# Market Review & Outlook: Correction and Perspective

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*Executive Summary*

- *Economic data and earnings expectations remain positive on balance.*
- *Inflationary fears and protectionist saber rattling caused increased volatility in interest rates and equities breaking an extended period of calm in the capital markets.*
- *Good planning and consistent rebalancing puts individuals in a position to make better decisions at times when staying the course is not comfortable.*
- *"Time In" versus "Timing" the market has proven to be an effective strategy to build wealth.*
- *Absolute return investment strategies rarely deliver the intended risk / reward results they promise and sometimes cause irreversible damage.*

The first quarter 2018 saw the first equity market correction in roughly two years. While this correction has barely touched the 10% decline level, it has done it twice and seems to be hanging around a little longer than most of the corrections we have seen since the 2008 recession. The initial decline was a response to the January employment report. Job growth was better than anticipated, but the year over year increase in average hourly earnings was also higher than anticipated sparking fears of inflation. The yield on the 10-year Treasury increased from 2.66% on January 26 to 2.94% on February 21. From there, rates stabilized despite another Fed funds increase and the equity markets settled down. The second downturn was brought on by a series of announcements that the United States would impose new tariffs, most directly targeting China. The fallout from these potential trade restrictions is open-ended, creating uncertainty in terms of both duration and financial impact.

## Fixed Income Market Index Returns

*As of March 31, 2018*

| Asset Class | Index | 1Q 2018 (%) | 1 year (%) | 3 years (%) | 5 years (%) | 10 years (%) |
|---|---|---|---|---|---|---|
| | BC Aggregate | -1.46 | 1.20 | 1.20 | 1.82 | 3.63 |
| **U.S. Taxable Bonds** | BC Intermediate Government Credit | -0.98 | 0.35 | 0.94 | 1.25 | 2.92 |
| | BC US Intermediate Credit | -1.36 | 1.10 | 1.67 | 2.05 | 4.28 |
| **U.S. Municipal Bonds** | BC Municipal Bond (5 Years) | -0.57 | 0.65 | 1.27 | 1.54 | 3.28 |
| **International Bonds** | Citigroup Non-US Government Bond | 4.42 | 12.93 | 5.02 | 1.36 | 1.82 |

*All returns greater than one year are annualized. Source: Greenhill Market Index Review as of March 31, 2018*

## Equity Market Index Returns

*As of March 31, 2018*

| Asset Class | Index | 1Q 2018 (%) | 1 year (%) | 3 years (%) | 5 years (%) | 10 years (%) |
|---|---|---|---|---|---|---|
| Large Cap U.S. | S&P 500 Index | -0.76 | 14.00 | 10.78 | 13.31 | 9.49 |
| | Russell 1000 Large Growth Index | 1.42 | 21.26 | 12.90 | 15.54 | 11.35 |
| | Russell 1000 Large Value Index | -2.84 | 6.94 | 7.86 | 10.78 | 7.77 |
| | DJ US Select Dividend Index | -2.54 | 8.26 | 10.87 | 12.45 | 9.54 |
| Mid Cap U.S. | S&P 400 Mid Cap Index | -0.77 | 10.99 | 8.96 | 11.97 | 10.91 |
| Small Cap U.S. | S&P 600 Small Cap Index | 0.57 | 12.67 | 10.76 | 13.56 | 11.35 |
| Developed International | MSCI EAFE Index | -1.52 | 14.81 | 5.55 | 6.50 | 2.74 |
| Emerging Markets | MSCI Emerging Market Index | 1.41 | 24.94 | 8.81 | 4.98 | 3.02 |
| Commodities | Bloomberg Commodity Total Return Index | -0.40 | 3.71 | -3.21 | -8.32 | -7.71 |
| Real Estate | NAREIT Equity Index | -6.67 | -1.09 | 2.96 | 6.68 | 6.90 |
| Global Market Cap Weighted | MSCI World Index* | -1.28 | 13.58 | 7.96 | 9.70 | 5.90 |

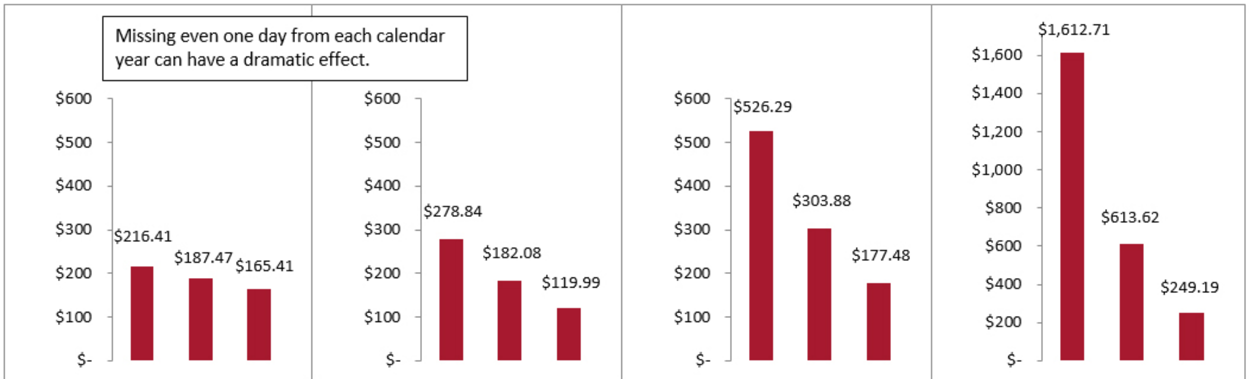
**The U.S. represents about 51% of the MSCI World Index.*
*All returns greater than one year are annualized.  Source: Greenhill Market Index Review as of March 31, 2018*

As of April 6, 2018, the S&P 500 is about 8.5% below the 52-week high established in January.  Total bond returns ended in negative territory for the quarter; however, returns stabilized following the very brief initial spike in the 10-year Treasury yield.

Do you "buy the dips" or "sell the rallies"?  Everybody seems to have an opinion.  We believe that this should not be an issue beyond small adjustments.  Yes, there are months, quarters, and even years in which a portfolio of stocks and bonds will deliver a negative return.  Sometimes the results are very negative; however, history shows that the long-term result is growth that is rarely, if ever, beaten by esoteric strategies that are designed to accomplish steady results without taking the risks inherent in equity investing.  Just as we are unable to foresee the timing, depth, and duration of most corrections, we are also not able to predict the timing and size of recoveries. As you can see in the exhibit on the next page, equity returns in any given year are heavily dependent on a few good days.  The opposite is also true; missing a few of the worst days can improve results, but is simply not practical.  First, equity returns go to participating equity investors and participating means taking risk; there is rarely a time when everything looks perfect.  Second, it is far more difficult to avoid a bad day in the market (assuming that you want to participate at all) than it is to stay invested once the correction has arrived.  Finally, there are costs to selling including taxes on capital gains, trading costs, and regret.  The market goes up more frequently than it goes down and sitting on the sidelines during a strong market just makes it harder to get back in.

As is typically the case, the hardest hit investments this correction were investments designed to deliver "absolute return" regardless of how risk assets performed.  There are mutual funds and partnerships that lost investors' entire principal because of leverage and the illusion that there is an easy way to achieve consistent results.  Most of these investment vehicles made a bet on the mercurial VIX index, which measures volatility expectations as implied by options prices.  In our opinion, the VIX is at best useless. Volatility usually comes as a surprise and has changed

*S&P 500 Index*




| | 5 Years 2013-2017 | | | 10 Years 2008-2017 | | | 15 Years 2003-2017 | | | 25 Years 1993-2017 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Less Worst 5 Days | Entire Period | Less Best 5 Days | Less Worst 10 Days | Entire Period | Less Best 10 Days | Less Worst 15 Days | Entire Period | Less Best 15 Days | Less Worst 25 Days | Entire Period | Less Best 25 Days |
| Ending Value | $ 216.41 | $ 187.47 | $ 165.41 | $ 278.84 | $ 182.08 | $ 119.99 | $ 526.29 | $ 303.88 | $ 177.48 | $ 1,612.71 | $ 613.62 | $ 249.19 |
| Percent Change | 116.4% | 87.5% | 65.4% | 178.8% | 82.1% | 20.0% | 426.3% | 203.9% | 77.5% | 1512.7% | 513.6% | 149.2% |
| Compound Annual Rate | 16.7% | 13.4% | 10.6% | 10.8% | 6.2% | 1.8% | 11.7% | 7.7% | 3.9% | 11.8% | 7.5% | 3.7% |
| Percentage of Days | 99.6% | 100% | 99.6% | 99.6% | 100% | 99.6% | 99.6% | 100% | 99.6% | 99.6% | 100% | 99.6% |

Note: The "Entire Period" includes every day, while "Less Worst" removes the worst day and "Less Best" removes the best day from each calendar year

Data: Capital Appreciation; $100 invested at period inception

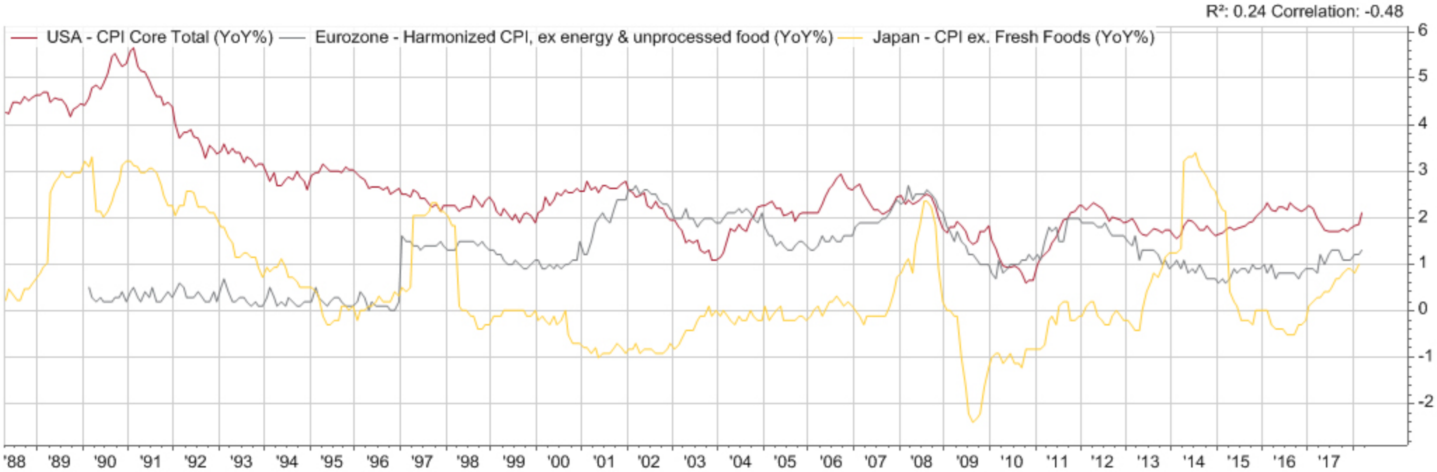
Sources: Standard & Poor's Corporation; 

before an investor has time to react. There are no underlying fundamentals or intrinsic value to measure, just a present reading of future sentiment, and therefore, not worth an investor's hard earned capital in our opinion.

The US economy continues to perform well based on healthy consumption and private investment. This deep into an expansion, it is natural to look for cracks, but at the moment we see nothing worse than moderation from very high levels. Unemployment remains very low at 4.1%. March saw a disappointing 103,000 addition to nonfarm payrolls, but February payrolls had grown 320,000. There have been variations in monthly reports all along, but the 200,000 job per month average is healthy and appears to be consistent. Weather was attributed some credit for the slow March by many analysts. Average hourly earnings, the figure that first spooked the equity market in February, increased 2.7% versus the 2.5% trend throughout most of 2016 and 2017. This is higher, but it represents more money in consumers' wallets as much as inflation risk. Forward looking indicators like the ISM Manufacturing Index, durable goods orders, and consumer confidence have moderated, but remain strong. The March ISM Manufacturing PMI fell to 59.3 from 60.8. Any number above 50 represents an outlook for growth, so the absolute level remains very high.

Fourth quarter earnings were a little confusing due to the new tax law, but the underlying results were generally good led by revenue growth and better profitability. Most companies took a fourth quarter charge to revalue some balance sheet items affected by the change in tax rates. S&P 500 earnings estimates for calendar 2018 have risen based on lower tax rates, repatriated foreign earnings and business momentum. The correction has reduced the S&P 500 price-to-earnings multiple to 16.6X 2018 earnings as of April 6, 2018, versus 18X at the end of 2017. We would note that current earnings expectations are very high. The consensus of estimates for 2018 S&P 500 earnings represents 19% growth versus 2017 with two more years of approximately 10% growth to follow. In addition to sales growth and margin expansion, the lower corporate tax rate, greater investment and potential for repurchases with

30-year Inflation Trends for Developed Markets as Measured by CPI




*Source: Factset as of April 6, 2018*

repatriated profits are fueling the optimistic earnings outlook. As we discussed last quarter, the true impact of the last two items is difficult to forecast.

The Fed raised the overnight Fed Funds rate to 1.75% in March and the forecast from the Fed and the market is for two more increases in 2018. 10-year Treasury rates have stabilized around 2.8%. This combination is causing the yield curve to flatten. We do not believe the Fed has the need or desire to be more aggressive based on current information. With continued moderate growth and limited evidence of inflation exceeding the Fed's 2% target, we believe the Fed will maintain the deliberate path we have seen so far. Please see the chart above for some longer-term perspective on inflation in the United States, the Eurozone, and Japan.

We believe that good planning and consistent rebalancing puts individuals in a position to make better decisions at times when staying the course is not comfortable. Trump's potential tariffs represent a departure from the widely held belief that trade promotes prosperity and ultimately peace. We do not know how the Chinese will respond or what damage might result. Chinese exports account for very little of US GDP, but it is clear that the issues we are navigating with China today will determine the path of the world for years to come. We are going to have to come to some agreements, but self-interest dictates that cooperation offers greater potential than constant rivalry. So far, this seems to be mostly posturing to change things at the margin. We hope this is where it ends. ■