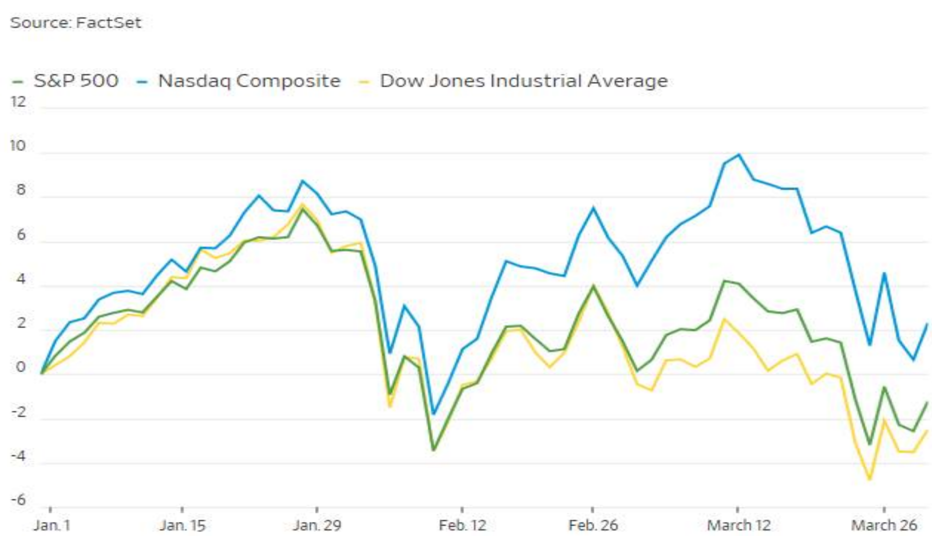
2018 First Quarter Review & Outlook

> *Volatility has ramped up, inflationary pressures are more prevalent, interest rates are on the cusp of change, so that presents a higher level of uncertainty and higher investor angst.*
> —Terry Sandven, Chief Equity Strategist at U.S. Bank Wealth Management

***Equities***

After one of the strongest-performing Januarys in over two decades, equities began sliding in February with the Dow Jones Industrial Average suffering its first 10% correction since early 2016. The sudden fall was driven by several factors; including Federal Reserve rate hike fears—sparked by evidence of inflationary wage pressures and a more hawkish change in leadership at the Fed—and escalating trade war tensions ignited by the Trump administration. Also playing roles in the market's fall were the unwinding of the short volatility trade (traders caught incorrectly betting on low stock market turbulence), and late-quarter technology stock weakness caused by negative breaking news (such as concerns over the privacy breaches of Facebook). The Dow ended the quarter down 2.5%, while the broad S&P 500 Index was off by 1.2%. Only the Nasdaq Composite finished in the green. The CBOE Volatility Index (or VIX) surged about 80% during the first quarter, after this measure of equity-market turbulence fell for three years nearing an all-time low in January.




***Fixed Income***

The yield on the benchmark 10-year U.S. Treasury note posted its third consecutive quarterly gain, boosted by expectations for surging inflation in the wake of a $1.5 trillion tax cut passed at the end of last year. The 10-year Treasury yield rose 50 basis points to 2.90%, hitting its highest point since the "taper tantrum" in late 2013. Rising yields mean lower bond prices. Inflation undermines the value of bonds by eroding the purchasing power of its fixed interest payments and principal.

As with the stock market, January saw a large jump (in bond yields) in response to tax reform. Then was followed by two months of range-bound yield movement as the initial strong January wage data number was revised lower in the following month's labor report. Subsequent weaker-than-forecasted inflation data suggested that the tax cuts were unlikely to spur growth as analysts once expected. This revelation steadied bond prices. Bonds also attracted buyers as falling stock prices spooked some equity investors, leading to more purchases of "safe" high-quality government and corporate bonds.

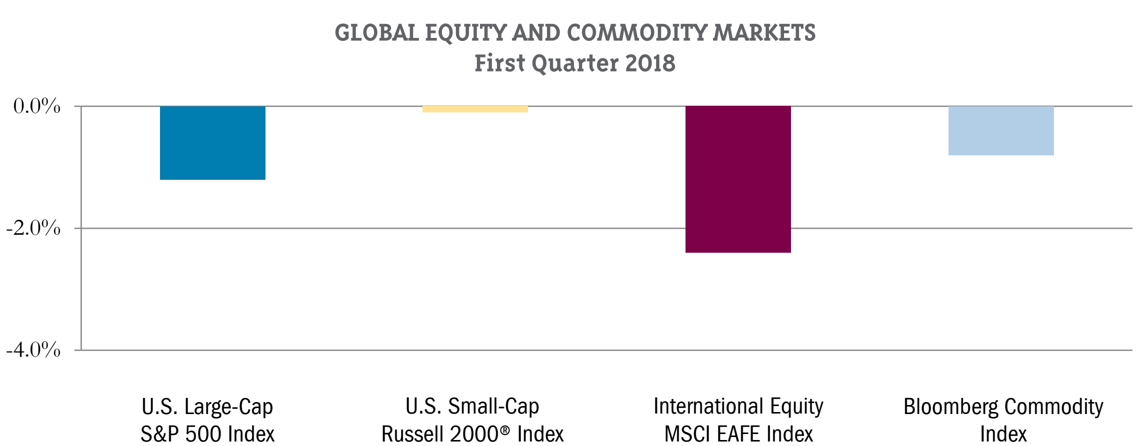

Yield on the 10-Year Treasury Note.

*Global Market Performance*

As mentioned, the broad-market S&P 500 Index fell 1.2% for its first quarterly loss since 2015, while the Dow Jones Industrial Average of the largest stocks slipped 2.5% over the same period. The tech-heavy Nasdaq Composite rose 2.3% despite a sharp quarter-end decline. Winners in the quarter included growth, small-company, technology, consumer discretionary and emerging market stocks.

It's not just the United States that was suddenly dealing with increased economic and geopolitical concerns. Stock markets around the world have reacted negatively to the possibility of a wide-reaching trade war. Global companies making up the MSCI World Index earn more than half of their sales from international trade. As such, developed international stocks slumped 2.4% in the past three months as measured by the MSCI EAFE Index in U.S. dollars. However, when measured in euros, European markets actually outperformed U.S. stocks as the euro currency gained in value versus the dollar. The MSCI Emerging Markets Index was one of the few global indices to advance for the first quarter, up by 1.4%. Solid growth and low inflation out of the Asia Pacific region continued to drive emerging markets forward. However, recent tariff actions (specifically involving China and the U.S.) and talks of further retaliation have paused the region's equity market advance.

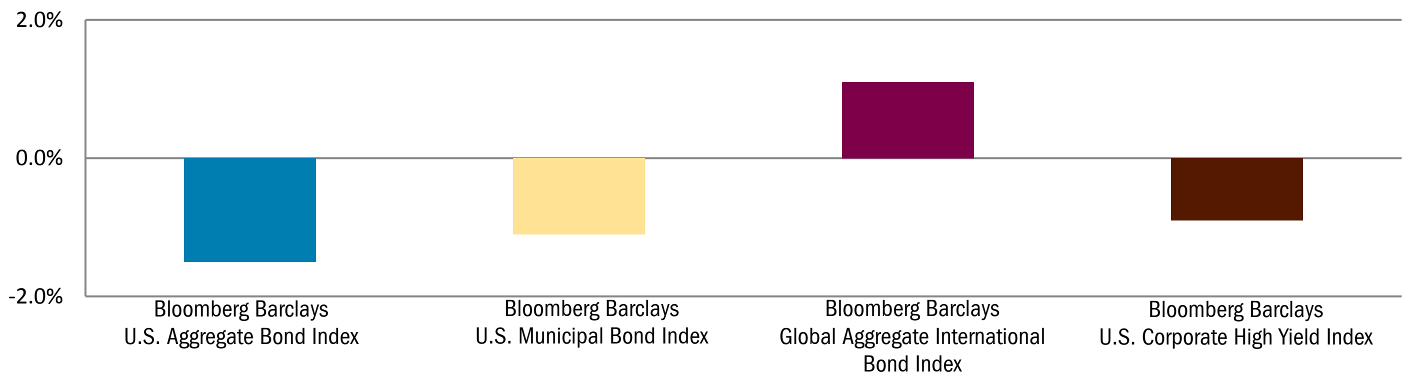
Natural resources and other commodities were essentially flat for the quarter (-0.8%) as measured by the Bloomberg Commodity Index. A declining dollar helped the commodity index price. Gold gained in value, aided by investors searching for a traditional safe haven during the quarter's equity turbulence. Crude oil and natural gas declined in price. Grains varied widely from double-digit gains to equal losses. (The Bloomberg Commodity Index measures the collective returns of a basket of 23 commodity futures contracts representing the energy, precious and industrial metals, grains and livestock industries.)



The yield on the benchmark 10-year U.S. Treasury note posted its third consecutive quarterly gain (along with bond price losses). The increase of 0.33 percentage points was the largest for a quarter since the three months ending December 2016. The 10-year yield reached a four-year peak at 2.94% on Feb. 21, and has since fallen to 2.74%. After the Federal Reserve raised borrowing rates at its March meeting, investors head into the second quarter looking for signs of whether officials are edging closer to signaling a fourth interest-rate increase this year. Or perhaps fewer hikes if the economy shows signs of weakening leading indicators.

For the first quarter the Bloomberg Barclays U.S. Aggregate Bond Index of high-quality government, mortgage and corporate bonds dropped 1.5%. Non-investment grade or high-yield bonds fell 0.9% as investors were concerned about low credit quality during a declining stock market. State government municipal bonds lost 1.1% for the past three months as measured by the Bloomberg Barclays Capital Municipal Bond Index; the largest drop of any first quarter for the past 15 years. Muni bond values usually jump in the first few months of the year as investors look to reinvest cash from stock gains and maturing bonds. New tax rules and concerns about rising interest rates pushed down demand for newly issued municipal debt. The Bloomberg Barclays Capital Global Bond Index was up 1.1% for the quarter, due mainly to favorable local currency values versus the U.S. dollar.

**FIXED INCOME MARKETS**
**First Quarter 2018**



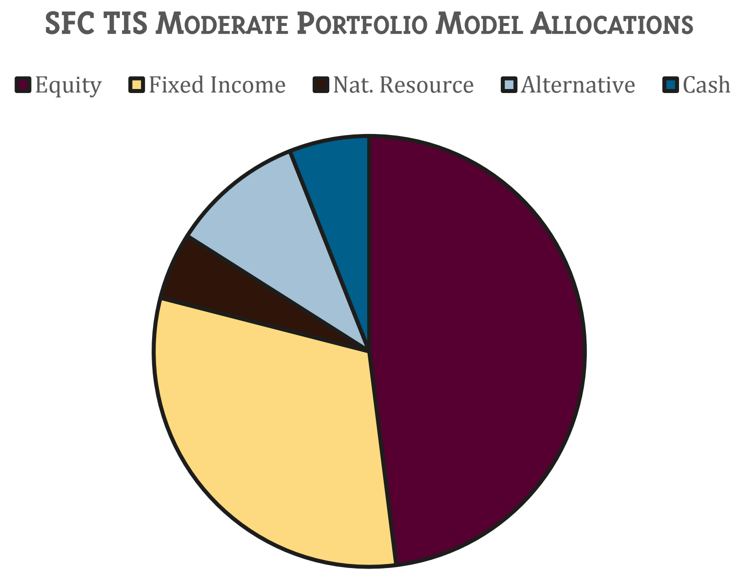

## Portfolio Review

*A measure of volatility in U.S. stocks had one of its biggest quarterly rises ever, reflecting growing investor concerns ...*
—Gunjan Banerji, The Wall Street Journal

SFC Tactical Investment Strategies (TIS) model portfolios overall recorded slight losses—along with the stock and bonds markets—but nevertheless outperformed the respective indices and peer benchmarks. While we are never pleased with losses, we are satisfied that our strategy succeeded in minimizing losses during a turbulent market. Being underweight stocks and core bonds versus neutral portfolio targets going into the year helped mitigate damages. Also, our stock and bond holdings overall outperformed the respective indices. And while mildly disappointed of our alternative investments' performance at quarter end, these holdings (such as precious metals and hedged equity) served client accounts well as portfolio "stabilizers" when market volatility and losses finally returned after nine straight quarters of equity-market advances.

Were we surprised about the market correction? A resounding no! As written in our February *Market & Portfolio Update* ... "The recent sudden and significant drop in global stock markets has many investors on edge. With memories fresh of continuous equity highs, retail "mom & pop" investors as well as professional money managers seemed to be caught off guard by this stock market correction of about 10%. Not us. As written in our *Year-End 2017 Investment Insights*; '… while we are "running with the bulls" for now, we are still somewhat cautious (with lower stock positions than normal) compared to other upbeat money managers … This is in light of high stock valuations and the potential for lower returns going forward, along with rising interest rates and possible declining bond prices.' "

What trade action was taken during the quarter's turmoil? As also mentioned in our February *Market & Portfolio Update*, we made minor simultaneous trades to increase stock positions at lower prices in best-valued-and-growing emerging markets, and bought additional fixed income holdings that will potentially prevent bond losses as interest rates rise. Some excess cash and a small portion of "core" or traditional bond holdings were sold for these purchases. So while perhaps not immediately profitable, over the coming quarters we expect these trades to be beneficial to account holders.





"I'M NOT REALLY A GURU. I JUST COME UP HERE TO MEDITATE WHEN THERE'S A STOCK MARKET CORRECTION."

■ Market Outlook

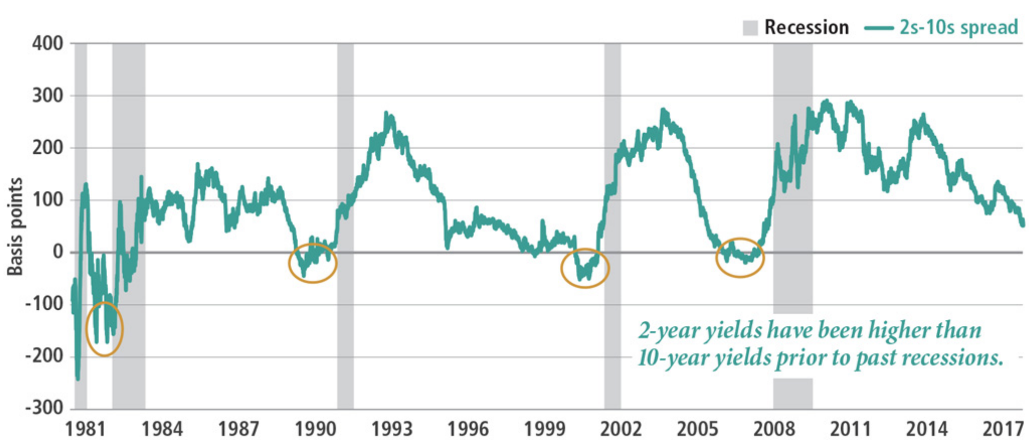
*It is critical for investors to have a well-informed view on the timing of the business cycle because of its importance as a driver of investment performance.*
— Guggenheim Investments; Macroeconomic and Investment Research Team

As we enter into the second quarter of 2018, January's stock market euphoria has given way to fears of a trade war sparked by the Trump administration, an aggressive Federal Reserve raising borrowing rates too quickly (halting a growing economy) and the return of market instability that has led to a stock market correction. The challenge of late business-cycle investing is that equity valuations—such as price/earnings ratios—are stretched. Also, there are worries about the economy overheating (higher inflation). And, importantly, concerns that the Fed is taking away the easy-money punchbowl that has juiced the economic and market recovery post-Great Recession.

Still, on a positive note, economic and corporate earnings growth are forecasted to be solid for the year, and surveys of U.S. consumers and investors suggest plenty of optimism even after the recent equity-market tumble. In the *long run* stock market prices are driven by corporate profits, *not* short-term investor behavior or geopolitical headlines—whether positive or negative. So, the upcoming quarterly corporate earnings season may give us a good idea how the rest of 2018 will play out. For now analysts are projecting a year of strong double-digit profit increases for S&P 500 companies, which could bode well for stock prices once market volatility subsides.

Switching to the bond market, the benchmark 10-year U.S. Treasury note has stabilized over the past weeks after hitting a 4-year high intra quarter. As such, government and high-quality corporate bond prices have steadied. Fears of runaway inflation forcing the Federal Reserve to speed up rate hikes have been temporarily halted as new softer inflation data and tariff war headlines have diminished this concern. Nevertheless, with the 10-year U.S. Treasury note recently moving lower, the yield curve—specifically the spread between 2-year and 10-year Treasury yields—has flattened further (its narrowest since 2007). Why is this important? When the 2-year yield rises above longer-term Treasury yields, the yield curve becomes "inverted." An inverted yield curve is the bond market's way of saying the financial system is broken, and can usually predict that a recession is looming. So while our view is that an inverted yield curve and impending recession are not imminent, it's an important indicator that we'll be monitoring.

Inverted yield curves have preceded most past recessions




Source: PIMCO, Bloomberg. The National Bureau of Economic Research. Data as of 31 December 2017.

So even after minor modifications to SFC TIS portfolios during the first quarter as a result of market movements, stock and bond client account positions still remain underweight to higher "neutral" model portfolio stock/bond percentages for reasons previously mentioned. And, there are "alternative" investment holdings to steady portfolio turbulence. This strategy has proven effective in an uncertain and volatile market environment, such as the current climate we are experiencing.

We appreciate your continued confidence. Your inquiries are welcomed.

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**Sources**: Bloomberg Commodity Index, *Tables & Charts – March 2018 Edition*; Charles Schwab, *Schwab Market Perspective: Navigating the Changing Market Environment* , March 30, 2018; Guggenheim Investments, *Macroeconomic and Investment Research*, January 2018; The Houston Chronicle, *Stocks End a Rocky Quarter With a Bang*, March 30, 2018; JP Morgan Asset Management, *Guide to the Markets*, March 2018; Marketfield Asset Management, *The Weekly Speculator*, April 5, 2018; Russell Investments, *2018 Global Market Outlook – Q2 Update*, April 2018; State Street Global Advisors, *SPDR ETFs Chart Pack*, April 2018 Edition; The Wall Street Journal (multiple publications).

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