HIGHTOWER
RDM FINANCIAL GROUP

MARKET UPDATE
MARCH 28, 2018

Unlike 2017, equity markets have experienced more ups and downs in the early part of this year. As we head towards the end of the first quarter of 2018, we wanted to provide you with a brief update on our thoughts regarding the economy and the markets. We will be sending you a more detailed market update over the next few weeks. As of this writing, the broad-based S & P 500 is down just under 2% on a year to date basis, the Russell 2000 small capitalization index is down about 1% and the Nasdaq market (full of technology stocks) is still in positive territory since December 31st (all on a total return basis). Overseas, the MSCI EAFE Index (Europe, Australasia and the Far East) is down just under 5% while the MSCI Emerging Markets Index has posted a gain of about 2% year-to-date.

So, this is not a blowout in the markets unless you are just reading the headlines. One of the problems we face is that the media finds it more exciting to highlight either the very best or the very worst statistics they can use as headlines. Yes, this kind of financial news coverage is more dramatic, but this is not the way we choose to manage your accounts.

At the end of the day, the primary reason an individual stock is priced at a certain level is based on a company's earnings. While our job includes making informed decisions on where we think the economy and the markets are headed, it is really company fundamentals and the outlook for corporate profits that matters most.

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We still believe that the global economy is growing and that more recently, tax legislation in the U.S. should provide a boost for economic growth over the next few quarters. Trade wars and geopolitical concerns are real but we believe these issues are likely to get resolved before too long. As we have often said, trying to time 5% or 10% moves in the market is fraught with more risks than we are prepared to take. Thus, at least for now, we plan to stay fully allocated.

Unlike 2017, when volatility remained extremely low and we experienced just eight 1% one day moves in the S & P 500 (4 on the upside and 4 on the downside), so far this year there have been more than 20 days with 1% market moves. This is more in line with the historical average of the past several decades. Looking at the list of headwinds that we currently see, there has been additional turnover in the Trump Whitehouse (note: the departure of Gary Cohen as an economic advisor to the president has not helped), 10-year interest rates have moved higher in early 2018 (breaking out above the range of approximately 2% to 2.6% that we saw in 2017), the Fed has signaled that more rate hikes are likely over the next couple of years and trade wars are now a growing threat to market stability.

In the short term, our biggest concern is that U.S. tariffs lead to a wider global trade war that threatens global economic growth and financial market stability. In reality, countries like China have more to lose than the U.S. So, we think there will be a negotiated settlement. We remain optimistic that cooler heads will prevail, and at this point we really don't know how far the Trump administration is willing to go. President Trump's recent decision to order around $50 billion in tariffs on a wide range of Chinese imports, despite the risk of setting off a wider trade war, reflects growing disillusionment with China that they will provide a level playing field when it comes to international trade. So far China has responded with tariffs of just $3 billion dollars. However, if China retaliates further, which is certainly possible, that could hurt a wide range of U.S. companies such as Apple, Ford and Boeing (for example) that sell goods overseas. According to wall street analysts, China plans to buy about $1 trillion of Boeing's aircrafts over the next two decades.

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Our thinking right now is that the Trump administration is pushing China (and other countries) as part of his hardnosed negotiating tactic, trying to extract more favorable (in many cases fairer) trade terms to help reduce our ever-growing trade deficit. Ironically, if Trump is not successful and more countries retaliate against the U.S., the president could end up hurting some of the voters that actually helped elect him to become president. From our perspective, all parties simply have too much to lose to get caught up in an extended trade war.

Last weekend there were some hints that bilateral negotiations could pay dividends. The Wall Street Journal reported that at the China Development Forum, its Vice Commerce Minister expressed hope that the U.S. and China might be able to negotiate their trade dispute. U.S. Treasury Secretary Mnuchin told Fox News that while the Trump administration is pressing ahead with tariffs, it was hopeful of reaching a deal on trade and access to Chinese markets. Like other investors, we are unclear on how this will ultimately play out so we are keeping a close eye on things.

Overall, we believe that there is still likely much more time left in the current economic cycle and bull market. Turning to the U.S. economy, we believe that the economic backdrop remains positive. U.S. Treasury yields are historically low (but rising somewhat reflecting healthy underlying economic growth), the Federal Reserve Bank continues to normalize short term rates, corporate profits are growing solidly (thanks in part to recent tax legislation), inflation has moved up modesty (but remains at historically low levels) and economic data overseas continues to look relatively healthy. Short term economic data points that we monitor include the monthly leading economic index, the Federal Reserve Bank's lending conditions, weekly jobless claims, earnings revisions, credit spreads, consumer and business confidence levels and manufacturing orders, which all currently appear pretty healthy.

Earlier this year, the International Monetary Fund (IMF) raised its economic growth forecast for the world's developed and emerging markets (source: World Economic Outlook Update, January 22, 2018). According to the IMF, emerging markets are currently forecast to

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grow 4.9% in 2018 and 5.0% in 2019 compared with 4.7% last year. Developed markets including the U.S. are currently forecast to grow 3.9% in both 2018 and 2019 compared with an increase of 3.7% last year. So importantly the world continues to grow in early 2018.

We will certainly be watching the Federal Reserve and its impact on the economy. Historically when the central bank increases short term rates and they rise above long-term rates (called a rate inversion), this has led to a recession with a lag of a few quarters up to about two years (source: Factset). Right now, the short-term Fed Funds rate is about 1.75% and the U.S. Treasury 10 Year Yield is about 2.80%. This spread (2.80%-1.75%) is about 100 basis points. If the Federal Reserve Bank continues to raise short term rates in the quarters ahead (as currently forecast) and the spread between short and long-term rates continues to move towards 0%, this will become a growing concern.

On a more positive note, research from Merrill Lynch (RIC Overview, March 13, 2018) indicates that during the final 12 months of the Federal Reserve Bank's last 5 rate hiking cycles equity markets (based on the S & P 500), the market generated average annual gains of 18% per year with a perfect track record. Granted this is not a very large sample size but it is still encouraging. The data is not surprising because when you think about it, the central bank typically raises rates when economic activity is positive, corporate profits are rising and the economy is growing (similar to the environment today).

Historically, it's not until the Federal Reserve Bank stops raising rates that things start to turn more uncertain. In the 12 months following the central bank's last rate hike, equity markets have historically gained an average of 10% per year. However, market returns have been more mixed with equity markets posting gains 60% of the time and declines 40% of the time. There are always a number of different moving parts to evaluate (i.e. business and consumer confidence levels, the employment outlook, credit conditions etc.) but we believe that the Federal Reserve Bank plays a key role in the outlook for the economy and financial markets over time. We sense that the central bank will be data driven and will move cautiously over the next several quarters.

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Looking closely at market internals we are starting to see some clues that the selling may let up soon. For example, last Friday the put-call ratio for option prices hit its highest level in two years, there were $20 billion in ETF outflows, the VIX volatility index was roughly half the level it touched at the market lows in early February and fewer stocks hit 20 day lows last Friday compared with on February 6, 2018 (source: Strategas Research). Also, importantly, high yield credit spreads remain largely range bound, having only widened out by about 45 basis points over the past several weeks. Market conditions remain fluid and we will keep an eye out for further changes.

In summary, over the near term, financial markets are likely to take their cue from the White House and trade policy. Unfortunately, this means equity markets are likely to remain choppy until we see greater clarity. S & P 500 corporate profits for the first quarter of 2018 (due out in a few short weeks) are currently forecast to rise about 19% on a year over year basis (source: Factset). This could lead investors to focus back on fundamentals (which have been pretty positive over the past several quarters). Before the recent escalation in trade issues, the U.S. (and global) economy appeared to be on pretty solid footing with a low probability of a recession over the next few quarters. This is still our base case but we will need to monitor global economic conditions more closely in the months ahead.

Right now, the current market decline looks like another test for the markets along the lines of several that have come before throughout the current 9-year old bull market. If the markets are to rebound on a sustained basis, it will be important to see greater individual company and market sector participation over the next few months (note: it can't just be technology stocks going up).

There have been plenty of reasons to run to cash over the past several years but we remained invested which was the right strategy to follow for our clients. Repeated buying and selling (even if you can correctly time market movements on a consistent basis) has tax implications which can negatively impact a client's long-term rate of return. We are not saying that the strategy we have followed the past several years will always be right so we need to remain flexible.

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Our fixed income strategy is working well. We have talked before about our approach of laddering corporate bonds with a majority of our client's fixed income assets while combining that with a mix of strategic multi-sector bond funds (for liquidity and dry powder). Our better performing portfolios on a year to date basis are those that have equity and fixed income together. Our strategic bond funds continue to perform well so far this year. Compared with advisors that simply focus on bond funds (with lots of duration risk), we believe that we are following a prudent approach to fixed income investing.

Finally, having the right asset allocation is an important part of the overall investment process that helps investors ride out the inevitable ups and downs that come with investing. As we have said many times before, emotions are often the biggest detriment to achieving long term economic success. We believe that sticking to the appropriate asset allocation is a solid strategy for the long term.

Looking longer term down the road we remain optimistic. The world continues to grow, a large percentage of the population in emerging markets are moving out of poverty towards the middle class and new products and technologies will help expand and reshape consumer and business spending over time. However, there will also be some challenges ahead. We remain watchful regarding our nation's growing budget and trade deficits, geo-political hot spots around the world, the fact that valuation levels remain above trend and that the we may face some added uncertainty as the world's major central bank's start to unwind trillions of dollars in asset purchase programs. These issues could lead to periods of economic and market volatility that will need to be monitored in the future.

As always please give us a call if you have any questions.

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