TAKING THE PULSE

Market Review **MAY 2018**

On a world-wide scale, most economic data is living up to expectations—the American economy is no exception. What's more, American production has been noticeably robust in this already long global recovery. This has allowed the US central bank to tap on the monetary stimulus brakes and has also brought out the inflation hawks in droves.

In a deliberate attempt to get ahead of the inflationary curve, the US central bank and fixed-income market participants are causing US interest rates to rise. Their calculus is consistent with a healthy economy and a midway business cycle.

The vitality of the business cycle is evident from the sheer strength of corporate profits from the first-quarter of 2018. About half of the US stock market has reported profits now, and so far they are up some 23% from a year ago. Stock prices, however, trade near February's corrected levels. So why are most stocks in the red this year when the profits underlying those stocks are so good? One explanation is that stock markets tend to be extremely forward-looking. The profits seen today may have already been priced into last year's returns. According to current price-to-earnings ratios (P/E), the US stock market is predicted to price 2019's earnings at approximately 17 times.

What hasn't corrected is US economic growth. The US economy grew at an annualized rate of 2.3% in the first-quarter of 2018. This now marks the fourth consecutive quarter of plus 2% growth. Unfortunately, consumer expenditure data was a disappointment. Consumer expenditures grew at an annualized rate of 1.1% in the most recent quarter. That was well short of the annualized rate of 13.7% of the previous quarter. Hurricane recovery purchases and unseasonably cold weather were put to blame for lighter consumption habits. Still, large capital expenditures and inventory restocking helped guide the economy forward. Even the US trade deficit made a small-but positive contribution.

Economist have a median estimate of 2.7% growth for the US economy this year. Consumption and trade must improve substantially in the next three quarters to hit the target. Additionally, business trends cannot stall. However, some recent business surveys reveal a less than sanguine outlook for the US economy. The trade tariffs on metals is just one example that has soured the mood.

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Take, for example, the Empire State Manufacturing survey and a report by the Philly Fed. Both cite major capacity constraints in manufacturing and industrial production. Trade tariffs were said to increase production friction and be a direct cause for delaying deliveries and increasing labor demands. These side effects are good news for employment but can cause "dramatic" increases for prices as the Fed's Beige Book so colloquially put it.

Higher price risks have awoken the inflation pundits. Consequentially, fixed-income securities in treasury markets were sold to protect against the value eroding effects of inflation. Interest rates rose on the selling, which briefly pushed the benchmark treasury yield above 3% in April. The last time the benchmark yield was 3% was four years ago. Treasury sellers in combination with US central bank policy have narrowed the interest rate spread between long-term and short-term interest rates. A narrower spread is frustrating for both financial institutions and monetary policy makers.

The US dollar is inadvertently benefiting from rising US interest rates. A successful American strike on Syria and relaxed central bank policy of England, Europe, and Japan have also helped return value to the greenback. The US dollar has been brought back out of the red and into the black this year. A strong US dollar, however, means higher import prices for American consumers and less American exports.

Lastly, oil and energy stocks are back in the news. The price for an unrefined barrel of oil almost touched $70 in April. Energy stocks led the stock market with gains of almost 9.5%. Disputes regarding Iranian supply may directly determine the future direction of the price of oil.

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Market Movers

On the year, US financial markets are beginning to slip behind international markets. US interest rates are on the rise while non-US interest rates remain ultra-low. The notable divergence should have influential effects on global asset returns moving forward. With respect to the US, higher interest rates could point to a late-stage business cycle or simply a part of normalization. Either way, it is meaningful for asset allocation strategies and a major consideration for our current positioning. In April, our Core Allocation portfolios generally performed slightly better than the benchmark, Morningstar's World Allocation category average. Total returns on small stocks, high-yield bonds, and energy-related assets were an important backdrop of the portfolios this month.

Asset Categories	*Monthly*	*YTD*
US STOCKS	0.16%	-0.84%
FOREIGN STOCKS	0.00%	0.24%
US BONDS	-0.12%	-0.88%
FOREIGN BONDS	-1.21%	-0.81%
HARD ASSETS	1.72%	0.20%
HYBRIDS	-0.29%	-0.21%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING APRIL 30, 2018.

US STOCKS were mixed in April. Total returns of large and small cap stocks produced gains. Total returns of mid-caps made another retreat. Additionally, value stocks outperformed growth stocks last month. The investment team believes the existing cycle is favorable of value stocks and had tilted the Core Allocations towards value stocks at the beginning of the year. On the year, the US stock category is in the red.

FOREIGN STOCKS were also mixed in April. Total returns of developed market stocks fared well, but faltering were the emerging market stocks. Emerging market stocks have struggled since last January. Coincidentally, the last few months have dealt with trade war talks, geopolitical tensions, and a choppy US dollar. On the year, however, total returns of developed and emerging market stocks are in the black.

US BONDS were another asset class with mixed performance in April. Interestingly, lower quality bonds experienced favorable total returns. Gains made by lower quality bonds seem somewhat counterintuitive with a weak US stock market, but our portfolios benefited from this allocation. Other areas of relative strength include bonds of short-term maturity dates. As a category whole this year, total returns of US bonds are negative.

FOREIGN BONDS underperformed last month and are slightly down for the year. Emerging market bonds were the most badly bruised. Still, weak comments by large world banks is not indicative of rising non-US interest rates anytime soon. That should support foreign bond prices in developed markets.

HARD ASSET total returns are all over the place this year. Investors, however, found reasons to buy energy assets and the energy sector broke-out in April. April moved annual total returns into positive territory for energy. Precious metals, however, are in the red for the month and the year. Real estate was another sweet spot this month but is negative for the year. Our use of hard assets has been an important risk management tool for traditional stock and bond investments.

HYBRIDS as a whole are making a series of small pullbacks. April was of no exception. Although, total returns of convertible bonds are a clear outlier this year with strong performance. Preferred stocks, on-the-other-hand, were weak in the month and on the year. For the year, the category has provided risk management and relatively attractive performance.