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RDM FINANCIAL GROUP

Market Update
February 16, 2018

Over As of this writing, the market is now back in positive territory for the year. With the recent market decline (which occurred over just 9 trading days), the widely watched S & P 500 has now experienced a decline of 10.1% off of its prior January 26th all-time high. For reference, this represents the 7th correction of 10% or more since the market bottomed back in 2009. The last time this happened was back in early 2016, when fears of weak economic growth and problems in China dominated the headlines. While a market pullback from time to time should not be all that surprising, it is the sudden nature of the recent market decline and shift in sentiment that has grabbed market headlines.

Now that we have experienced a market correction (for the first time in more than a year), does that mean that everything will be smooth sailing from here? We can't be sure, but what we can tell you is that looking at the big picture, consumer and business confidence appears healthy, liquidity conditions remain positive, corporate profits are rising and the U.S. and global economy appears to be on pretty solid footing. Bond yields are currently rising due to positive global growth along with a modest uptick in inflation. For reference, the U.S. 10 Year Treasury yield currently stands at about 2.9% (versus a yield of 2.40% to start the year) and a 20-year average of around 3.70%.

Turning to inflation, there are several different inflation gauges that investors watch over time. Focusing on the widely watched Core Consumer Price Index (Core CPI) which dates back to the 1950's, inflation has been pretty well behaved over the past 20 years or so (see chart on page 2 – source: Factset).

On February 14th, the monthly CPI inflation report was released and core inflation rose 0.3% month over month versus expectations of an increase of 0.2%. On a year over year basis, core CPI inflation currently stands at 1.8% compared with a reading of

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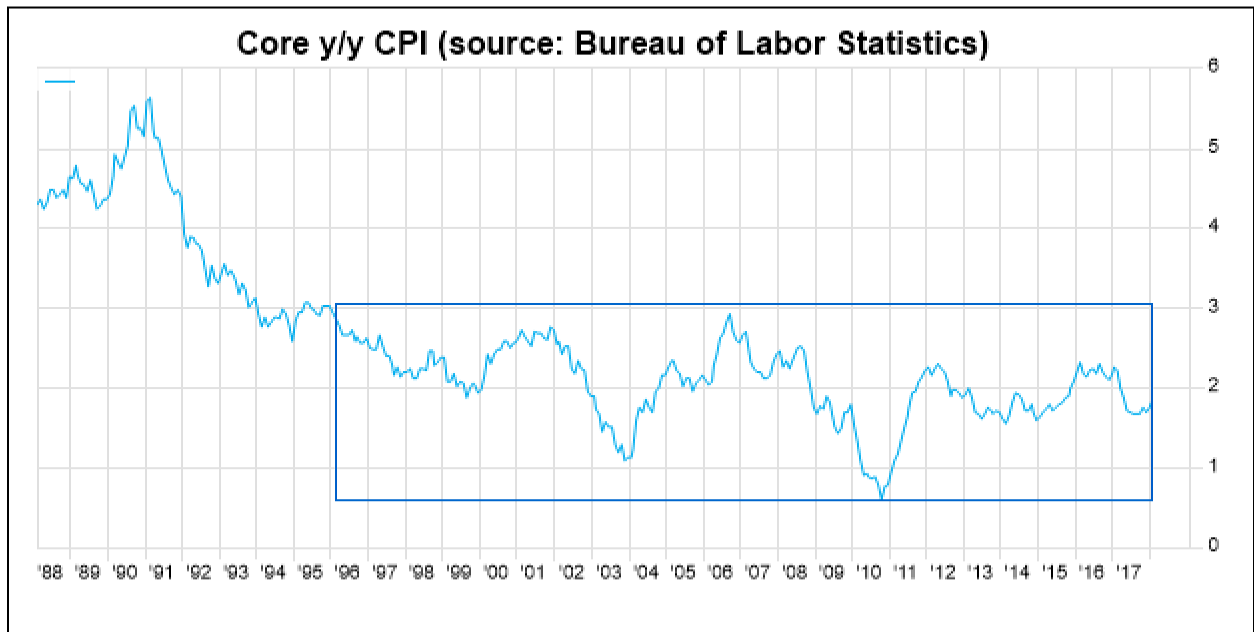

1.8% last month. This hardly seems like a big concern. However, if you take the last three months and annualize that data (which provides a better idea of what may lie ahead), it indicates that inflation data has been stronger, rising at a 2.9% annual rate.

Why does this matter? This is one of many inflation indices that the Federal Reserve Bank monitors but if it continues to rise, this could lead the central bank to tighten policy more aggressively than investors expected. Right now, three rate hikes seem reasonable in 2018 with a fourth rate hike a possibility. We recognize that inflation is rising somewhat as the economy continues to improve. However, powerful forces including globalization, technology innovation and a historically low rate of union membership (for example) are likely to prevent runaway inflation that might truly roil the bond and equity markets.

Looking back, recent volatility can be traced to a number of factors: some investors got involved in risky securities that allow you to bet against volatility, financial markets have started to adjust to an environment of rising rates and less central bank stimulus, wages and inflation may finally be moving somewhat higher after several years stuck at very low levels, there is talk that risk parity funds (that target a certain level of volatility) were forced to sell stocks and rebalance their holdings, and rapid trading from quant funds likely contributed to the violent market swings that we experienced over the past week or two. Lastly, simple profit taking given the fact the market advance has gone on so long

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without even a short-term pullback may have also played a role in the recent down draft.

An important fact of investing is that market corrections (in the range of 10 – 20%) commonly occur throughout the course of bull markets. On average dating back to 1948, there has been about one every 1.3 years (source: American Funds). According to S & P, we recently experienced the 22nd correction since WWII. Based on data from S & P, market corrections have led to an average 14% decline in the market that took a median (i.e. have took longer and half were shorter) of 98 days to complete. The typical correction has required 84 days to get back to breakeven. According to Sam Stovall, Chief Investment Strategist at S & P, when a market correction occurs in less time than the average correction (like the current period), it also takes less time for the market to fully recover. We think (but cannot be 100% sure) that this will be the case this time around.

At the end of the day, we are watching a number of different economic and market indicators for signs that the worst may be behind us. While we can't be 100% confident that there may not be more downside in coming weeks, by watching timely key economic indicators such as weekly jobless claims, new orders from manufacturers, corporate credit spreads, consumer and business confidence levels and earnings revisions (which all look pretty healthy), we can monitor economic and market fundamentals to determine if the economy remains on track.

While the stocks side of our portfolios has recovered right in line with the equity markets, we believe our shining star so far this year has been the performance of our fixed income portfolios (both individual bonds and fixed income funds). While the stated current price of our individual bonds has certainly declined as a result of rising bond yields in recent days (due to the historically inverse relationship between interest rates and bond prices), unlike pooled vehicles like ETF's and traditional bond mutual funds, our individual bonds have specific maturity dates. Thus, we know the yield to maturity (or yield to worst if a bond is callable) at the time of initial purchase. Therefore, recent swings in prices are not material to your long long-term rates of return. In fact, rising rates allow us to purchase additional bonds with higher yields as bonds mature within your fixed income bond ladder.

In addition to owning individual bonds, virtually every fixed income portfolio at RDM Financial owns a basket of six carefully selected bonds funds. While that may sound like a contradiction, it isn't. First, we felt that given the low interest rate environment,

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that investing in very short-term bonds as part of the ladder would provide almost no net benefit for client portfolios (bond yields are just too low to make a difference on the short end). Second, we want to have assets available that are liquid to take advantage of new investment opportunities. Third, owning a basket of fixed income low duration bond funds provides us with liquidity so that we are not forced to break a bond (i.e. sell individual bonds before maturity) when clients might need additional cash.

In terms of managing the fixed income side of your portfolio, it is an important part of our strategy that we not be forced to sell individual bonds before maturity (note: we may sell bonds from time to time to upgrade the quality of your portfolio when the opportunity arises.) It is clear that the investment strategy we follow on the fixed income side is more time consuming. However, we feel it is the safer, more prudent and right thing to do for our clients.

In summary, the liquidity driven bull market (whereby central banks around the world purchased trillions in assets) of the past several years may now be behind us. This simply reflects the fact that the economy (both here and abroad) is on better footing now and no longer needs the kind of emergency measures that were previously in place. Instead of central bank stimulus programs, equity market returns are increasingly going to be driven by improving business fundamentals.

We view the recent market downturn as a temporary correction that occurs from time to time in the course of equity bull markets. A majority of the market's decline is likely behind us at this stage but it may take additional time (and possibly somewhat lower prices) before the market fully recovers back to its prior January 26 all-time high. Looking ahead, volatility levels are unlikely to fall back to the unusually low levels that we experienced for much of 2017, but they should subside from the recent spike that we experienced.

While the recent market decline was scary and unnerving to some, we believe the economic backdrop remains constructive for now and that equity markets are likely to grind higher in the months ahead.

Interest rates are likely to continue moving higher reflecting positive economic growth and somewhat higher inflation.

Eventually the markets will start to focus on potential problems including rising deficits, higher interest rates and ultimately, the end of the current

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business cycle. However, we believe these are problems for investors to focus on down the road.

As always, feel free to reach out and give us a call with any questions you may have.

Respectfully,

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Index Disclaimer:

The S & P 500 is widely regarded as the best single gauge of the U.S. equities market. The S & P 500 focuses on the large-cap segment of the market and includes a sample of 500 leading companies in leading industries throughout the U.S. economy.

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