AMB Newsletter
2nd Quarter 2018

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1st Quarter 2018 Review

2017 was marked by low volatility and a slow melt up in the equity markets that seemed to carry over into 2018. After posting approximately a 22% return in 2017, the market as measured by the S&P 500 rose another 7.5% in the first 3 weeks of 2018, but it was not to last. In the subsequent 2 months, the equity markets fought with bouts of volatility in which the VIX spiked above 50 which was a massive move considering it averaged under 11 in 2017. After it was all said and done, the market finished slightly lower for the quarter, a surprising feat considering how vulnerable the market looked in the middle of February.

One factor that did not change, however, was the leadership group. As we wrote last quarter, "To say 2017 was the year of growth is an understatement as value stocks underperformed their US counterparts by a whopping 1000 bps. US technology stocks rose by 40% in 2017. Along with this, tech is the heaviest weighted sector in the S&P 500 which helped push the total return for the market over 21% for the year. Tech was not alone in the rally as it was very broad-based with consumer discretionary, materials, healthcare, financials, and materials all returning upwards of 20% on the year. However, as we predicted at the beginning of the year, defensive sectors such as utilities, staples, and telecom lagged on the year." This same theme carried over and so far in 2018, US growth has outperformed value by approximately 425 bps measured by the Russell 1000 Value (2.83%) and the Russell 1000 Growth 1.42%, as of March 31, 2018. We do believe that this leadership will shift in the near future but putting a specific time frame on this would be rash of us.

Global Developed Equity markets lagged their US counterparts to start 2018 with a return of (1.41%) measured by the MSCI EAFE vs the (0.76%) posted by the S&P 500. Currencies continue to play a large part as the US Dollar continues to weaken causing corporate profits of international companies to hurt. Other reasons for developed market underperformance include but are not limited to geopolitical headwinds as well as fiscal policy headwinds that the US is not facing. In other words, the benefits from tax cuts and deregulation that US companies are enjoying are not happening globally. However, we do believe international markets are in the early stages of their recovery and have more upside potential over the long run than US market.

Emerging market equities posted a strong January, extending their 2017 gains. However, the same volatility that we witnessed in developed markets was seen in the emerging markets. The MSCI Emerging Markets (EM) Index weakened in February and March but still managed to rise 1.4% in the first quarter. The return was positive and above that of developed markets; however, some EM's were hit worse than others such as China's mainland equities which posted a return of (4%) for the quarter. Dollar weakness continues to fuel EM markets along with rising commodity prices. As long as this trend holds, we would expect EM's to continue to perform well.

Fixed income markets found themselves under pressure once again in the first quarter of 2018 finishing down approximately 1% measured by the Bloomberg Barclays Intermediate Gov/Credit index. Many factors played into this including the Federal Reserve raising its benchmark 25 basis points to the range of 1.5% to 1.75% which marked the sixth time since the financial crisis that it has raised rates. The Fed also reiterated its forecast of three hikes for this year which means it expects two more for 2018. Along with this guidance, we have seen inflation expectations increase over the past few months along with wage growth expectations. Currently, neither inflation nor wage growth have gained traction in the real economy which is why we believe the move in rates was overdone. Over the longer term, we still expect rates on the intermediate to longer-end of the curve to remain subdued.

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2st Quarter 2018 Outlook

Economy

The global economy started to show signs of life over the past two years and that trend has continued into 2018. What is the driving force behind this global acceleration? After years of stumbles, it seems as if the global economy might finally be back on track; but what is interesting, each part of the globe seems to be benefiting from something different. For instance, emerging markets are benefiting from a weak dollar and rising commodity prices. The Eurozone is benefiting from an undervalued currency and considerable pent-up demand. As we mentioned before, we believe the Eurozone is in the early innings of their recovery. The UK is dealing with BREXIT quite well and is benefiting from competitive exports which have been a big surprise to most. Japan seems to have finally sparked inflation and has seen GDP pick up tremendously over the past year. China is the only economy that seems to be slowing but is still posting 5%+ GDP numbers. The US is benefiting from fiscal policy changes. A culmination of things happening at the same time has led to this global recovery, and we believe it has staying power.

Here in the US, the economic expansion we are enjoying is the third longest in history. We have enjoyed nine straight years of economic expansion that has not always been pretty but has been steady to say the least. Last year marked the first year we received a boost from a source other than monetary policy when tax reform in the US was signed into law. Along with tax reform, steps to improve trade agreements with our partners and also the removal of burdensome regulation are also underway. This should allow the US to benefit from stronger capital investment spending and the improving global economy as long as political tensions do not derail progress. For these reasons, we expect US growth to continue its upward trajectory throughout 2018.

How long will this last? Hard to say as we do believe we are nearing the end of this economic cycle in the US; however, putting a time frame on that is impossible. Here are some things the US will have in its favor over the next few years:

- Tighter employment markets could push up wages.
- Higher wages lead to higher consumer spending.
- Corporate profits should remain strong.
- Pro-business policies push up fixed capital investment.
- Easier Fiscal Policy is a positive for the economy in our view.
- Overseas cash being repatriated and used for mergers & acquisitions, dividends and buybacks.

For these reasons, we remain bullish on the overall economy in the US and equity markets.

Equity Market

2018 has been marred by volatility caused by many uncertainties which led to nearly all major stock and bond categories falling into negative territory for the first quarter. In the US, small cap stocks and growth-oriented categories fared better than large caps and value categories. Growth outperforming value is the same theme that we witnessed last year. However, we do believe value will outpace growth in the second half of 2018. Small cap outperformance is something we have not seen since 2016. Trade negotiation seemed to play a big part in this. Small caps do most of their business domestically, so it would make sense for them to trade higher when talks of protectionism are taking place at the highest level of government.

Interest rates have started to move higher, so when do they become competition for stocks? We have been asked this question quite often recently and our answer remains constant. Despite a very long and powerful bull market, the case for an overweight to U.S. stocks over bonds persists. It is true that stocks are slightly expensive relative to historical metrics; however, when taking into account the current earnings yield on the market vs interest rates (yield of the average debt rating of S&P 500 companies), equities remain the better option.

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Equity Market (Continued)

Something we believe is worth repeating is our takeaway from previous letters. "Are stocks overpriced? Is the market in a bubble? When can we expect a correction? These are pertinent, important questions; however, in AMB's view, one of the most bullish signs for the equity markets is the fact that these types of questions are being asked. Bull markets do not end during times of cautious mentality but rather during times of extreme euphoria. We continue to believe that we are in a bull market that has shifted from being driven by interest rates and low inflation to being driven by higher earnings."

Our outlook for the rest of 2018 remains positive. Volatility in 2017 was the outlier – not what we are currently experiencing. In our view, the ups and downs of 2018 are more comforting than what we experienced last year. Also, based on our current outlook of earnings and the economy, stocks should continue on their bull run through 2018 and beyond.

The major risks to our projections fall squarely on tensions between the US and the rest of the world. As the current administration pushes the "America First" agenda, it could derail the current progress that has been made. Geopolitical risks aside, we believe the longer term impact of proposed negotiations and initiatives will be a net positive for the United States but getting there could be quite rough.

Fixed Income

The first month of 2018 was, for the most part, a repeat of what we saw at the end of 2017. Low volatility and credit spread compression. The yield curve started the quarter by steepening on hopes of future growth and inflation from the recently passed Tax Cuts and Jobs Act; but following the January jobs report and recent wage inflation data, the curve has continued its flattening pattern. Overall, it was a tough quarter for fixed income markets across the board.

During the quarter, the Federal Open Market Committee (FOMC) raised the federal funds rate, bringing the target rate to 1.50%-1.75%. This was their sixth rate hike during this cycle. Along with the hike, the FOMC also raised their economic outlook, which according to the data, would allow for 8 total hikes in the coming 3 years (7 more). For this reason, we maintain that rates on the front end will continue to move higher with monetary policy continuing to tighten. This is the reason we have been underweight or void the front end of the curve for the past few years. We still recommend being overweight the intermediate to longer end of the curve.

In our view, the January payrolls report was a primary catalyst that led to increased volatility in both equity and fixed income markets. As we mentioned, wage inflation data has moderated and both survey and market-based forward inflation indicators have fallen leading to the continued flattening of the curve. We still believe intermediate to longer end rates will remain low throughout 2018 due to multiple factors. Frist, international rates are still well below rates here in the US. Because of this, we should continue to see strong international demand for our paper keeping a lid on rates. Second, AMB believes inflation and growth in the US will pick up in 2018 but will waiver in the following years. Finally, in our view long run GDP will average approximately 2%; and unless we begin to see wage growth, we do not believe inflation will take hold. For these reasons, the intermediate area of the curve remains more appealing to us and applying a barbell strategy is best suited for the current market situation.

Investors need to remember why we invest in fixed income. It is not the growth engine of portfolios, but it is what brings stability and predictability to them. When using a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and the safety of principal (which will be repaid upon maturity as long as the bond is credit worthy). Pundits that speak to fixed income being riskier than the stock market are making a generalized blanket statement that we feel is not accurate. Fixed income provides diversification and stability to an inherently more volatile equity portfolio, and we feel it should play a part in every portfolio in some facet.

Conclusion

Volatility has returned to both equity and fixed income markets, and we expect this to continue throughout 2018. Even with the geopolitical turmoil, the markets have fared well after giving up the January run-up. Growth stocks outperforming value has carried over into 2018; but as we mentioned, we expect this to change later in the year. Our overall view on the equity market remains positive, but we do believe political uncertainty will cause increased volatility. Fixed income markets have struggled to start the year, and the continued flattening pattern is worrisome when extrapolating to future expectations. However, credit markets have held together which is a positive sign on the overall economy. As always, we appreciate the opportunity to help you achieve your financial goals.

Matthew J. Roach
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