

First Quarter Review

2017 was marked by abnormally low volatility and a slow melt up in the equity markets that seemed to carry over into 2018. After posting a 22% return in 2017, the S&P 500 rose another 7.5% in the first 3 weeks of 2018. The smooth ride did not last, as domestic markets experienced a short but sharp market correction which saw the market temporarily decline 10% over just nine trading days. U.S. stocks then rebounded through mid-March, clawing back the majority of losses before dipping slightly again as the quarter came to a close. After it was all said and done, the S&P 500 finished slightly lower for the quarter, a surprising feat considering how vulnerable the market looked in the middle of February.

U.S. Markets:

The S&P 500 posted its first down quarter since the third quarter of 2015, losing 0.76%. Prior to this past quarter, the large cap benchmark saw gains in 19 of the last 20 quarters dating back to the beginning of 2013. This included gains in 15 consecutive months, a streak that was broken in February of this year.

To further illustrate the shifting market environment, at the close of the quarter we had already seen 13 losses of 1% or worse. This is in sharp contrast to 2017, when we saw just four 1% down days over the entire year.

Even with the increased volatility, U.S. stocks declined only modestly on higher interest rate and inflation expectations in addition to concerns over the impact of new trade tariffs. Returns for shares of growth-oriented companies outpaced more value-oriented stocks, which continued a theme we've witnessed for some time now. Economic data was mostly positive, with labor market and retail indicators showing improvement.

Foreign Markets:

Developed foreign markets also got off to a strong start early in the year, only to experience similar losses to U.S. stocks during the sharp correction in early February. For the quarter, developed international markets were down roughly 1%. Emerging market stocks held true to their higher-volatility reputation, shooting up 11% to start the year, falling 12% during the mid-quarter correction, and finally outgaining both U.S. and developed international stocks by posting a 1.15%

return for the quarter. European stocks declined amid investor worries about a global market sell-off, rising U.S. interest rates and a strengthening euro. Stocks fell despite signs of ongoing improvement in the euro-zone economy, including healthy gross domestic product growth and a declining unemployment rate. Emerging markets stocks rose for a fifth consecutive quarter, helped by steady economic growth in China and other developing countries, higher oil prices and a weaker dollar. It was the only major equity index to finish in positive territory.

Fixed Income Markets:

Domestic core bonds were down roughly 1.5% in the first quarter, as interest rates continued to tick upward amidst inflation concerns and the Fed choosing to raise the federal funds rate for the sixth time since December of 2015. Municipal bonds yielded similar returns, losing 1.26% for the quarter. Global bonds fared much better, providing a positive 1.13% return. U.S. Treasury bonds tumbled as interest rates climbed on higher inflation expectations. With the Federal Reserve launching its first rate hike of 2018, the yield on the benchmark 10-year Treasury note climbed 34 basis points to end the quarter at 2.74%. Corporate bonds and mortgage-backed securities also lost ground. The European Central Bank and the Bank of Japan held rates steady, even as their respective economies continued to show signs of significant

<i>Asset Class</i>	<i>1Q</i>	<i>1 Year</i>	<i>5 Years (Ann.)</i>
U.S. Large-Cap	-0.76%	13.99%	13.31%
U.S. Large Growth	1.93%	19.69%	15.37%
U.S. Large Value	-3.57%	7.69%	10.87%
U.S. Small Blend	0.57%	12.68%	13.56%
Developed Int'l Stocks	-1.00%	15.92%	7.14%
Emerging-Markets Stocks	1.15%	23.97%	4.41%
REITs	-4.86%	0.86%	5.55%
Investment-Grade Bonds	-1.49%	1.16%	1.77%
Municipal Bonds	-1.26%	2.12%	2.23%
High-Yield Bonds	-1.13%	2.61%	3.59%
Global Bonds	1.13%	5.85%	1.43%

improvement. The U.S. dollar declined against the euro, the British pound, the Japanese yen, and most other currencies.

Q1 & the Return of Volatility:

The return of volatility was the big story of the quarter, as the S&P 500 index suffered its first 10% correction since January 2016.

This correction was driven by several factors, including inflationary/Fed fears, the short volatility unwind, and good old-fashioned human emotion in response to the first substantial sell-off in two years. Heightened concerns that the Fed would quicken its pace of rate hikes after a bigger than expected increase in wages was the primary catalyst that drove the stock market correction in late January through early February. Though not the root cause of the correction, the sell-off intensified because of a complicated and crowded trade where investors essentially bet on volatility staying low. Once volatility began to increase in late January, many market participants who had aggressively expressed that view were caught on the wrong side of the trade. We believe the market disruptions from the unwinding of short volatility trades are largely behind us, though we continue to expect periodic bouts of market volatility from unforeseeable sources over the course of 2018.

In addition to worries about rising interest rates and inflation expectations, talk of potential trade wars and tariffs sent developed markets reeling at various times throughout the quarter. Obviously a significant shift in trade policy could have dramatic unintended consequences, so we remain cautious and on alert for potential risks. Our (somewhat idealistic) hope here is that recent trade tensions may lead to fairer and still-free trade, in which countries show greater willingness to protect intellectual property, modernize trade agreements, and reduce non-tariff barriers.

Looking Forward:

Another observation about the market correction in February is that it was caused not by indications of an economic slowdown or recession, but by fears the economy may be getting a bit too strong, with a tight labor market finally causing rising wage growth and broader inflationary pressures. Fundamentally,

even after the correction, the U.S. economy and global economy still look solid. Global growth may no longer be accelerating, but it remains at above-trend levels and the likelihood of a recession over the next year or so still appears low (absent a macro/geopolitical shock). The global economic and corporate earnings growth outlook has not materially changed from what it was earlier in the year. The near-term macro back-drop is still supportive for riskier assets such as global stocks, even though the U.S. economic recovery is getting long in the tooth.

As we have consistently pointed out in previous writings, we cannot predict what will happen next – whether interest rates will continue to rise, what global events will occur, or what our President may say or do tomorrow. Even if we could, we would not be able to consistently predict what the consequences would be for equity and bond markets, as the global economy is a highly complex system with a seemingly infinite number of variables constantly interacting with one another. We therefore choose to direct our energy and attention towards much more important objectives, such as aligning clients' portfolios with their most important long-term goals, risk tolerance, and cash flow situations.

Over the long-term, global market volatility will provide opportunities to rebalance client portfolios to ensure they remain in-line with our target asset allocations. We strive to remove emotion from this process, allowing us to effectively sell high, buy low, and capture returns in a calculated, thoughtful manner.

Big Picture Focus:

Although the 10% market correction proved to be very short-lived, it provided a reality check for investors in terms of testing their true risk tolerance as compared to a hypothetical risk questionnaire or an initial discussion with their financial advisor. To the extent you were paying attention to the markets and your portfolio during that nine-day period: how did it feel to see the value drop by that magnitude? If it was starting to cause heavy discomfort or stress, that's probably a sign that we should revisit the amount of risk you are taking in your portfolio. As we pointed out in our year-end letter, stock market corrections of 10% or more in any given year are perfectly normal, with the average intra-year decline in the S&P 500 sitting at 14% over the last 40 years. We think this is

a reasonable expectation for the future as well, and is why stocks are called “risky assets.” In exchange for their higher long-term expected returns, you must be willing and able to ride out inevitable periods of decline. Our mission is to make this a reality for our clients by helping them avoid overreacting to market events both negative and positive, while maintaining a laser-focus on each client’s long-term objectives.

As we alluded to in our previous year-end newsletter, we will continue to practice the principles of long-term investing that have reliably produced favorable results over time: planning; a rational optimism based on experience; patience and discipline. These principles remain the pillars of our investment advice in 2018 and beyond.

As always, we appreciate your confidence and welcome questions about your individual portfolio or financial situation.

-We thank you for your continued support!