First Quarter 2018 Market Newsletter Summary

- Volatility returned to the markets in the first quarter of 2018.

- Historically, volatility has been a part and parcel of the markets. The recent drawdown is well within historical norms.

- Economies and corporate earnings are strong around the world.

- Inflation, interest rate, trade and political uncertainties could weigh on the markets.

- Investors should not time the market or make hasty changes to the portfolios based on macro and economic news flows.

- Constructing a well-diversified portfolio with superior investment products and staying invested in the market is the best approach.

.

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	-0.76%	-0.76%	13.99%	10.78%	13.31%
S&P Mid Cap 400	-0.77%	-0.77%	10.97%	8.96%	13.11%
S&P Small Cap 600	0.57%	0.57%	12.68%	10.76%	13.56%
MSCI Emerging Markets	1.47%	1.47%	25.37%	9.21%	5.37%
MSCI EAFE	-1.41%	-1.41%	15.32%	6.05%	6.98%
Investment Grade Credit (C0A0)	-2.19%	-2.19%	2.68%	2.35%	3.03%
Non-Investment Grade Credit (H0A0)	-0.90%	-0.90%	3.69%	5.18%	5.01%
Bloomberg Commodity Index Total Return	-0.40%	-0.40%	3.71%	-3.21%	-8.31%
Dollar Index (DXY)	-2.33%	-2.33%	-10.34%	-2.93%	1.63%
Vanguard Total Bond Market Index (VBMFX)	-1.49%	-1.49%	1.01%	1.01%	1.62%
10 Yr Rate	2.74% 03/31/2018	2.45% 12/31/2017	1.79% 03/31/2017	1.93% 03/31/2015	1.85% 03/31/2013

Source: Standard and Poor's, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of April 2, 2018			
	Latest Release	Recent Trend	Notes
Non Farm Employment	313,000	Positive	February non farm payroll was strong and much higher than consensus. Previous month's numbers were also significantly revised up. Wage growth was less than expected and alleviated fears of inflation. Unemployment was steady at 4.1%.
Weekly Claims for Unemployment Insurance	215,000	Positive	Claims is at the lowest level in 45 years reflecting a strong labor market.
ISM Manufacturing Index (Number over 50 points to growth)	59.3	Positive	After hitting the highest level in 14 years last month, the index eased a bit, but is still very strong. All underlying components were strong.
ISM Non Manufacturing Index (Over 50 points to growth)	59.5	Positive	Like manufacturing, the services sector is very healthy.
Consumer Prices (Month over month change)	0.2%	Positive	Inflation is still subdued. Fears of inflation, which rose in February after the job's report showed rising wage growth, has been alleviated to some extent. Year over year inflation is 2.2% overall and 1.8% excluding the volatile energy and food inflation.

	Latest Release	Recent Trend	Notes
Producer Prices (Month over month change)	0.2%	Positive	Like consumer price inflation, producer price inflation is subdued.
Retail Sales (Month over month change)	-0.1%	Negative	A strong job market, high consumer confidence and the recent tax cuts is not translating into retail spending. The good news is that year over year, retail sales is still up a healthy 4%.
Consumer Confidence (Conference Board)	127.7	Positive	Consumer confidence eased a bit last month, but is still very high.
Durable Goods (Month over month change)	3.1%	Positive	This was much better than expected. Core capital goods (After removing defense and aircraft sales) was also up a healthy 1.2%. This had been one of the weak areas of the economy for a while and is now exhibiting strength.
Industrial Production	1.1%	Positive	Industrial production grew better than expected in February. Most underlying components were strong especially manufacturing which was up 1.2%
Capacity Utilization	78.1%	Positive	Capacity utilization jumped up 0.7% and could be worrying for inflation.
Housing Starts	1.236MM	Positive	Housing starts fell noticeably last month, however the 5 month average is still positive.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.8%	Positive	Home prices have grown 6.4% from last year. Prices firmed up especially in the west.
GDP (Real, Annualized)	2.9%	Positive	After several revisions, fourth quarter 2017 GDP seems reasonably strong.

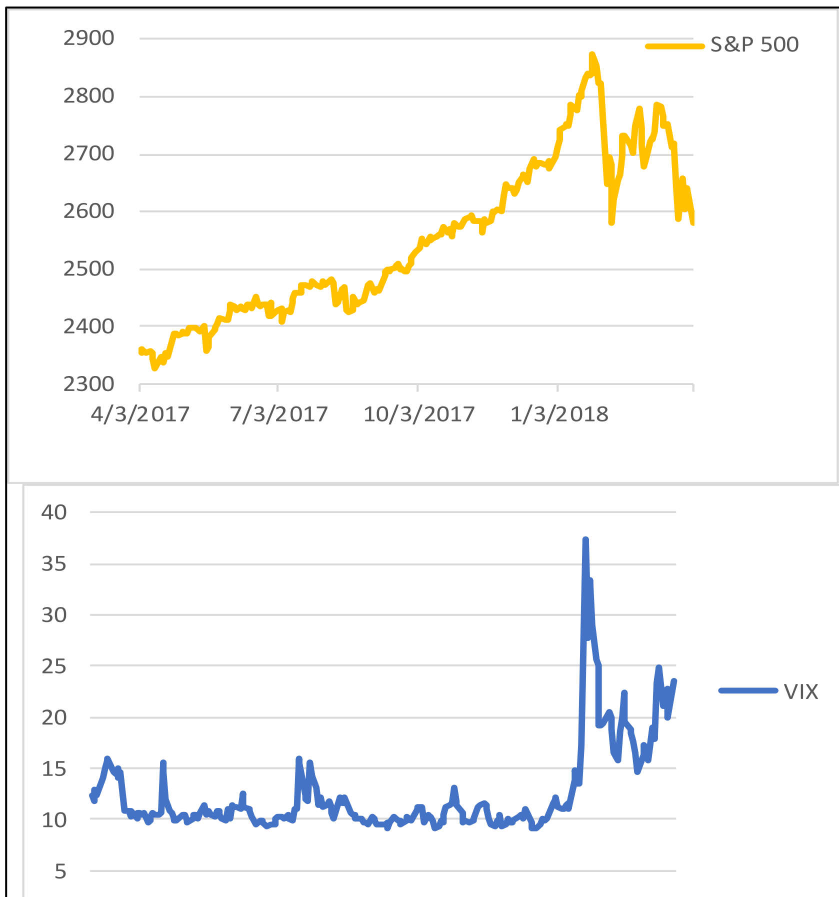
Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

Stocks started the year with the best performance in 31 years on optimism about the economy and corporate earnings and took investor sentiment to euphoric levels. However, volatility returned to the market in late January and by the end of the quarter, large capitalization stocks in the US and other non-US developed markets were down a notch year to date. Smaller capitalization stocks and emerging markets stocks rose marginally. Bonds fell as interest rates rose and credit spreads widened.

The change in the behavior of the market between last year and this year has been dramatic. Figure 1 illustrates it well. Last year, the 'Teflon market' relentlessly made new highs unworried by any bad news, but since the end of January a host of reasons transformed the market into a 'nervous Nellie'. As we have noted before, last year's tranquil market was an exception and this year's volatile market is more the norm. As seen in figure 1A, as per calculations by Factset, historically the market has experienced a correction i.e. a drop of 10% or more, 55% of the time. A correction of between -10% and -20% has occurred 43% of the time. Interestingly, in years when the market falls by 10% or more, most of the time (74% of the time to be precise) it bounces back into positive territory by the end of the year.

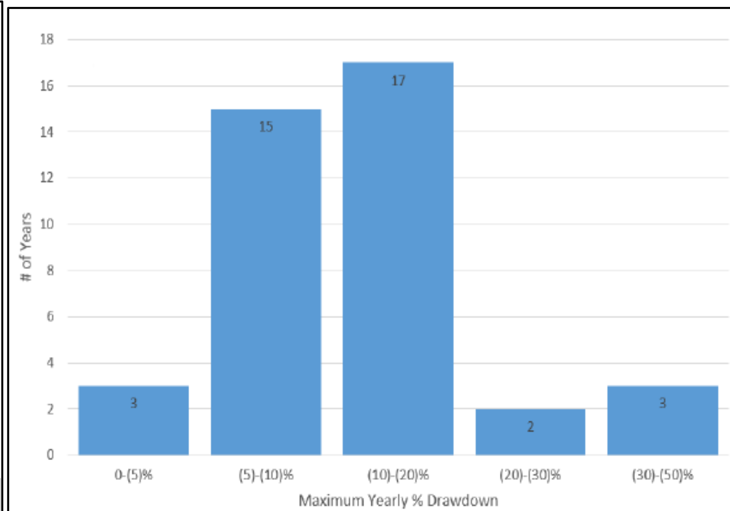
The January jobs report released in early February showed wages growing at a healthy clip. Markets, which had been worrying about a lack of inflation for the last few years, now worried about an increase in inflation and the possibility that the Federal Reserve (Fed) would have to increase interest rates more than expected to keep it under control. (An increase in interest rate is usually bad for stocks, all else being equal). Stocks fell sharply in early February and stock volatility as measured by the VIX index spiked up. Leveraged investment products that had sold short the VIX index and automated/machine trading that usually sell into a falling market, probably further exacerbated the situation.

Fig 1 : S&P and Volatility (VIX)



Source: Standard and Poor's, Chicago Board of Option Exchange.

Fig 1A: Historical market corrections



Source: Calculations by Factset

Just as markets were recovering from the initial bout of volatility, the Trump administration announced tariffs on steel and aluminum imports followed by trade measures against China, leading to fears of a trade war. A trade war can lead to a drop in international trade which can adversely affect global growth. Historically, tariffs have not had the intended positive effect for the country imposing it. For example, when the US raised steel tariffs in 2002, the US gross domestic product (GDP) fell by $30MM and the US lost 200,000 jobs (including 13,000 in raw steel making) according to the US International Trade Commission.

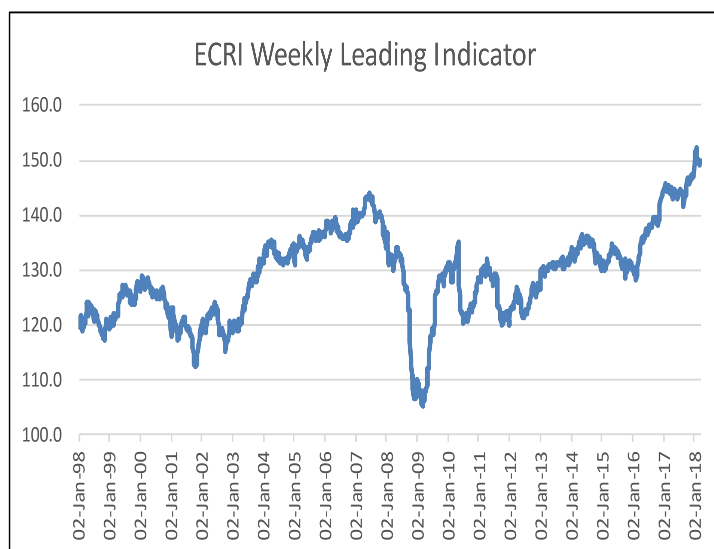
Subsequent actions by the President in exempting countries such as Canada and Mexico from the steel tariffs and reports of behind the scene negotiations between the US and China allayed fears of a full-blown trade war. We haven't seen a trade war in 90 years and there are good reasons to believe we may not see one anytime soon: Increasing globalization, longer and interconnected supply chains, experience with the fallout of a trade war (during the depression) and the

availability of the WTO to resolve trade disputes. However, trade tensions do present a real risk to the market and could lead to continued volatility until it is fully resolved.

Finally, concerns about user data privacy caused stocks such as Facebook and Amazon to drop sharply and the entire technology sector fell in sympathy. The user backlash and raging debate about the responsibility of these companies to protect user data is likely to bring tighter regulation. Facebook is already making several changes to the way it collects and shares consumer data. Markets are rightly concerned about how it would impact the profitability of these companies that thrive on user data for targeted digital advertising. However, the degree to which the entire sector fell, even stocks like Microsoft for example, which accounts for only about 4% of digital ad revenue, is a bit extreme. After the indiscriminate selling, technology sector valuations are modest. (See below).

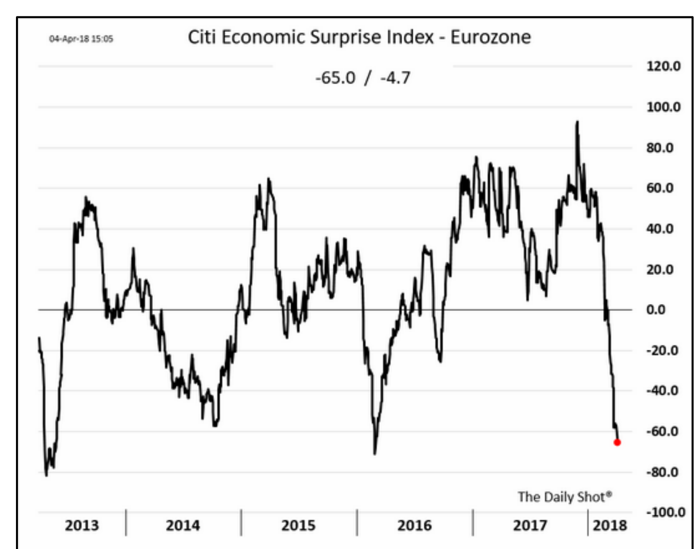
While, it is impossible to predict which way markets will immediately go from here, the underlying economy and corporate earnings are strong. As seen in Table 2 above, almost all areas of the economy are healthy. The one area that has recently been a bit soft is retail sales that came in lower than expected last month. However, on a year over year basis, retail sales look much better having grown a healthy 4% since last year. Overall, the economy is expected to continue to grow as reflected in the ECRI weekly leading index (Figure 2)

Fig 2 : ECRI Weekly Leading Indicator



Source: ECRI

Fig 3: Citigroup Economic Surprise Index- Eurozone



Source: The Daily Shot by the Wall Street Journal

Earnings of companies in the S&P 500 index grew by14.8% in the 4th quarter of 2017 over the same period the year before. This was 4.4% better than what wall street analysts had forecasted, as per Factset. Companies also delivered an impressive 8.2% growth in sales, which was the best performance since the 4th quarter of 2011. This is significant as readers may remember that for years companies were improving profitability by improving margins but were unable to grow revenues. The strength in corporate earnings is set to continue in the first quarter of 2018 as companies in the S&P 500 are expected to report earnings growth of 17.3%, the highest rate since the first quarter of 2011. Analysts' earnings expectations have been revised higher since December 2017 when the expected earnings growth rate was only 11.3%. Ten sectors have higher growth rates today (compared to December 31) due to upward revisions to estimates. This is different from the recent past, when analyst's earnings expectations were revised down over time and suggests positive momentum in corporate fundamentals.

During the first quarter, analysts were revising earnings estimates upwards even as the market was falling- as a result, stock valuations have moderated significantly. The S&P 500 index is now trading at a 12-month forward P/E ratio of 16.4, down from over 18 earlier in the year. At this level, it is trading close to its 25-year average. (Figure 3). Technology,

Healthcare and Telecom sectors are trading below their 20-year average P/E (P/E is the Price to earnings ratio, a measure of valuation of stocks - the lower the better) (Table 3).

Table 3: Sector earnings growth and valuation

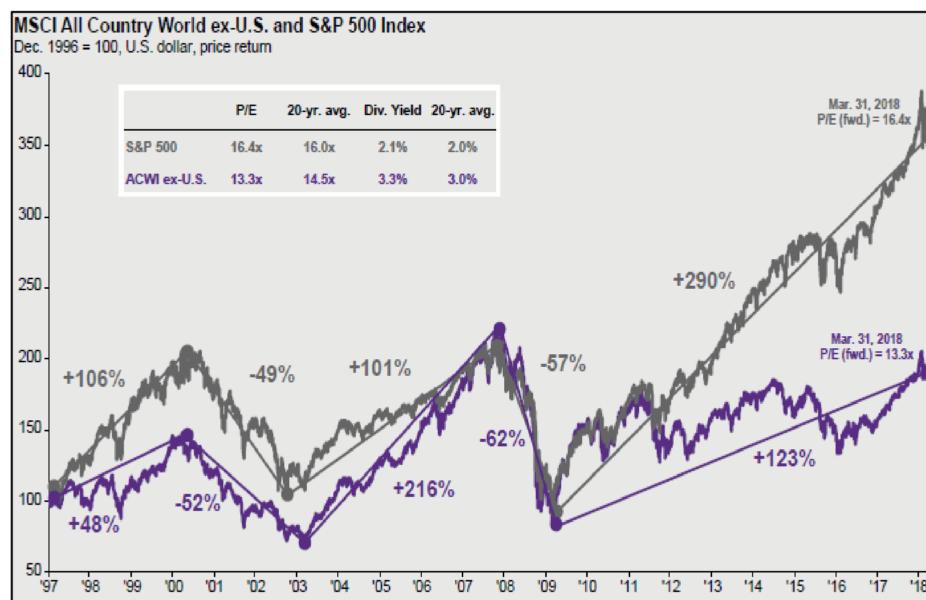
	Financials	Materials	Real Estate	Industrials	Cons Discret.	Technology	Energy	Healthcare	Cons. Staples	Telecom	Utilities	S&P 500
Earnings Growth	24.0%	22.8%	4.4%	19.0%	14.2%	27.2%	39.0%	13.2%	13.3%	16.9%	7.8%	19.9%
20 year average	5.3%	8.6%	2.7%	6.5%	9.3%	9.3%	10.7%	9.0%	5.7%	2.8%	2.5%	6.0%
Forward P/E Ratio	13.0X	15.9X	16.9X	16.9X	19.7X	17.9X	19.6X	15.3X	17.3X	10.5X	16.2X	16.4X
20 year average	12.8X	14.0X	15.2X	16.3X	18.0X	20.9X	17.6X	17.4X	17.1X	16.4X	14.2X	16.0X

Source: Factset

Economies outside the US are also in good shape, although recently economic indicators have come in a bit softer than expected. The Citigroup economic surprise index has dropped below zero for the Eurozone (Figure 3). There are a few short-term reasons for the slowdown such as weather-related factors, stretched supply chains causing production bottlenecks, a stronger Euro hurting exports and the usual seasonal slowdown. However, the overall momentum of the global economy is still positive. Leading economic indicators for the Euro are rising as seen in Figure 5 and Global Purchasing Manager's Index (A manufacturing index) is over 50 in almost all the regions indicating that global manufacturing is growing. Both, the OECD and the IMF have revised upwards their forecast of global economic growth for 2018 as seen in Figures 6 and 7.

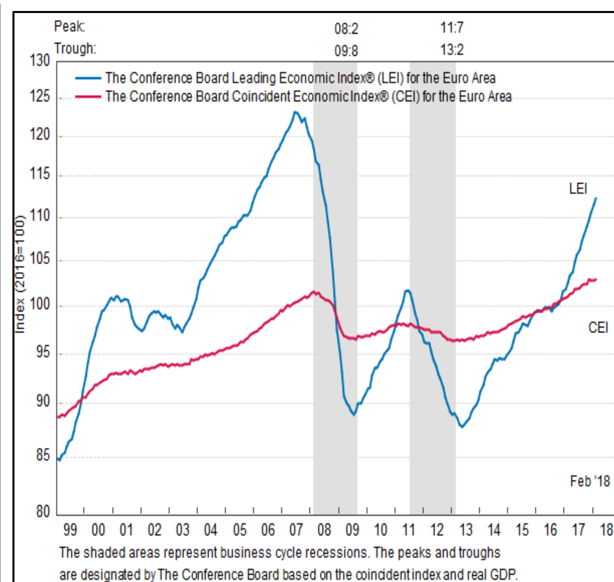
Global corporate earnings are growing nicely and while there are fears that US earnings may have peaked, Emerging Markets and European earnings are still below prior peaks set in 2011 and 2007 respectively, which could mean there may still be some room for growth. Non-US stock are reasonably value at 13.3 time forward 12 months earnings, which is below the 25-year average of 14.5 times. (Figure 4)

Fig 4: MSCI All Country ex-US and S&P 500 Index



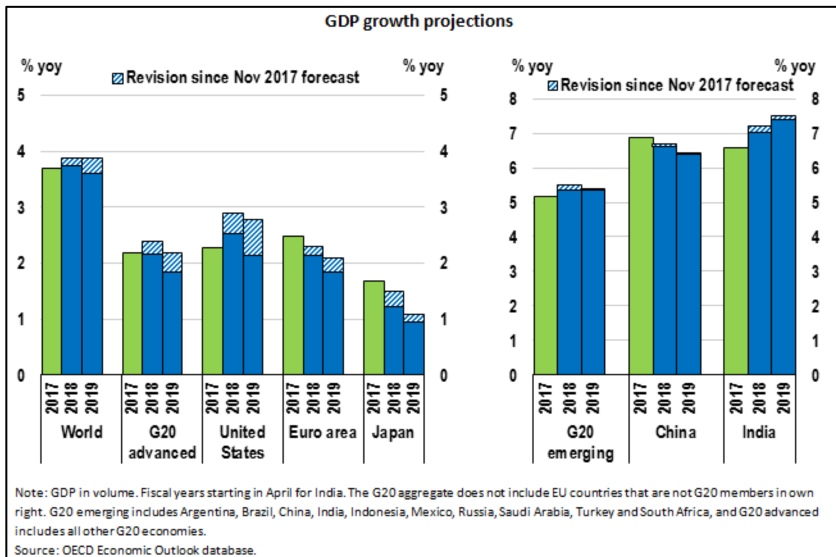
Source: JP Morgan: "Guide to the Markets"

Fig 5: Leading Economic Index: Euro Area



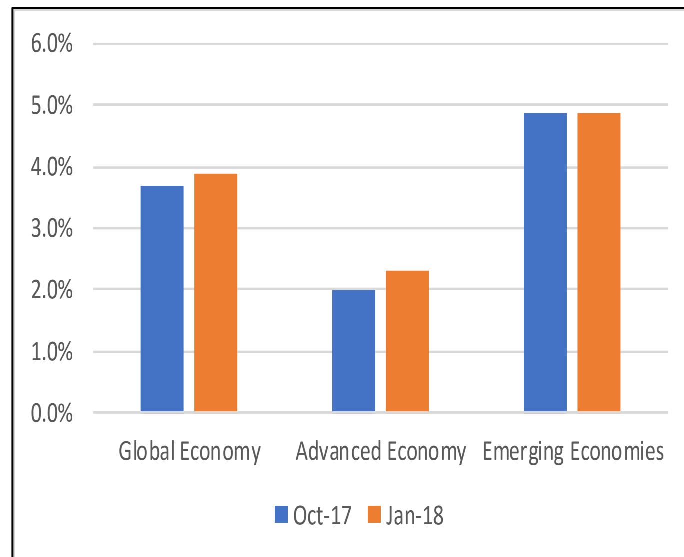
Source: Conference Board

Fig 6: OECD World Economic Growth Projections



Source: OECD

Fig 7: IMF World Economic Growth Projections



Source: IMF

What we are doing

We are not economic forecasters and we do not make changes to the portfolio in response to every piece of economic and political news that comes out. We however, pay attention to the general economy and if possible attempt to add value at the margins based on our investment outlook and portfolio positioning. At present, based on the financial and economic indicators that we follow, we do not believe that a recession is at the horizon, although it seems that we are in the late stages of this economic cycle. However, there is no standard length of time that late stages of the economy last. Further, stocks appreciate considerably towards the end of the bull market. In fact, historically the final 12 months have accounted for 20% of the total bull market returns as per calculations by Bloomberg.

The markets may remain volatile until there is clarity about the inflation, interest rate and political factors that was discussed earlier in this newsletter. Volatility is an uncomfortable experience and investors are tempted to time the market to avoid it. As we have discussed numerous times in the past, we have a very unfavorable opinion of market timing and believe that it is value destructive. A better approach is to stay invested in the markets using a diversified portfolio that is constructed based on client objectives and using superior investment products.

Disclaimer: Sarsi LLC ("Sarsi") is a Registered Investment Advisory Firm regulated by the State of New Jersey in accordance and compliance with applicable securities laws and regulations. Sarsi does not render or offer to render personalized investment advice through this newsletter. The information provided herein is for informational purposes only and does not constitute financial, investment or legal advice. Investment advice can only be rendered after delivery of the Firm's disclosure statement (Form ADV Part II) and execution of an investment advisory agreement between the client and Sarsi.