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First Quarter Investment Commentary
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"In the building practices of ancient Rome, when the scaffolding was removed from a completed Roman arch, the engineer stood beneath. If the arch came crashing down, he was the first to know. Thus his concern for the quality of the arch was intensely personal, and it is not surprising that so many Roman arches have survived." (hedge fund manager, Seth Klarman, 1991,"Margin of Safety")

The Quarter

- The current bull market marked its ninth anniversary in March
- Volatility returned. The indexes had their first 10% decline since 2016 and the VIX Index of volatility soared.
- The Federal Open Market Committee (FOMC) raised the federal funds rate for the 6th time this cycle.
- Jerome Powell was confirmed by the Senate in January to become the 16th chair of the Federal Reserve, replacing Janet Yellen.

Economic and Market Review and Update

As the quarter came to a close, "March Madness" was in full swing. I am not just referring to the NCAA tournament, but the wild swings in equity markets. The week ended March 23 was the worst performing week in two years, with the S&P 500 Index -5.95% during the week. The S&P 500 has swung over +/- 1% twenty trading days so far this year compared to five days for the entire year 2017. Volatility has returned as uncertainty and doubt has replaced complacency in financial markets.

The headlines driving this change are dominated by trade war fears and the Federal Reserve outlook for interest rates. The Trump administration initially placed tariffs on steel and aluminum, which was watered down as Trump began exempting most US allies. More recently, President Trump announced he would impose 25% tariffs on $60 billion worth of Chinese imports covering 1,300 products. This was in retaliation for years of Chinese intellectual property theft against foreign companies. The Chinese retaliated with a modest $3 billion tariff against 128 US imports. Markets fear a full blown trade war, which historically has been a negative for the global economy. We believe free trade is a positive for the world economy, but fairness is equally important. Some countries have trade practices that are harmful to American exporters and these should be addressed. But a trade war is not productive for anyone. Protectionism leads to slower economic growth, less effective allocation of resources, reduced productivity growth, and higher inflation.

The Federal Reserve increased the federal funds rate by 25 basis points (0.25%) to a range of 1.5%-1.75% at its meeting in March. While this was not a surprise, the FOMC indicated “the economic outlook has strengthened in recent months”, raising its forecast for economic growth and reducing its projections for the unemployment rate (reflecting a tighter labor market). What raised concern in financial markets was the Fed becoming slightly more hawkish on interest rates. The FOMC expects to increase the short term interest rate to 3.5% by the end of 2020 (higher than prior forecasts). In a rising interest rate environment, future expected returns are lower. Additionally, as short rates increase, fear is that at some point the yield curve (the difference between short-term and long-term interest rates) inverts. Historically, an inverted yield curve predicts recession. If short-term rates are equal to or above long-term rates, the bond market is signaling that it expects little economic growth and inflation ahead. But more importantly, financial institutions borrow short term to lend long term, at a higher interest rate. This spread creates lending profits and why loans are made. If it is no longer profitable to lend, less loans are made. Consumer spending can fall, businesses invest less, and the economy slides into a recession.

When it comes to Federal Reserve policy, financial markets are faced with a couple of uncertainties. First, they are reducing their balance sheet which means they are letting bonds mature and are not replacing them with new bonds. This reduces money in the economy. There is no historical precedent for this, so the full impact is unknown. Secondly, the Fed is being led by a new chair, Jerome Powell. He is not a trained economist, but rather is a veteran of Wall Street. The positive in this is he is not held steadfast to economic models and is willing to be more patient observing the data. Perhaps he will not increase short rates to the point of inverting the yield curve.

Meanwhile, economic growth continues to be solid. Company surveys and leading economic indicators suggest accelerating growth near term. Employment and income are growing and corporate earnings are strong. So far, inflation has been tame and remained below the Federal Reserve’s 2% target. History suggests that odds of a recession are low until after inflation has a meaningful acceleration. History also suggests that the S&P trends higher until around the start of a recession.

While the risk of recession is low in the near term, we cannot be complacent of the risks, especially since we are likely at the later stages of the economic cycle. We have been raising cash for clients who are spending from their portfolios and have managers that are focused on risk management. “Stay calm, focus on your long-term strategy, and don’t let the market’s knee-jerk reactions to likely overblown speculative fears cause you to make costly short-term mistakes.” Investors should remain committed to sensible long-term investment strategies that meet your individual goals/time horizons/risk tolerances.

Timing is Everything

The global equity markets were rallying hard for the first three weeks of January. Then reality hit, as news of tariffs, higher interest rates and inflation injected volatility back into the market. Although none of us like volatility, we have to remember that 2017 was notable for the incredible *lack* of volatility. To think that this would continue is an example of *recency bias,* which is one of the fundamental underpinnings of behavioral finance. When we suffer from recency bias, we believe that recent events will be the baseline for events in the future. Think of when the Royals won the World Series in 2015 and we thought that maybe, just maybe, they could do it again in 2016. Recency bias can be detrimental to us as investors, as we believe that the market will continue to go up, but when it stops doing so we react emotionally.

With this in mind, let's have quick discussion on timing with regard to investments and trying to either avoid, or at least, minimize losses.

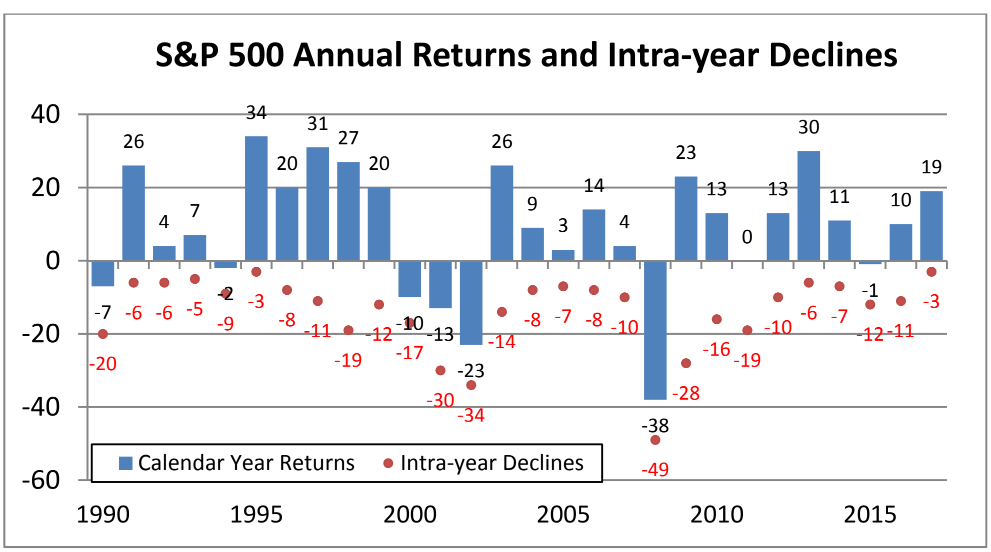
1. You can be right, but if you are not right at the right time, you are still wrong. Patience is not a virtue with many investors.

2. While nobody likes to lose money, not making money when everyone else is can be equally damaging emotionally. No investor likes to leave the party until the music stops. Is the band taking a break, or did it just finish its encore?

3. What are some of the options to protect your portfolio?

    - You can go to cash, but cash is paying you almost nothing. See 1 & 2, above.
    - You can buy put options on the S&P 500, but unless the market goes down before those options expire, you lose 100% of your money. An example of this is the extreme volatility that was experienced a few weeks back as people were short the VIX (volatility index) and the trade went against them. Many people saw their investment go to zero.
    - Buying the VXX, which tracks the short-term volatility index, is another option. As of 3/23/18, this particular investment was up over 75%, while the S&P 500 was down about 2%. Great, you say, what a perfect hedge against losses. However, over the last two years, VXX is down about 83%, meaning you would have had to be exactly right when buying this speculative item. See item 1, above.
    - Having a diversified portfolio should *mitigate* losses, but will never *eliminate* them, as much as we would like it to do so.

Diane has updated the chart below, showing 2017 returns for the S&P 500, illustrating just how smooth, and how unusual, the ride it was last year.



Closing Comments

The capital asset pricing model (CAPM) is a part of the Chartered Financial Analyst curriculum. Some of the creators of the CAPM later received the Nobel Memorial Prize in Economics. CAPM is used to arrive at the value of a risk asset, such as stocks, using certain assumptions. One of the assumptions is that all investors analyze information in the same manner. However, is this assumption accurate?

Diane did a great job of outlining the facts of the economy earlier in this commentary. As we know, just because we are presented with a fact does not mean that each of us will interpret it in the same way. Let me use the company Tesla as an example. The facts are that Tesla produces electric cars, as well as batteries for the cars and other uses. It is also a fact that the company is behind on its production of the new Model 3 and is hemorrhaging cash. Therefore, it is a bad investment. However, another individual may believe it is a great investment because production is behind due to overwhelming demand, the financial markets will readily provide needed financing and Elon Musk is a charismatic genius.

It is not facts that result in market movements. Rather, it is the *interpretation* of those facts by individuals that move the market, sometimes in a volatile fashion. You can make the argument that 2017 was such a non-volatile year because market participants all interpreted the facts in a similar fashion. This is no longer the case in 2018.

"According to market lore, greed and fear are cited as the two driving emotions of market participants. However, hope *and* fear *are primary; greed is simply hope run amok."*
Brendan Moyhihan, *Next Time Will Be Different*

Spring weather is coming our way (although it is 28º as I write this), and none too soon for those people in the Northeast. As always, give us a call if you have questions or concerns.

Kevin	Paul	Matt	Diane
Kevin S. McGrew	Paul L. Watkins	Matthew D. Ison	Diane C. Dercher

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