Quarterly Commentary

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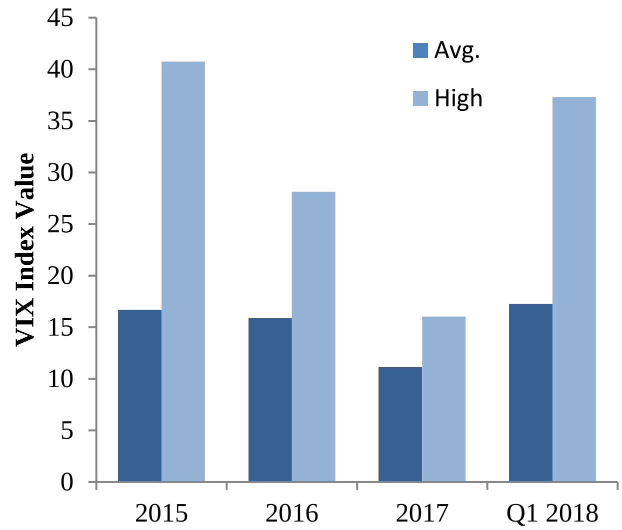
First Quarter 2018

On the back of positive momentum from the recently passed Tax Cuts and Jobs Act, as well as continued strength in confidence surveys for both businesses and consumers, capital markets began the year on strong footing. Risk assets, both in fixed income and equities, generally performed well with the S&P 500 off to its best start in decades through the month of January. In typical fashion, interest rates climbed as investors favored higher return asset classes, driving total returns for fixed income benchmarks into negative territory. As the quarter progressed, euphoria began to fade and was replaced by fears of higher rates stunting growth, central banks stepping away from the tremendous liquidity they have provided, and protectionist policies that could potentially result in trade wars between countries. By the end of March, asset gains had mostly reversed and were now underwater for the year. For fixed income investors, the move higher in rates was only partially unwound, resulting in returns of -1.46% for the quarter as measured by the Bloomberg Barclays U.S. Aggregate Bond Index.

A strong start to the year

As mentioned earlier, the year began with investors having a number of items to cheer about. It was anticipated that tax reform would make corporate America more competitive globally, boost capital expenditures, and increase employee wages. With higher wages and lower personal taxes, consumers could maintain, if not increase, the strongest yearly pace of retail spending since 2012 according to the U.S. Census Bureau. Additionally, fourth quarter corporate earnings easily topped analyst estimates and first quarter 2018 expectations were revised significantly higher according to FactSet Estimates. As more credence was given to firming inflation, fixed income investors had to contend with a sharp increase in Treasury yields by roughly 40 basis points. Almost all spread sectors outperformed their Treasury benchmarks during the month as risk premiums narrowed, with lower-rated and longer-duration securities benefiting the most.

Exhibit 1: The first quarter saw an increase in volatility from abnormally low levels as investors witnessed large price moves in the equity markets



Source: Bloomberg

Too much of a good thing

Once the books were closed for January, it appeared the narrative surrounding economic releases was taking on a more worrisome tone, possibly the result of fresh peaks in valuations. Now, and unlike earlier in the year, higher rates were a cause of concern that could jeopardize corporate profitability and stunt growth. In his first congressional testimony as the new Fed Chair, Jerome Powell's comments were taken as being more hawkish than his predecessor and investors started considering the risk of four rate hikes in 2018 and the potential for an inverted yield curve – typically a recession warning sign. Normally, constructive commentary from a central bank official would be cause for celebration, but these are not normal times. With broad-based global growth, central banks are in the early stages of unwinding their balance sheets, taking away the vast amounts of liquidity investors have enjoyed since the Financial Crisis. Adding additional concerns were the tariff announcements by President Trump stoking fears of a potential trade war between the U.S. and its trade partners.

Finally, economic data started pointing to a moderation in consumer spending and growth from the levels of late 2017.

These altered perceptions resulted in volatility increasing from unusually low levels and stock markets experienced a number of large point declines – one of which being the largest daily decline in history. In fixed income, spread sectors could not keep pace with corresponding Treasuries with lower-rated and longer-duration bonds now faring the worst. Surprisingly, interest rates only retraced about 10 basis points of the increases seen in January, perhaps due to expectations of the higher supply needed to fund the deficits from tax reform.

Where does this leave us?

The quarter may have ended on a sour note as investors took pause to reevaluate the changing landscape, but we believe the economic outlook remains intact. Confidence measures are still high, manufacturing and non-manufacturing surveys remain well into expansionary territory, and the economy continues to make progress towards full employment. Tax reform should put more wealth in the hands of both consumers and corporations and further extend this long running expansion. Yet, market volatility could be a consistent challenge as fiscal and monetary policies distort market channels. Will foreign investors continue buying US assets in the face of increased hedging costs, negative U.S. dollar returns, and more competitive rates at home? Will threats of tariffs and other protectionary policies result in renegotiated agreements or escalate into a full scale trade war? Will higher rates from increased supply impact growth and investor demand for fixed income or will demand from pension funds protecting their improved funded status place a ceiling on rates? Only time will tell, but we are in the late innings of the credit cycle and market gyrations should be expected that can create windows of opportunity.

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