Market Commentary

Q1 2018 in Perspective

Loring Ward's Asset Class Investing portfolios are strategically invested with a focus on long-term performance objectives. Portfolio allocations and investments are not adjusted in response to market news or economic events; however, we evaluate and report on market and economic conditions to provide our investors with perspective and to put portfolio performance in proper context.

Volatility came back with a vengeance this quarter. After a relatively tranquil January, stock markets around the globe saw a significant selloff right as the calendar flipped to February. Most indexes fell by about 10% in the first few weeks of February, the standard for a market correction. This correction was most notable because of its rapid speed, and also because of just how calm markets had been over the preceding years. For the quarter, Emerging Market stocks led the way, with MSCI Emerging Markets gaining 1.4%, while the S&P 500 fell 0.8%, and non-U.S. developed markets, as measured by MSCI World Ex US, weakened by 2.0%.

This quarter was interesting, as you saw corporate profits rising (due in some part to the tax law changes coming into effect) at the same time prices were falling. This has slightly improved the often-mentioned Shiller Cyclically Adjusted Price Earnings (CAPE) Ratio and other forward-looking P/E ratios. Additionally, most economic variables continued to head in the right direction, so it appeared to be a correction driven more on sentiment changes than actual economic evidence. The CBOE Volatility Index (VIX) — often referred to as the 'fear index' — measures expected volatility and had spent much of the last year at low levels around 10. But it exploded in early Feb to top 37 before spending much of the remaining quarter around 20. Historically, since 1990, the VIX has averaged 19.4, meaning the current expected volatility in the market is about equal to what we've seen over the last nearly 40 years.

New Fed Chairman Jerome Powell took over for outgoing Chairman Janet Yellen on February 5. As expected, the Fed raised rates by 25 basis points on March 21, Chairman Powell's first meeting. The new benchmark target rate is 1.50 – 1.75%, the sixth rate-hike since Dec. 2015. The Fed's estimate was for three rate hikes in 2018. For the quarter, the 2-Year Treasury rose 38 basis points to 2.27%, while the 10-Year Treasury advanced a similar 34 basis points to end at 2.74%.

The U.S. Dollar Index, a measure of the value of the United States dollar relative to a basket of foreign currencies, fell again in the first quarter — with the U.S. dollar depreciating by 1.4% compared to foreign currencies. For the trailing 12 months, the U.S. dollar weakened by 8.2%.

U.S. Economic Review

Domestic economic data continued to plug along at a healthy pace. Fourth quarter GDP increased at a 2.9% annual rate. For 2017, GDP increased by 2.3% driven by nonresidential fixed investments and exports. The unemployment rate in February came in at 4.1%, holding steady over the last five months. Despite the unemployment rate at or below 5% for the last two years, wage growth has been relatively tepid, ticking down to just 2.9% over the last year to November. The Fed's preferred gauge of overall inflation, the core Personal Consumption Expenditures (PCE) index, remained flat at 1.8% in February from the prior year.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg Economic Calendar, U.S. Department of the Treasury, Institute for Supply Management, Morningstar Direct 2018.

Financial Markets Review

U.S. stock indexes fell marginally across the board during a volatile quarter, with larger losses in Real Estate Investment Trusts. Emerging Markets were the only area of stock shown below to record positive gains, while International Developed eroded slightly. Bond yields advanced across the maturity curve, with longer exposures like the Barclays U.S. Aggregate Bond Index seeing losses of 1.46% for the quarter.

U.S. STOCKS				INTERNATIONAL STOCKS			BONDS	
U.S Large Cap Stocks	U.S. Value Stocks	U.S. Small Cap Stocks	U.S. REIT Stocks	EM Value Stocks	Int'l Small Cap Stocks	Int'l Value Stocks	Global 1-5 Year Bonds	U.S. Gov/ Credit 1-3 Year Bonds
-0.8%	-2.8%	-0.1%	-7.4%	+1.6%	-0.5%	-2.5%	+0.2%	-0.2%

Source: Morningstar 2018. Market segment (Index representation) as follows: U.S. Large Company Stocks (S&P 500 Index); U.S. Small Company Stocks (Russell 2000 Index), U.S. Value Stocks (Russell 1000 Value Index). U.S. Real Estate Market (Dow Jones U.S. Select REIT Index), International Value (MSCI World Ex USA Value Index (net div.)), International Small (MSCI World Ex USA Small Index (net div.)), Emerging Markets Value (MSCI Emerging Markets Value Index (net div)), Global Bonds (Citi WGBI 1-5 Yr Hdg U.S.D), U.S. Bonds (BofA ML Corp&Govt 1-3 Yr TR).

In the U.S., Small Growth stocks led the way in performance during Q1. Large Value stocks trailed their Large Growth counterparts by over 3%. Small stocks outperformed across the board, with the Small Core segment underperforming Large Core by 0.6%.

U.S. Stocks — Quarter 1, 2018

	Value	Core	Growth
Large	-2.8%	-0.7%	1.4%
Mid	-2.5%	-0.5%	2.2%
Small	-2.6%	-0.1%	2.3%

Source: Morningstar Direct 2018. US markets represented by respective Russell indexes for each category (Large: Russell 1000, Value, and Growth, Mid: Russell Mid Cap, Value and Growth, Small: Russell 2000, Value and Growth).

Internationally, returns were negative across the board, with the one exception of Small Growth gaining 0.8% for the quarter. Small Companies outperformed across the Value to Growth spectrum, while Value trailed its Growth counterparts across the Size spectrums.

International Stocks — Quarter 1, 2018

	Value	Core	Growth
Large	-2.5%	-2.1%	-1.6%
Mid	-2.4%	-1.7%	-1.3%
Small	-1.8%	-0.5%	0.8%

Source: Morningstar Direct 2018. International markets represented by respective MSCI World EX USA index series (Large: MSCI World EX USA Large, Value and Growth, Mid: MSCI World Ex USA Mid, Value and Growth, Small: MSCI World Ex USA Small, Value and Growth). .

More aggressive models saw weaker performance than more conservative models because of the lower returns in stocks compared to bonds. A diversified index mix of 65% stocks and 35% bonds would have lost 1.1% during the first quarter.

65/35 Index Mix: 2% Cash, 16% ST US Fixed Income, 17% Global Bonds, 15% US Large, 12% US Value, 8% US Small, 4% US REITs, 14% Intl Large Value, 7% Intl Small, 5% Emerging Markets Value

Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

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