

Market Commentary

Market & Economic Review | Second Quarter 2018

Q1 2018 Review

It didn't take long for the least volatile market in recent history to give way to a volatility spike and a return to a more normal environment. January was a continuation of last year's march higher, as U.S. equities continued to reach new highs building off the positive momentum coming into the year with a tax cut in place and expectations of strong corporate earnings. The U.S. Employment report that came out on February 2nd was the start of a sharp selloff that was followed by a volatile rest of the quarter. After the employment report came in better than expected and with 3% wage growth, the 10 year U.S. Treasury Bond increased in yield from 2.7% to 2.84%. At the same time the markets began to price in the return of \$1Tn deficits to pay for the tax cuts. With markets significantly up from the 2009 low and the possibility that the Fed may have to aggressively raise rates to keep inflation in check, investors began to have doubts about valuations being sustainable. A moderate drop turned into a significant selloff on February 5th. The VIX (measure of stock volatility) increased about 30% on February 2nd and then doubled on Monday the 5th. The outcome of this was the unwinding of trades that were betting that volatility would remain low. What began as a selloff based on fundamentals (higher rates) turned into a sharper and deeper selloff due to technical issues (short volatility trades unwinding). After recovering a significant portion of the selloff by mid-March, markets turned down again. This time, the talk of tariffs with China and other trading partners put some uncertainty around stocks whose revenue is tied heavily to international trade.

Asset Class Returns, 1Q 2018



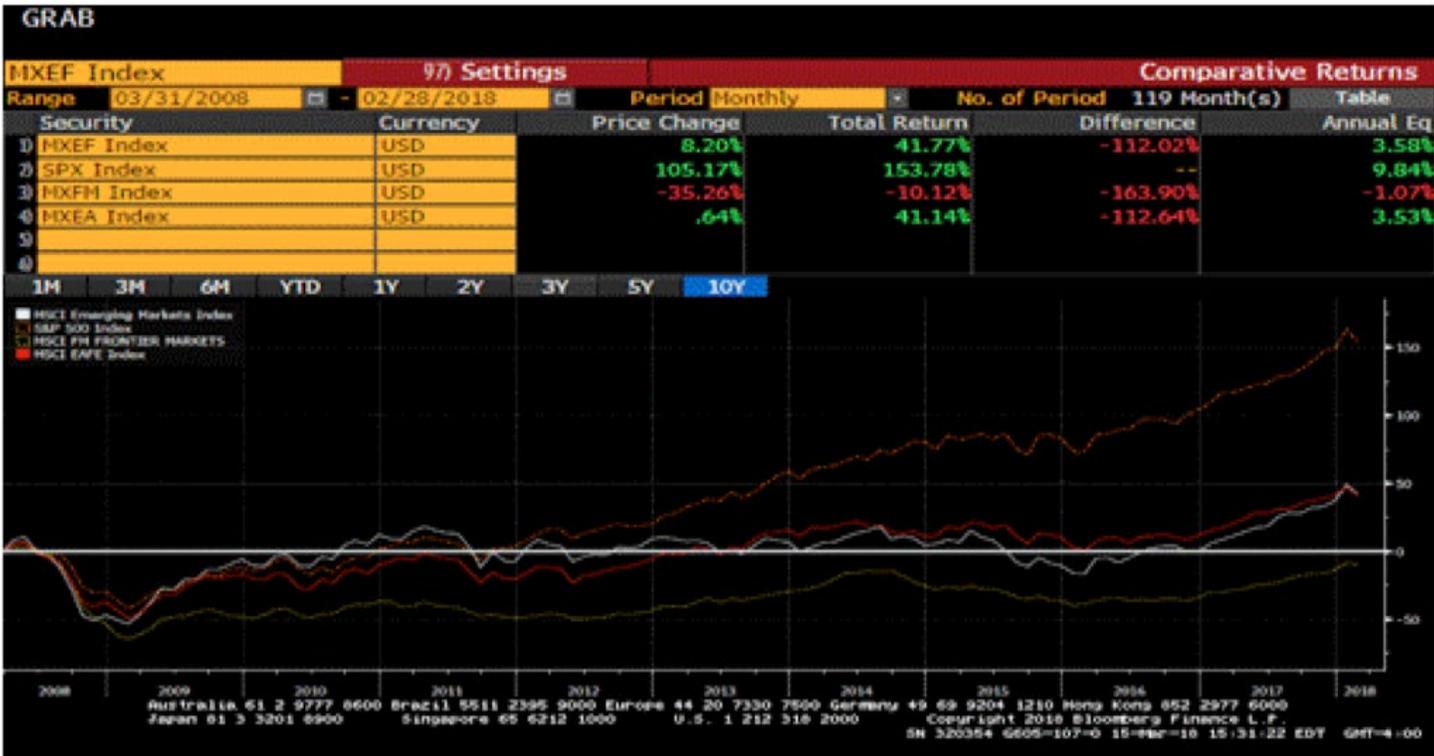
Source: NDR

Equities

The first quarter saw the S&P 500 have its first down quarter since the third quarter of 2015 ending off .76%. The month of January looked like a continuation of 2017 as large cap and growth stocks continued to lead the way. By the end of the quarter, small cap stocks were down slightly and ahead of large cap stocks. Internationally, developed markets lagged while emerging markets were a bright spot. The MSCI EAFE Index was down 1.53%, while MSCI Emerging Markets Index was up 1.42%. Emerging markets held up better as cash continued to come into the space due to investors seeing better values and room to go up more before getting significantly above the previous peak. In the chart below, we see that the S&P 500 is 153% above its level 10 years ago, while MSCI EAFE and MSCI Emerging Markets are only 41% higher. The Frontier markets (Vietnam, Argentina, Gulf States...etc.) are actually lower over that period.

With the market selling off and earnings estimates coming in at double digit growth rates, the S&P 500 moved from a forward P/E of over 20 to 16.5. A concern is how much of the higher earnings expectation is built into the market and can we break back above the January highs. Higher rates, especially on the short end, have benefited financial stocks, but have hurt consumer staples, real estate, and utility stocks.

During the quarter we added to our international exposure including emerging and frontier markets, while eliminating our position in Germany and slightly reducing U.S. large cap exposure. This shift was due to the reasons mentioned above, as valuations look more attractive outside the U.S. and Germany. We are closely watching the outperformance in small cap versus U.S. large cap that started in March with the talks of tariffs and possible trade wars. Overall, we see the environment for active management starting to pick up and may move more in that direction within international and possibly small cap.

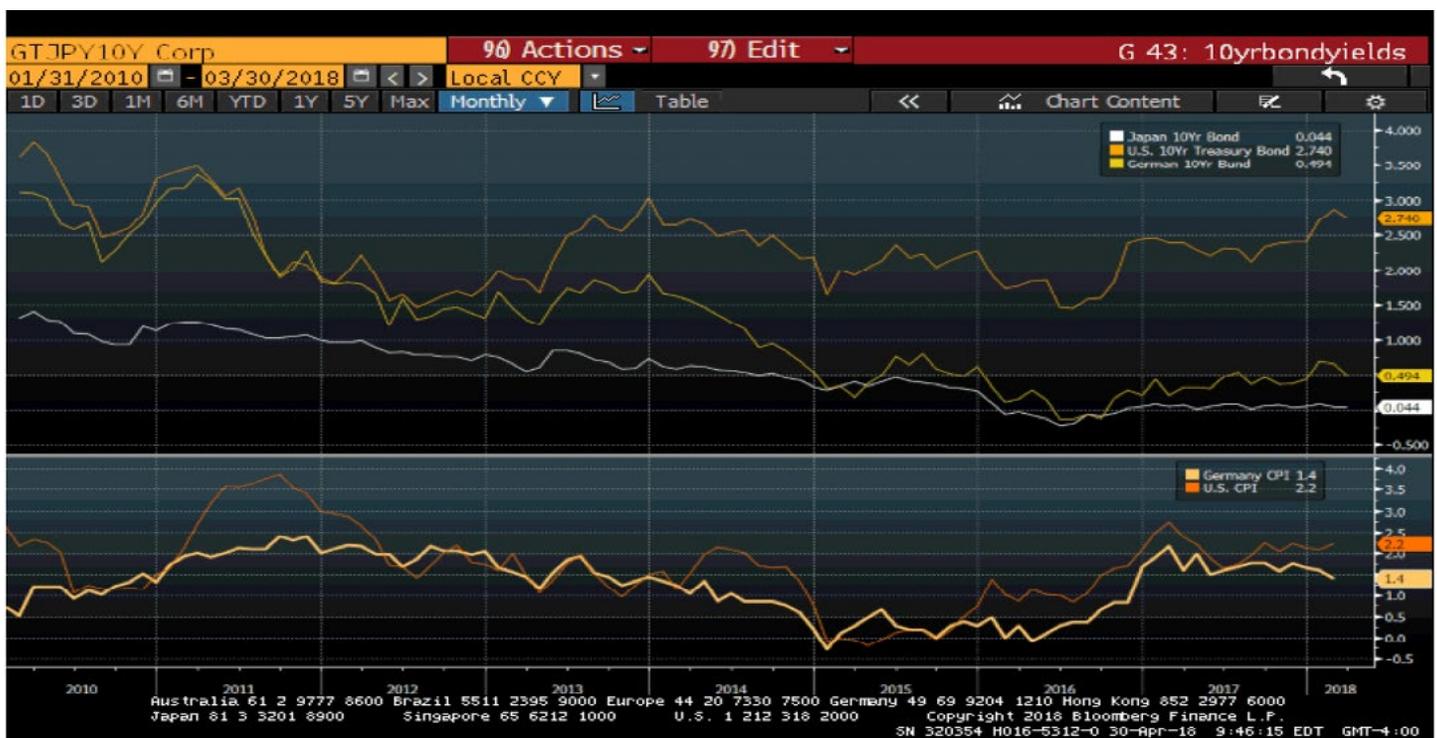


Source: Bloomberg

Fixed Income

The U.S. 10 Year Treasury Bond finished the quarter with a yield of 2.74% versus 2.41% at the beginning of the year. Yields approached 2.95% in February which is the highest yield since the beginning of 2014. Interest rates continued to move higher due to strong employment, improving economic statistics, and higher expectations for inflation. The Fed raised rates an additional 25 basis points in March and is expected to increase 2-3 more times during the year. The shape of the U.S. yield curve (10 Yr. yield vs. 2 Yr. yield) has been the source of a lot of discussion, most of it around concerns of flattening and possibly inverting. While the yield curve has flattened, it has been in the context of both the 2 year and 10 year moving higher in yield. The 2 year has moved up more in anticipation of the Fed raising rates, while the 10 year hasn't move as much due to the likelihood of much of the stimulus from tax cuts being more short term in nature. In addition, we see that U.S. yields are substantially higher than Germany and Japan. The 10 Year Treasury is about 225 basis points higher than the 10 Year German Bund, while inflation is only 80 basis points higher (Chart Below). Much of the difference is attributable to the ECB (European Central Bank) and Japan purchasing a larger percentage of their government's debt, but the yield differential should keep the U.S. 10 Year Treasury from rising too dramatically. As far as fears of the yield curve flattening in the U.S., it tends to only be an issue when the 10 Year Treasury is falling in yield, which it currently is not.

Our lower duration position relative to the benchmark was a benefit in the quarter, as the Barclays Aggregate Bond Index was off 1.46%. We continue to see good opportunity on the shorter end of the curve, as we are now able to get similar yields on 2-3 year bonds as we were on 10 year bonds not that long ago. In addition, the less risky bond yields are increasingly more attractive on a risk/reward basis than more risky assets within fixed income. Currently, the yield on a 2 Year U.S. Treasury is higher than the dividend yield on the S&P 500 for the first time since 2008. The barbell approach of being conservative with our fixed income exposure and maintaining a long term strategic exposure to equities is likely to continue especially as the diversification benefit of longer term bonds has lessened over the past couple of years.



Source: Bloomberg

Going Forward

We have likely shifted from the low volatility environment, driven by global quantitative easing, to a more normalized environment as policy begins to move towards tightening. In this environment, we are likely to see many of the anomalies and inefficiencies that we have written about in the past get disrupted. One area of concern is the dramatic increase in assets invested in ETFs that have liquidity mismatches. This would include areas like high yield, emerging market debt, and structured credit. Normal sell off's could lead to larger ones as the underlying instruments are less liquid than the ETFs themselves. While this likely would not last long term, it could be sharp and fast. As always, we will have dry powder to take advantage of these sorts of events.

We are in the process of starting to invest our newest private equity fund. The focus is on inefficient and less liquid strategies. A couple of areas we like include: Mezzanine, Consumer Products Growth Capital, and Secondaries. In addition, we are looking to add managers who are less correlated to equity and fixed income markets to our Absolute Return funds. With private equity we seek to provide a higher return than what equity markets will likely bring over the next 5-7 years, and with absolute return we seek a diversifier to traditional equity and fixed income.

Alternatives are a good source of diversification for a long term portfolio. We continue to see the turn in hedge fund strategy performance relative to equity and bond returns after a pretty tough stretch. Absolute return strategies will provide a cushion if we get into an environment of equities and fixed income coming off of historically high valuations. Our long short fund has an average manager market exposure of around 50%, as they have short positions to offset their long exposure. The environment for stock selection has been improving and will likely provide a good risk reward relative to long only indices going forward. In regards to private equity, we saw our managers have some good success early on with realizations in the order of 2.5x to 3x as money continues to pursue private opportunities. As we have mentioned we are focused on smaller and more disciplined managers who won't chase the valuations, but rather wait for the right opportunities. In looking at data from Cambridge Associates, we see that private equity provides the best relative return during periods of flat to declining equity markets. 2018 will be a year where investors and allocators will need to be disciplined and likely work a little harder to realize acceptable risk adjusted returns.

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