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MARKET REVIEW
MARCH 2018

KEEP AN EYE ON THREE

In the 1950s and 1960s, an often unfair tongue-in-cheek characterization of retail banking went as follows: Bankers hope to pay deposits at three and charge interest at six, so they can make it to the golf course by three. Those days are long gone with respect to both interest rate levels and brevity of workdays! Banking has indeed evolved from deposits and loans to a full suite of financial services. Yet, the economy and markets are in a curious place where many key economic and financial market indicators all hinge on the number three. For investors, being aware of the forces and trends that may drive these data points should help them better understand today's risks and opportunities.

"3" IN ECONOMIC DATA

Gross Domestic Product (GDP) and inflation are among the most widely cited economic data points. The annual average growth of GDP adjusted for inflation has been measured at 3.1% for the post-war period of 1947-2017[1]. This period includes boom times in the 1950s and 1960s when GDP averaged closer to 5.0%, with a few years running as fast as 8%. Many modern day economists believe that GDP can only grow at a 2.5%-3.0% annualized rate in the future. The U.S. Federal Reserve (Fed) informally targets 2.5% as the long-run expected growth rate for GDP, and could begin to worry about inflation pressures building should GDP growth measure 3.0% or higher for several quarters in a row.

Inflation, as measured by the Consumer Price Index (CPI), has risen at an average annual rate of 3.7% since 1948[2]. In 1958, a form of inflation that excluded food and energy prices was introduced, and it has risen at an average rate of 3.5% since then. Some readers will undoubtedly recall the double-digit inflation of the 1970s and 1980s, and we hope those days are long behind us.

The graph at the top left of the next page shows inflation and GDP growth since 2006. During this period, CPI rose as high as 5.5% a few months prior to the sub-prime housing crisis in the summer of 2008. More recently, CPI measured at, or near, zero for most of calendar year 2015, and has slowly been rising. GDP for spring and summer 2017 were measured at 3.1% and 3.2% growth rates. Two back-to-back quarters of growth this strong had not been experienced in the current expansion and some consider it a hopeful sign.

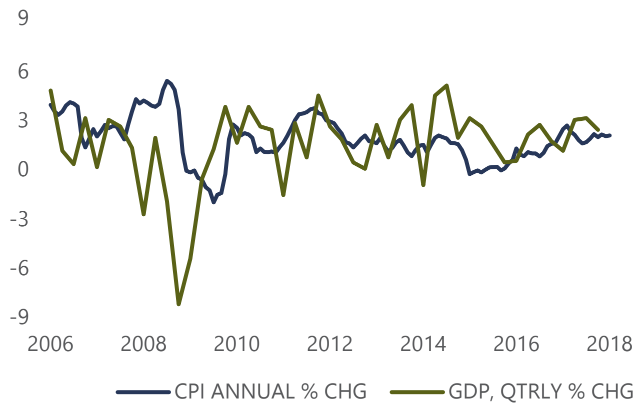
"3" IN THE MARKETS

The stock and bond markets even have their own important three's. Though it has been quite some time, a three percent dividend yield was formerly a common sign that a stock was attractive. Nowadays, with the S&P 500 yielding just under 2%, that 3% dividend yield would be very attractive.

The chart at the top right of the next page shows yields of the benchmark U.S. Treasury and 3-month T-bills, the latter being considered the bond market's interpretation of the policy rate for Federal Funds.

GROWTH AND INFLATION

2006 - JANUARY 2018



Source: Bloomberg. Past performance does not guarantee future results.

BOND YIELDS

YEARLY FROM 1952 THROUGH YTD 2018

Source: Bloomberg. Past performance does not guarantee future results.

During the near 60-year history of the U.S. 10-Year T-Note, it has rarely traded with a 3% yield. Consequently, a 3-month T-Bill has spent even less time with a 3% yield. What's really important to bond investors is the inflation adjusted, or real, return. The real return on 10-Year T-Notes has ranged 2%-4% over this period, roughly averaging 3%. Despite the low real return on bonds during the current bull market in equities, just comparing current income, a 3% yield on T-Notes would be competitive to stocks, earning 1% more with a fraction of the risk. The competitiveness between stocks and bonds gets more intersting for investors when Treasuries pay 1% more than the dividend yield on stocks.

CONCLUSION – THE THIRD "3" AND THE FED

3% GDP growth rates, 3% inflation rates, and 3% yields on 10-year U.S. Treasuries are all important milestones for the economy and markets. However, there is another important three to consider – the number of rate hikes expected this year. New Fed Chair Jerome Powell has testified before Congress that he intends to keep the same interest rate policies as his predecessors Janet Yellen and Ben Bernanke. As the ultra-accommodative monetary policy implemented by the Fed became less necessary, starting in 2015 the Fed pre-announced its intention to raise interest rates three to four times each year stopping when the Federal Funds rate reached 3%.

Though they announced a pace of three hikes per year, in the first two years they only hiked once each year. In the third year, 2017, they hiked three times[3]. Chair Powell has announced three hikes again for this year. With GDP growth last summer being in excess of 3% for two quarters and CPI going from zero to 2% in the last few years, the possibility of more than three rate hikes is significant. At some point this year, these rate hikes could be characterized as "restrictive" rather than "less accommodative." Though investing is a long-term endeavor, and we believe that equities should outperform bonds in the long-run, we acknowledge the potential for increased market volatility as inflation, GDP and the number of expected Fed rate hikes in 2018 approach three.

[1] U.S. Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/A191RL1A225NBEA

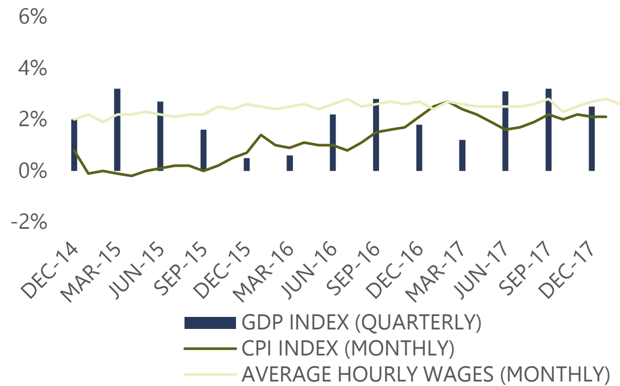
[2] U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/CPIAUCSL

[3] https://www.federalreserve.gov/monetarypolicy/openmarket.htm

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

DECEMBER 2014 THROUGH FEBRUARY 2018

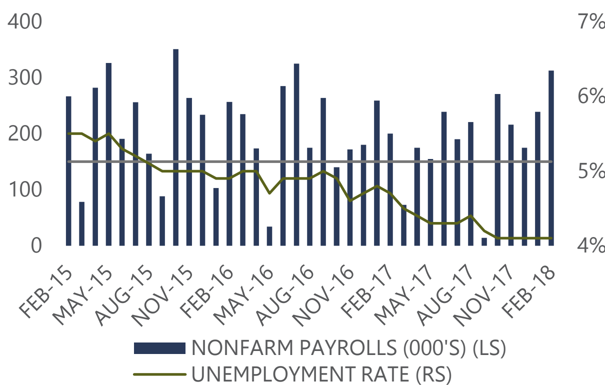


Source: Bloomberg

- U.S. GDP expanded at a 2.5% annual rate in the fourth quarter, revised downward from the initially reported 2.6% pace. Growth in consumer spending, which accounts for more than two-thirds of U.S. economic activity, was unrevised at 3.8% in the fourth quarter.
- The Core Personal Consumption Expenditure (PCE) price index increased 0.3% in January. The year-over-year reading for Core PCE remained steady at 1.5%, but below the Fed's 2.0% target.
- Headline CPI, which includes volatile food and energy costs, rose by 0.5% in January, above expectations of 0.3%. Broad consumer prices rose 2.1% over the twelve-month period ending in January 2018.

LABOR MARKET

FEBRUARY 2015 THROUGH FEBRUARY 2018

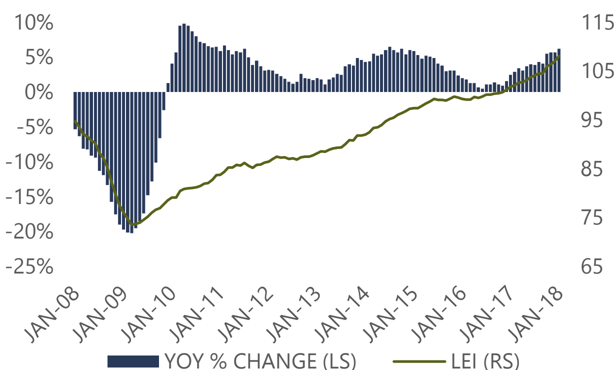


Source: Bloomberg

- U.S. nonfarm payroll employment rose sharply in February, adding 313,000 new jobs, coming in 108,000 jobs ahead of the Bloomberg consensus estimate.
- Average hourly earnings increased 0.1% for the month and 2.6% on an annualized basis, registering below expectations on both readings.
- The unemployment rate remained steady at a 17-year low of 4.1%. Discouraged workers reentered the work force, as evidenced by a 0.3% increase in the labor force participation rate to 63.0%.

LEADING ECONOMIC INDICATORS

JANUARY 2008 THROUGH JANUARY 2018



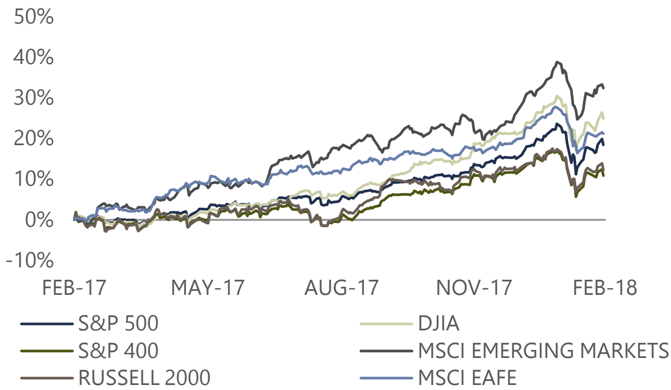
Source: Bloomberg

- The Conference Board LEI Index is comprised of ten economic components, and is considered a helpful gauge for estimating economic activity for the subsequent three to six months. The LEI Index increased 1.0% in January to 108.1, following an increase of 0.6% in December.
- In the sixth-month period ending January 2018, the LEI Index increased 3.8%, faster than the growth of 2.3% during the previous six months, pointing to continued momentum for the economy for the remainder of Q1 and Q2 2018.
- The largest positive contributors in the month's report came from building permits and the financial sector subcomponents including the S&P 500 Index level and U.S. yield curve.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, FEBRUARY 2017 THROUGH FEBRUARY 2018

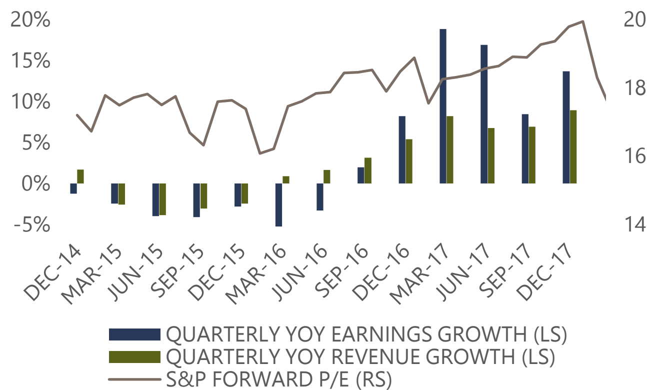


Source: Bloomberg

- Global equities experienced a sharp decline in February after very strong performance in January. Most major equity indexes recorded a monthly loss greater than 3.5%. Early in the month, the S&P 500 entered correction territory for the first time in two years amid investor concerns about rising interest rates and higher inflation expectations.
- Profit taking was likely another contributor to the recent correction considering January was the 15th consecutive month that the S&P 500 generated a positive total return, marking the longest streak in history.
- Equities rebounded after February's initial decline as investor concerns eased and focus shifted back to strong corporate fundamentals and economic data.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, DECEMBER 2014 THROUGH FEBRUARY 2018

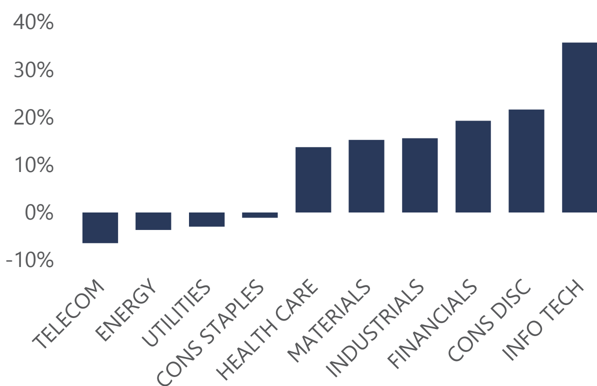


Source: Bloomberg

- Fourth quarter earnings reporting season is almost complete with results reported from 97% of S&P 500 companies. Full quarter S&P 500 earnings and sales growth are expected to be 13.7% and 9.0%, respectively.
- All 11 sectors of the S&P 500 reported positive quarterly earnings and sales growth for the first time since the third quarter of 2011. The energy, materials, and technology sectors experienced the strongest growth.
- Analysts are estimating stronger growth in 2018 with quarterly earnings estimated to grow at a year-over-year clip of over 20% in each quarter. The expected acceleration in earnings growth is primarily driven by the reduced corporate tax rate.

S&P 500 SECTORS 12-MONTH RETURNS (PRICE)

FEBRUARY 2017 THROUGH FEBRUARY 2018



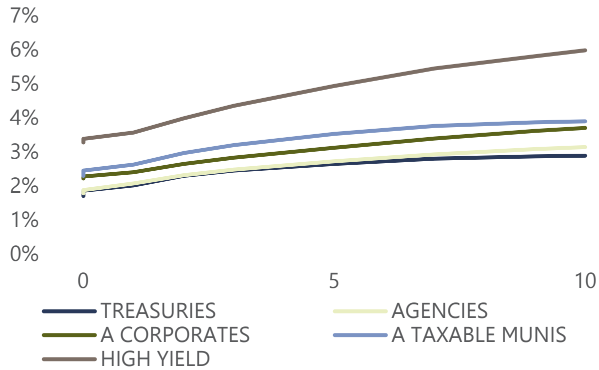
Source: Bloomberg

- Technology was the only S&P 500 sector with a positive total return in February. Strong earnings and sales growth continue to support the sector's performance.
- Outside of technology, weakness was widespread among the other sectors as each sector fell around 3.0% or more last month.
- The energy sector fell 10.8% in February, its worst monthly performance since 2011. Weakness among energy stocks was driven by a larger-than-expected rise in oil inventory and comments from the International Energy Agency (IEA) that U.S. crude oil output is estimated to exceed demand this year.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF FEBRUARY 2018

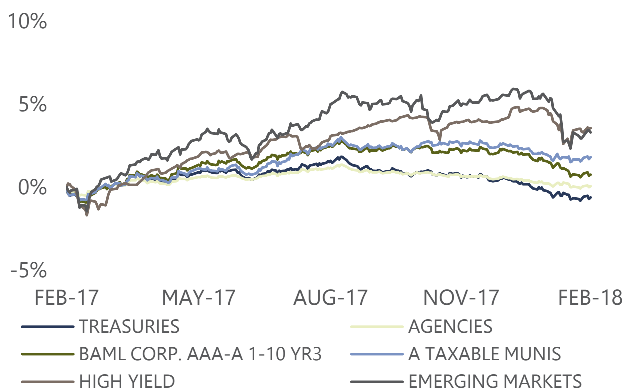


Source: Bloomberg

- The yield curve (the yield differential between the 2-year U.S. Treasury note and the 10-year bond) steepened somewhat in February following ten-year lows reached in January, as rates across the curve climbed higher. The yield curve reached a three-month high of 77.9 basis points on February 12, before closing the month at a differential of 60.7 basis points.
- After a spike in implied 10-year U.S. breakeven inflation rates in January, expected inflation rates held steady in February.
- After flattening in the fourth quarter of 2017, Bloomberg's BVAL AAA Baseline Curve, a measure of tax-exempt muni yields, has steepened 47 basis points in 2018.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

FEBRUARY 2017 THROUGH FEBRUARY 2018

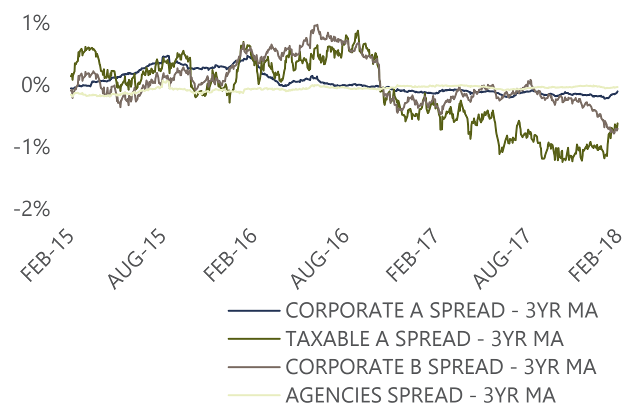


Source: Bloomberg

- U.S. high yield and emerging market bonds continue to maintain their strength over the rest of the market from a total return perspective. After a strong February, high yield surpassed emerging market bonds as the best performing fixed income asset class over the last 12 months.
- Among the more traditional asset classes, taxable municipal bonds have extended their outperformance relative to investment grade corporate bonds in the first two months of 2018.
- U.S. Treasuries have posted negative returns year to date and over the last twelve months as the market's recent infatuation with inflation has driven yields higher and prices lower thus far in 2018.

SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE

FEBRUARY 2017 THROUGH FEBRUARY 2018



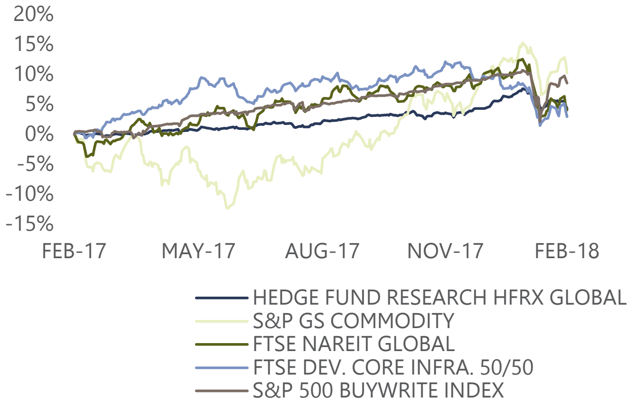
Source: Bloomberg

- Spreads in most sectors of the corporate market widened during the month of February. Investors who bought in the middle part of the month appeared to time their purchases at an attractive entry point, especially those adding non-investment grade corporates.
- Agencies appear relatively cheap compared to their spreads over the last three years and compared to where other parts of the bond market trade in relation to their historical spread levels.
- Tight spreads in riskier asset classes can signal turning points in the credit cycle. Despite narrow spreads, high yield defaults remain below their historical norms.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

FEBRUARY 2017 THROUGH FEBRUARY 2018

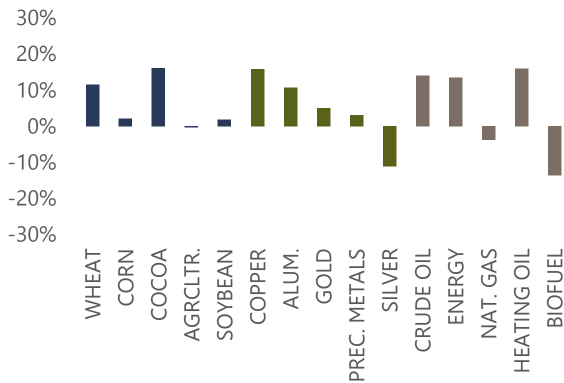


Source: Bloomberg

- Benchmarks designed to reflect the performance of the hedge fund, commodities and options writing strategy asset classes held up better than the 4.2% loss suffered by the global equity benchmark MSCI ACWI Index in February.
- Led by commodities, all five of the alternative asset class indexes outpaced the Bloomberg Barclays Aggregate Bond Index's 0.5% total return over the twelve-month period ending in February, but fell short of the MSCI ACWI Index's 19.4% total return over the period.
- Global REITs experienced an especially challenging February, as a move higher in U.S. interest rates put pressure on prices of many higher yielding sectors.

COMMODITIES, 12-MONTH SPOT RETURNS

FEBRUARY 2017 THROUGH FEBRUARY 2018



Source: Bloomberg

- Natural gas futures surged nearly 40% over a five-week period ending in late January following heightened heating demand and record low temperatures across the eastern and central regions of the United States. By the end of February, a strong response by domestic producers brought prices back down below early December levels.
- Uncertainty surrounding an upcoming Venezuelan election and potential U.S. sanctions on the oil producing nation could temporarily reduce global oil supplies heading into the spring and summer. Venezuela, home to the largest proven oil reserves in the world, produced 1.6 million barrels of oil per day in January, marking the lowest production level since 2003.

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