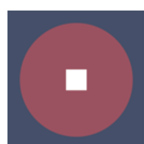

LongView
ASSET MANAGEMENT

2018 First Quarter Review and Outlook

After two years of unusually calm and steady gains, stock market volatility has returned. The US and most international stock markets rose sharply in January before seesawing through February and March to end the quarter lower. While the year-to-date declines were unremarkable—the S&P 500 index lost only -0.76% since December 31st—the markets' gyrations understandably captured investors' attention. The S&P 500 Index rose or fell by more than 2% on six days during the first quarter, compared to *zero* such moves throughout the whole of 2017, and dropped over -10% from its all-time record high set on January 26th. With the Bloomberg Barclays US Aggregate Bond Index declining -1.46% and 10-Year Treasuries -2.39%, bonds provided little comfort. Emerging markets stood out as one of the few areas of cheer for investors.

A number of factors contributed to market reversals and the jump in volatility. Low unemployment and a ballooning US budget deficit have raised concerns that inflation will become a problem. If so, interest rates could rise more quickly, curbing economic growth. The new Federal Reserve Chair, Jerome Powell, is perceived to be more "hawkish" than Janet Yellen, and is more likely to push for higher rates in order to dampen inflationary pressures. The Fed raised short-term rates by 0.25% in March, the 5th such increase since 2015, with three more increases expected this year.

Trade tensions have also impacted markets. After announcing tariffs on steel and aluminum imports, the Trump administration exchanged escalating tariff threats with the Chinese government as well as with longstanding US allies. The President's hot rhetoric has been walked back by other officials but has nonetheless prompted concerns of a global trade war. The resignation of chief economic advisor Gary Cohn, Secretary of State Rex Tillerson, and other moderating voices in the administration, has only added to uncertainty.

In addition, technology stocks that have led the US market upward over the past several years were battered. Revelations about the exploitation of personal information on social media platforms to influence elections increases the likelihood that Facebook, Google and other companies will face increased regulation in the US, as they already do in Europe. Production snags at Tesla, and tweet attacks on Amazon by the President, added to the gloom in tech.

Portfolio Notes

In our equity portfolios, emerging markets and small cap companies were the primary contributors to returns. The largest detractors were developed international markets and interest rate-sensitive REITs. Superior credit quality (resulting from our sale of high-yield bond funds last year) and shorter maturities helped our bond holdings outperform their benchmark. Our alternative strategy funds, meanwhile, performed exactly as per their mandate, generating small gains during a period when other asset classes were down.

Outlook
As we pointed out in our year-end letter, the world economy has maintained its slow but dogged expansion. Domestic unemployment is at historically low levels and wage growth is finally picking up as labor scarcity increases competition for skilled workers. Corporate profits—already robust—have gained momentum from last year's tax cuts. Most indicators point to stronger growth overseas, particularly in emerging markets. Manufacturing output continues to expand in both developed and emerging nations.

Like the Federal Reserve, the European Central Bank and Bank of Japan have begun the process of raising interest rates to more normal levels. Higher rates have not yet materially impacted borrowing or spending, and inflation remains subdued. Nevertheless, the normalization of rates has resulted in heightened volatility as investors take a more critical look at market valuations and longer-term growth prospects. We believe that this period of adjustment in markets is likely to continue.

One positive outcome of recent market declines is that equity valuations that were above long-term averages have returned closer to normal levels as stock prices have fallen and company earnings have risen. Also significant is that, with short interest rates rising, cash is beginning to look attractive for the first time in years.

In his first 15 months in office, the President's rhetoric has been much more extreme than his administration's actions. The steel and aluminum tariff announcements were quickly reframed to exempt key allies and it will be months—possibly not until after November's elections—before specific policies are put in place. Risks have increased, but the current tensions could prove to be more tariff skirmish than trade war.

To put recent volatility in perspective, the S&P 500 has had an average intra-year drop of -13.8% since 1980. Over this thirty-eight year period, the index provided positive returns in all but six years and posted an average annual gain of +11.8%. These returns include the crash of 1987, the dot-com bubble of 2000-2002 and the financial crisis of 2008. The clear lesson is that investors are rewarded for remaining invested.

Unfortunately, most individuals do not capture those returns. A 2017 Morningstar study showed that the average US investor in diversified equity mutual funds had gained 15% less than the average mutual fund. In fixed income funds, the average investor return was almost 20% lower[1]. This illustrates the actual *cost* to investors of moving in and out of funds in the attempt to time the markets.

We have no doubt that investor optimism will be tested in 2018 by geopolitical uncertainty and a chaotic and unpredictable administration in Washington DC. In this climate, caution would seem to be the order of the day. We have taken steps to raise the quality and shorten the duration of our bond holdings. Our equity portfolios are widely diversified across both domestic and international markets. Our alternative strategy funds should continue to provide stability and a degree of insulation from rising rates. We have conviction in our approach and its ability to deliver attractive returns over time despite the regular, inevitable periods of stress.

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[1] For the 10-year period ending 12/31/16, the average diversified US equity mutual fund had an annualized return of +5.15%, compared to the average investor return of +4.36%. The annualized gain in fixed income funds was +3.72%, compared to the average investor return of +2.99%.

Please don't hesitate to contact us with any questions you may have. We wish you a beautiful Spring and thank you as always for your trust.

David Cantor

Harlan Flint