HIGHTOWER
VWG WEALTH MANAGEMENT

1st Quarter 2018 Review

The S&P 500 Index began the year jumping quickly out of the gates, gaining +7.4% in only 18 trading sessions. This surge in investor sentiment and strong money flows quickly reversed, proving the speed and slope of this ascent unsustainable. The benchmark for U.S. large stocks then plunged -10.2% in 9 days, ending February 8! From there the index staged a decent recovery, only to falter into the quarter's close. The S&P 500 lost -1.0% for the quarter, its first losing quarter in the last 10. In only four other periods in its history has the S&P 500 Index equaled or exceeded 9 consecutive positive quarters.

Most equity indices fared better, while experiencing similar volatility. U.S. small stocks, measured by the Russell 2000 Index, lost -0.2%. The MSCI EAFE Index, a measure of international stocks in developed economies, fell -0.9%. The MSCI Emerging Markets index continued its recent positive run, belying fears of protectionist tariffs. It rose +2.5% for the quarter. The exception was the EuroStoxx 50 Index, composed primarily of blue-chip multinational corporations headquartered in Germany, France and Italy. It dropped -6.7%.

Downward moves also occurred throughout bonds, adding to the market disruption. The yield of the 10-year U.S. Treasury Note rose from 2.43% to 2.94%, then backed off to 2.74% at quarter's close. This led to the Barclays Aggregate Bond Index losing -1.5% for the quarter. The Bloomberg Barclays High Yield Bond Index fell -1.5%, and the S&P National Municipal Bond Index dropped -1.3%.

Short-term interest rates rose in tandem, sparked by the yield of the 2-year U.S. Treasury Note increasing from 1.91% to 2.25%, further flattening the 2/10 yield spread. This added to volatility by raising concerns about the length of our current economic cycle, and of the ability for financial institutions to deliver expected earnings growth. With this move, the yield of 2-year U.S. Treasury note surpassed the S&P 500 dividend yield for the first time since 2008!

Crude oil's strength in the 2nd half of 2017 continued in the 1st quarter, reflecting firm demand, controlled inventories, and a bit of inflation concerns. The NYMEX West Texas Intermediate Crude continuous futures contract gained +7.5%. Copper pulled back after a strong 2017, with the NYMEX High Grade Copper continuous futures contract falling -8.2% for the quarter. The NYMEX Gold continuous futures contract edged up +1.3%.

Just as Spring Follows Winter, Some Volatility Eventually Returns to Markets

While remaining positive on equities and other "risk on" assets in our last three quarterly commentaries, we have warned of potential dangers lurking under the surface. We have cautioned that:

- A prolonged low volatility period can also result in excessive risk taking.
- Clients should not be further increasing their allocations to stocks, particularly richly valued, high profile, large U.S. growth stocks.
- Because of the S&P 500 Index's positive performance over the past five years (and coincident richer valuation), the expected forward return for large U.S. stocks was lower.
- The market's complacency towards unsettling global macro events, and erratic U.S. policy and leadership, was cause for concern.
- Some inflationary pressures were building in the U.S. and internationally. These, combined with the start of gradual liquidity reductions, had the potential to unsettle unprepared bond and equity markets.
- The time to incorporate some protection and defense into portfolios is when it is out-of-favor and inexpensive, not later when uncertainty and volatility rises.

Lastly, in our February client newsletter, we highly recommended that everyone read "The Four," by Scott Galloway. One of the book's primary themes is that Amazon, Apple, Facebook and Google's redefinition and dominance of today's world should be subject to heightened criticism, due to their engaging in unfair business practices, tax avoidance schemes, and personal privacy compromises.

All of these chickens came crashing to roost during the 1st Quarter of 2018. The fact that they all conspired to quickly change the complexion of the markets was not a surprise to us, following more than two nicely positive years in large U.S. stocks amidst historically low levels of volatility. We witnessed:

- A sharp rise in U.S. interest rates and LIBOR spreads, accompanied by tightening labor markets, inflation concerns, and a widening projected federal deficit.
- An extreme "melt-up" move in equity sentiment and money flows in January, leading to a two day 1840 point drop in the Dow Jones Industrial Average at February's start, and a "blowout" in the CBOE Market Volatility Index.
- A flurry of top U.S. administrative departures and resignations, including the Secretary of State, the National Security Adviser, and the Director of the National Economic Council.

- Global trade tensions, marked by the U.S. imposition of import tariffs, fanning fears for the sustainability of the current synchronous economic expansion.
- Late March's second push down in equity markets, highlighted by negative headlines at Facebook, General Electric and Tesla, leading to a correction in the previously invulnerable large technology market leaders.

Moving into the 2nd quarter, where do things stand? VWG Wealth Management remains positive on stocks and other "risk on" assets as long-term investments. Global economic and corporate earnings positives enjoyed over the past year are still firmly in place. First Trust's Brian Wesbury expects U.S. tax reform and regulatory relief to provide a tailwind for profits in the quarters ahead. He also pushes back on rising interest rates as being a negative. He states that "despite the rise in the yield of the 2yr U.S. Treasury Note, short term interest rates remain far below normal, relative to the level of economic growth (GDP) currently enjoyed." Famed strategist and economist Dr. Ed Yardeni concurs, stating "I suspect that neither analysts nor investors have fully discounted the big windfall the Tax Cut and Jobs Act will provide to corporate bottom lines." He believes that stock buybacks and dividend increases could get a lift from significant repatriated earnings.

History also supports our stance. Dan Clifton of Strategas Research Partners points out that "the average midterm election year correction in the U.S. stock market is 18%, but these often end up being buying opportunities. The S&P 500 Index has not declined in the 12 months following a midterm election year since 1946!"

We expect bouts of market unrest. The extreme calm of the past two years was an anomaly, and is not likely to be repeated soon. Although the action of U.S. stocks has been recently unsettling, market volatility (measured by the S&P 500 Index average daily trading range) is just moving back to its long-term average *(Chris Verrone, Strategas Research Partners).*

It is also very possible that the U.S. economy and corporate earnings outperform the stock market this year. Equity markets have outperformed the real economy since the Federal Reserve instituted quantitative easing, and as it ends the reverse could occur. In the six calendar years 2012-2017, S&P 500 aggregate earnings grew +4.0% per year *(NYU Stern School of Business).* In the same period, the S&P 500 Index (including dividends) returned +15.7% per year. Wide outperformance of stocks compared with earnings cannot persist indefinitely.

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Portfolio Strategy and Asset Positioning

Although many commentators have unsuccessfully called for a pullback over the past 18 months, no one ever enjoys a market correction when it occurs. Such is the same present condition. Anxiety is heightened, perhaps justified by the news headline or tweet du jour. Some investors feel compelled to react or "do something" in response. Unfortunately, patience and "doing nothing" is often the most prudent course. After such a long, relatively effortless rise in markets, we suspect more corrective time and uncertainty will be required, with some purging of weaker hands.

Therefore, as always, diversification is called for. This includes holding some cash and/or stable short-term bonds as "dry powder" should conditions worsen. Within equities, we recommend some trimming into strength for those clients aggressively positioned. We will also average into equities during periods of weakness for those underweighted. All investors can consider swapping some long equities into partially hedged strategies and risk defined structured notes. Adding to small U.S. stocks (without becoming overly allocated to equities) makes sense to us. These underperformed in 2017, and they may be better positioned to benefit from U.S. corporate tax reform, while being a bit more insulated from trade skirmishes. And in bonds, we will add to short duration strategies, and will increase allocations if we see 3.1% or more on the 10-year U.S. Treasury Note.

We also continue to advocate discriminating use of niche private real estate and other boutique strategies and managers for appropriate long-term investors. We believe that these could provide differentiated returns with the potential of outperforming publicly-traded stocks and bonds.

Best wishes to our clients and friends for a sunny, rejuvenating spring season!
We'll look forward to speaking with many of you soon.

Regards,

VWG Wealth Management

Suzanne, Ashley, Rashmi, Lynette, Michelle, Christina, Justin, Amanda, Sarah, Patricia, John, Rick and Jeff

** Index Data Sourced from FactSet Research and Morningstar*

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