow. However, based on forward projected S&P 500 earnings, valuations look

more reasonable. We are finding an increasing number of high-quality stocks across sectors that are trading at attractive valuations in relation to their earnings growth and dividend yields.

- The period of subdued market volatility that prevailed in 2016-2017 is not likely to be repeated in the coming year. The combination of ebbing central bank liquidity, geopolitical tensions (including trade frictions), and an increased role for computer-driven trading strategies all suggest increased stock market volatility in the months and years ahead.

The Path Forward

As we have written in prior letters, we have taken steps to prepare for the challenges outlined above. Equity weightings have been modestly reduced in our balanced and all-equity portfolios. We have added to holdings in short term U.S. Treasury securities with maturities of 1-2 years and yields greater than 2%. These securities are highly liquid, provide protection from rising interest rates and earn a competitive return. For new equity purchases, we are emphasizing companies with improving balance sheet liquidity and sustainable free cash flow generation. We continue to seek opportunities in foreign markets where relative valuations are attractive.

As always, we welcome your comments and questions.