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U.S. Financial Markets
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Stock Market Development

US equities began 2018 strongly, supported by increasing strength in economic data, robust earnings and the passage of a major tax reform. GDP for Q4 2017 was revised upward to 2.9%, and industrial activity, although somewhat slower, continued to indicate economic expansion. However, during the latter part of the quarter, elevated inflation fears and escalating US-China trade sanctions led to increasing turbulence in the market. Technical factors have an outsized effect on markets, because many computer-based trading programs buy and sell massive quantities of stocks when events, like a technical breach of a moving average, occur. Furthermore, corporate America, the biggest source of demand for stocks and, as shown during the rout in February, a stabilizer for the market, is not permitted to buy their own shares five weeks before and two weeks after quarterly earnings releases which start this month. The S&P 500 Index ended the quarter down 0.7% and also down 10% from its high on 01/26/18. In the long run fundamentals will win over short term driven market movements. Most industry sectors were down, but the weakest performance was in telecommunication and consumer staples, technology and consumer discretionary were the only positive sectors over the quarter.

Fixed-Income Market Developments

Performance in the fixed-income markets has been decidedly negative across the board in the first quarter of 2018, as the impact from rising interest rates and widening credit spreads have taken their toll. The US Treasury yield curve continued to flatten modestly, with shorter maturities impacted by interest rate increases and substantial new issuance in March. Ten-year yields rose from 2.41% to 2.74%, reaching a high of 2.95 % in February, five-year yields from 2.21% to 2.56% and two-year yields from 1.88% to 2.27%. Corporate bonds underperformed treasuries and investment grade bonds underperformed high yield bonds. In a Q1 marred by wild swings in equity and credit markets, corporate high yield debt performed remarkably, with the Bloomberg Barclays U.S. High Yield Bond Index almost matching the S&P 500 Index total return, but with significantly less volatility. The junk index outpaced its investment grade counterpart, partly due to its shorter duration, and may continue to outperform as interest rates shift to a new equilibrium amid a more hawkish Federal Reserve and looser fiscal policies, while 2Q has historically been the best quarter for corporate high yield returns.

The Economy

Interest rates remain accommodative despite Fed rate increases. The cost of financing relative to the pace of growth is a critical determinant of future growth. When real interest rates exceed GDP growth this typically leads to a recession. Economic sentiment has been positive for long enough to spur private sector hiring, production and investments. As the unemployment rate heads to below 4%, labor shortages are likely to extend beyond skilled workers and push wages higher, which will benefit the consumer-driven economy.

We expect a widespread trade war to be avoided in the next 60 days while proposed tariffs are under discussion and are likely to be watered down. Access to the largest economy in the world is providing the Trump administration with leverage to halt unfair trade practices, bring parties to the table and diffuse critical geopolitical tensions.

Federal Reserve Policy

The Fed is expected to raise interest rates three times this year. The preference seems to be for a patient policy approach this year and an accelerated pace in future years in order to avoid the risk of stifling potential gains from tax reform and to avert excessive flattening of the yield curve. Two primary factors will decide the pace of interest rate increases: 1.) a substantial firming of wage pressures as the labor market tightens, 2.) currency stability as the Fed and other central banks are in the process of accelerating the reducing of their balance-sheet reinvestments. The Fed is holding total securities in the amount of $ 4.2 trillion ($ 1.8 trillion are mortgage-backed and $ 2.4 trillion are Treasury securities). At the proposed pace, it would take around 3-4 years to bring the balance sheet assets down to the level consistent with the required level of liabilities.

TN-Outlook

We expect the stock market to find its footing once again if S&P 500 companies prove a solid foundation with positive 1Q earnings reports. Positive guidance beyond earnings surprises will be key amid increasing uncertainty and rising market volatility. As S&P 500 EPS growth accelerates toward its highest level since 2Q11, tax effects will be carefully evaluated, but the focus will be on revenue and operating income. Management commentary on potential trade disruption and preparations for tariff implementation are likely to affect the directions of analyst forecasts. Energy, financials and materials lead the earnings consensus forecast for 16.5% YOY growth, though all 11 economic sectors are expected to report profit gains. Earnings comparisons in the commodity-focused energy and materials sectors remain the most beneficial as these sectors were laggards in 2017. Technology, mainly software, semiconductors, as well as healthcare, especially biotechnology, are other sectors of expected earnings strength in 1Q reports. Softness is expected to be led by consumer staples, particularly in household products, utilities and portions of retail, including multiline and food and staples. Over the past three months domestic-company EPS revisions have outpaced companies with international exposure, courtesy of the lower U.S. corporate tax rate. We expect the pace of stock buyback announcements to pick up with 1Q earnings reports, as companies have a better handle on U.S. tax policy. However, based on company Q&A transcripts from 4Q

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reports, it seems evident that stock buybacks have taken a back seat to wages and investing cash back into business.

Although regulation is likely to increase for technology companies, they still offer secular and cyclical growth. It is the only sector with net cash on their balance sheets, and it has an interesting potential for dividend growth. The focus on investing should continue to be on companies with the least earnings volatility and not price volatility. The so-called low defensive, high-dividend-yield stocks with low price volatility like utilities, telecom, and real estate investment trusts are among the sectors with the highest volatility of earnings of all sectors. Dividend payout ratios are close to 100% which leaves little room to increase dividends. Technology, industrials, and consumer-cyclical stocks as well as financials today have much less volatile earnings. We expect these sectors to continue to do well. Consumer-discretionary stocks are likely to underperform the market as the Fed increases interest rates.

In fixed-income investing we will continue our strategy in staying short and ladder maturities as the correction continues.

We expect Trump- rhetoric induced volatility in the markets to continue but sound economic fundamentals and strong corporate performance to not only lend support but set the stage for a higher market.

Happy investing!

Your dedicated Terra Nova Team!

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