Investment Commentary

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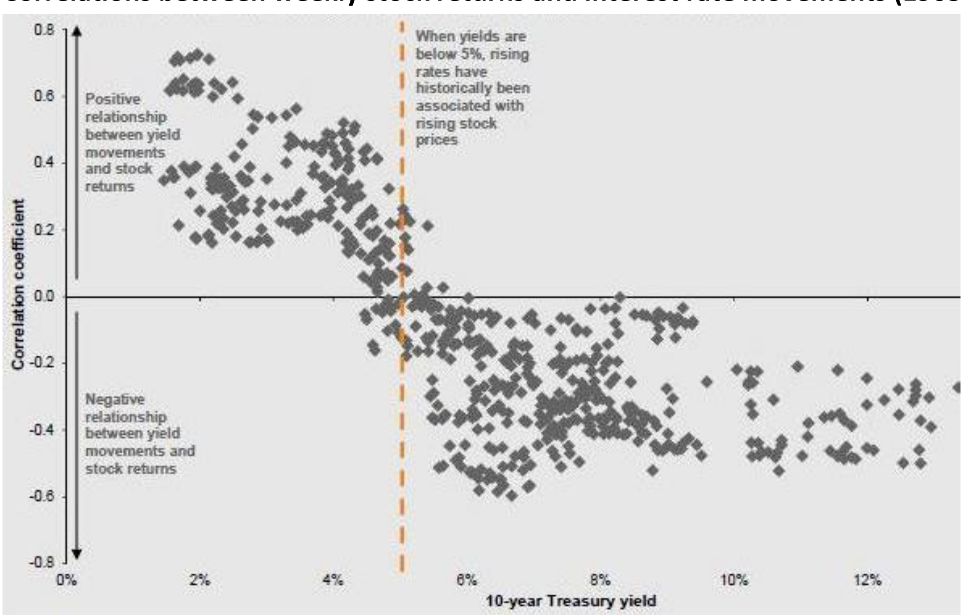
Although much has changed since 2017, our basic premise for understanding the markets today remains. The economy is on solid footing in our view, allowing for businesses and their earnings to grow – also typically leading to normal positive market returns. We also hold the view that the stock market remains expensive on many measures and this is accentuating recent volatility when bad news appears.

As the news cycle has been bombarded by a variety of topics that sound a lot like "risk," the stock market, as measured by the S&P 500 stands approximately 7.5% off its all-time highs as of this writing. However, there is not much of a unifying theme to the 2018 headlines:

- First, the market selloff was driven by rising interest rates and inflation-risk;
- Next, tariffs seemed to pose a threat to the economy;
- Then, Facebook highlighted the notion that large tech companies are not perfect;
- Now, President Trump has bombed Syria and Amazon at the same time.

These are the type of things that can lead to significant problems in the market, but at this stage, the storylines are less problematic. For example, rising interest rates tend to be problematic when rates are already high. However, when rates are low such as today, rising rates tend to be somewhat associated with rising stock markets (see chart). Low rate environments tend to occur when economic growth is below average. When rates rise, this signals the market believes prices and general economic activity will pick-up to more healthy levels – something stock market participants like.

Correlations between weekly stock returns and interest rate movements (1963-2018)



Source: JP Morgan. S&P 500, 10-Year Treasury Bonds.

Also, consider the threat of a trade war. Economists are mostly unified in the position that more trade is better than less trade and limiting trade poses a risk to economic growth. While the market seemed to initially worry about Trump's potential to kick off a trade war, an actual trade war seems remote. Finally, stock-specific headlines usually do not tank the market. As a result, we do not see today's headline as worrisome enough to trigger a bear market.

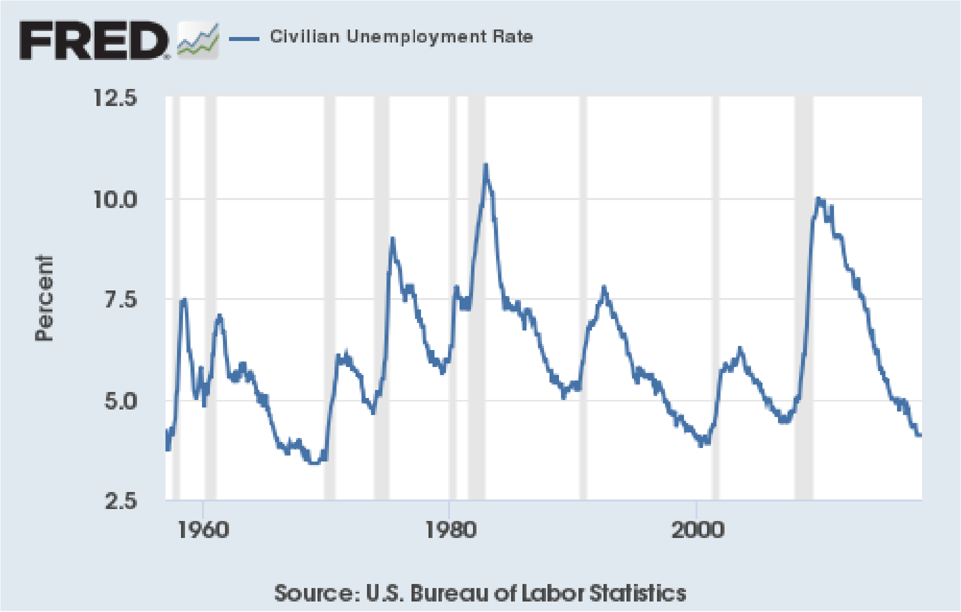
We are keeping an eye on longer-term risks. In our January 2018 commentary, we highlighted four risks to the stock market:

1. High stock valuations;
2. Rising interest rates;
3. Rising credit spreads;
4. Negative yield curve.

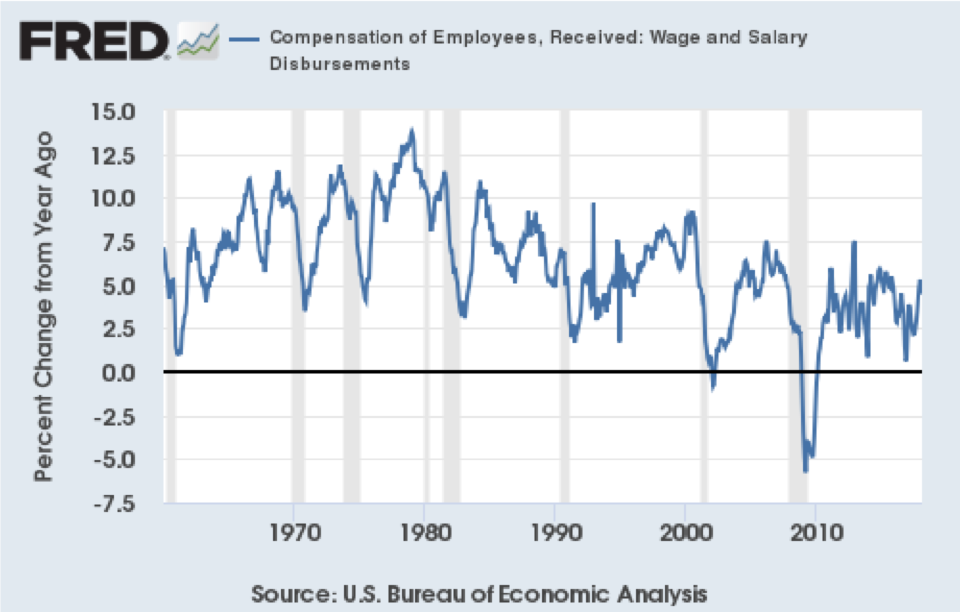
Our view remains that while each of these risks poses a longer-term threat to the market none are problematic at this stage in the economy. On the contrary, we believe we will first see an acceleration of economic growth that encourages higher market valuations, credit expansion, and eventually Federal Reserve intervention; ultimately setting the stage for a drawn out market decline.

In the meantime, the stage is set for a pick-up in economic growth. For example, consumers represent approximately two-thirds of the economy and are in solid shape.

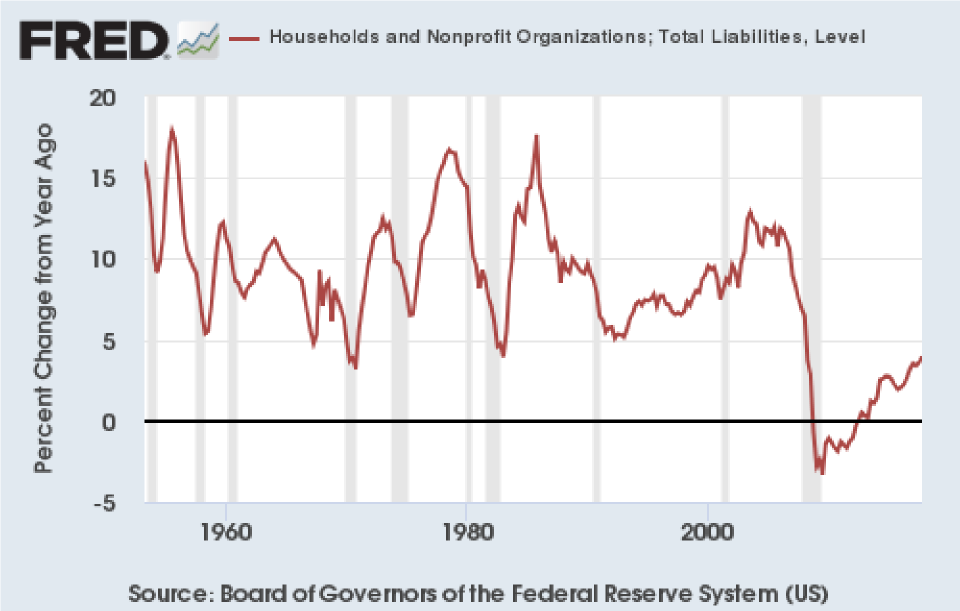
People are getting paid: Unemployment Rate is Low



…and getting raises (wages are rising)



…setting the stage for credit expansion (household borrowing growth is below average)



Further, consider businesses now have a new incentive to invest in physical capital given the tax break on repatriating foreign profits and the ability to expense capital expenditures.

The net effect is the stage is set for a pick-up in economic growth in our view. While the market is considerably expensive on some metrics, it is more reasonable based on others:

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.4x	16.1x	0.1
CAPE	Shiller's P/E	32.8	26.5	1.0
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	2.9	2.9	0.0
P/CF	Price to cash flow	12.0	10.7	0.7
EY Spread	EY minus Baa yield	1.5%	-0.2%	-0.9

Source: JP Morgan, Guide to the Markets March 31, 2018

In conclusion, we continue to believe 2018 is presented with a reasonable set of circumstances that are consistent with normal positive market returns plus continued volatility. However, we may be entering an upswing in economic activity which would be consistent with rising interest rates and the final phase of a long market expansion. Market participants may be tempted to time the market based on less significant headline risks thereby putting their long-term strategic investment strategy at risk. As a result, it is a good time to re-evaluate your current investment strategy and ensure long-term strategic asset allocations remain an important part of your approach to investing.

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