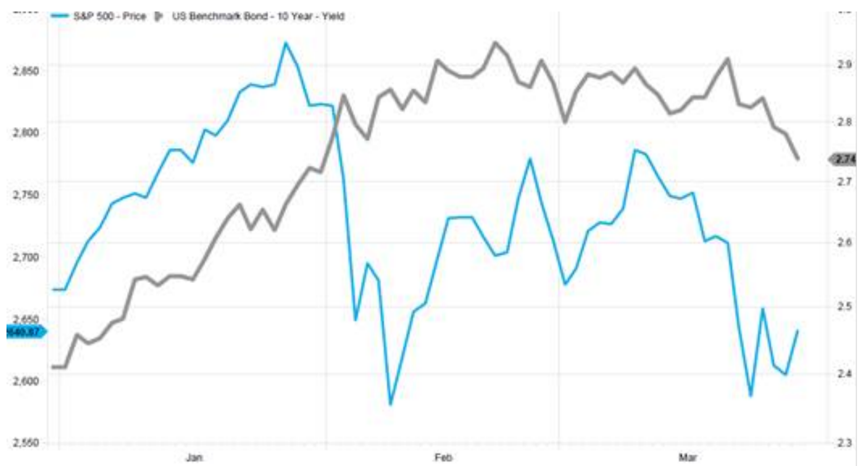
Investment Update

First Quarter 2018

The steady ascent in stock prices throughout last year steepened in January, with the S&P 500 setting records in 14 of 21 trading days. The interest rate of the 10-year Treasury increased from 2.4% at the beginning of the year to near 3% by mid-February leading to price declines for the quarter. The upsurge in major stock indices crested in late January and then broke into a sell-off that ultimately saw the S&P 500 drop almost 12% over the following ten trading days.



After rebounding, the S&P 500 ended the quarter down around 1% with the index registering 23 daily moves of greater than 1%. The return of volatility was jarring after the nearly fifteen months of quiescent trading since the 2016 elections, but it was actually the lack of volatility during that time that was exceptional. Our friends at DataTrek Research calculated that the S&P500 has averaged 53 1%-plus moves per year (or more than once per week) since 1958, while 2017 only saw eight. Importantly, heightened volatility is not necessarily associated with market declines. Over that longer period, the market ended higher during two-thirds of the years with an above average number of 1%-plus moves.

The Initial Drop The report on wage inflation at the end of January heightened concerns that employers were starting to have to increase wages with unemployment low, fueling acceleration in overall price inflation. While rising wages would generally qualify as good news, the potential for more rate increases from the Federal Reserve than previously forecasted, and uncertainty about how the Fed will operate under new chair Jerome Powell sent the stock market down. In the midst of the slide that followed, no one appeared to be suggesting that company fundamentals were deteriorating. Rather, market participants seemed to be suddenly reconsidering the appropriate valuation level to assign to earnings in what was likely to be a higher inflation and interest rate environment going forward.

Equity Markets (Total Returns)	1Q18	1-Year
Dow Jones Industrials	-2.0%	19.4%
S&P 500	-0.8%	14.0%
S&P Mid-Cap	-0.8%	11.0%
S&P Small-Cap	0.6%	12.7%
MSCI All-Country World	-0.8%	15.7%
MSCI Foreign Developed Markets	-1.9%	14.5%
MSCI Foreign Emerging Markets	1.4%	24.9%
US Bond Markets	**1Q18**	**1-Year**
Barclays US Gov't/Credit Intermediate	-1.0%	0.4%
Barclays US Gov't/Credit Long	-3.6%	5.1%
BAML Municipal Intermediate	-0.7%	1.1%

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We would observe that market pundits often stretch to ascribe a narrative to the daily action in the stock market where one does not necessarily exist, or where hindsight might prove the case to be different. Much of the selling over the ten day drop actually appears to have been driven by the unwinding of trading strategies predicated on a lack of volatility. The sudden increase in volatility caused these strategies to indiscriminately sell positions, which created more volatility and yet more sales.

Late Tech-Driven Fade Large technology companies have significantly outperformed the market for several years. There is a general sense that their products or services are supported by long-term secular demand trends and will be less affected by the normal economic cycle as a result. For this reason, money has flowed in to their shares in times of market dislocation as other traditional safe haven sectors like healthcare and consumer staples face their own secular headwinds. However, in March, a collection of company-specific issues at the likes of Facebook and Amazon led to significant 15-25% pullbacks in some of the largest technology companies in the world. Inasmuch as the sector is by far the largest in the S&P 500 at about 25% of market capitalization, its volatility has an outsized effect on the index to both the upside and downside.

The Rest of 2018 As measured by the price/earnings ratio, US stocks are less expensive to start the second quarter than at the end of last year. Prices have dropped while companies also continue to issue strong guidance for future earnings. Many will report a one-time increase in earnings due to last year's change in the tax code, and analysts continue to project 2019's to be about 10% % above this year's. Even with a compression in market valuation, the predicted strength in earnings growth should generally support prices in the market.

Geopolitical tensions in Asia, which have weighed on investors sentiment from time to time, seem to be thawing recently. The Olympics and Paralympics were conducted in South Korea in February and March and expectations had long since been that there would be at least a temporary suspension in the threat of hostilities, just as weapons were put down for the ancient Olympics. The detente seemed to be taken one step further as the two Koreas marched together in the opening and closing ceremonies under a common flag, and fielded a joint women's hockey team (although it was not very good). Since then the North Korean leadership has met with South Korean and Chinese leadership, and we may soon see a meeting with ours.

While less damaging than the military sort, worries about trade wars have been the dominant consideration in the markets over the last few weeks. After the election, we said that the realization of the President's most protectionist campaign rhetoric would be a distinct negative, and of late it has resurfaced. Some sanctions have been imposed by China and the US, although they affect a small percentage of overall trade between the two countries. We are hopeful that this will all result in all parties coming together at the negotiating table to achieve a balanced approach to trade going forward.