Market Review and Outlook
March 2018

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Market Summary

March 2018

- Volatility returned to the markets in Q1 amid higher interest rates, increased Fed tightening expectations, tax cut optimism, and trade tariff concerns.
- Higher actual and expected economic growth and inflation pushed all interest rates significantly higher, including long term rates, which had heretofore remained in a range at lower levels.
- After a robust rise in Equities of about 6% in January, higher rates sparked an official correction, falling 10% from their record high levels.
- The bond market generated negative returns across sectors. Investment grade corporate bond risk premiums widened causing further underperformance.
- High Yield, inflation protected, and short term securities tempered losses, and adjustable rate securities posted positive returns of about +.50%
- Despite higher volatility, growth stocks continued to outperform value as higher rates had a negative impact on dividend paying REIT and Utility sectors.
- Japan, China, and emerging markets generated positive returns in Q1.
- US GDP posted a broad based 2.9% Q4 annualized growth, with CPI reaching over 2%. Employment and investment continue to expand as a strong pace.
- Oil prices extended gains as the strong global economy has supported the demand side of the equation despite significant increase in US production.
- The Fed has been communicating increased rate hikes with stronger conviction given their upgraded outlook for faster growth and higher inflation.
- Market volatility will continue as sentiment sorts out the benefits of tax cuts together with the risks of international trade agreements.

Market Summary - March 31, 2018

Index	Q1	1 Year	Yield
Bond Market			
ICE BofAML Master	-1.5%	3.54%	3.04%
ICE BofAML 1-5 Year G/C A+	-0.4%	1.61%	2.51%
US Treasuries	-1.2%	2.43%	2.54%
US TIPS (Inflation Protection)	-0.8%	3.34%	0.54%
US MBS Index	-1.2%	2.45%	3.26%
Corporate Bonds	-2.2%	6.48%	3.77%
High Yield Corporates	-0.9%	7.48%	6.33%
Merrill Muni Index	-1.1%	5.42%	2.60%
International Bonds	0.8%	0.41%	0.49%
Stock Market Indices			End Value
DOW Jones Avg.	-1.95%	19.22%	24,103.11
S&P 500 (Large Cap)	-0.75%	13.89%	2,640.87
NASDAQ Composite	2.60%	20.76%	7,063.45
Russell 2000 (Small Cap)	-0.07%	11.74%	1,529.43
EAFE (International)	-1.43%	15.05%	2,005.67
FTSE 100 (England)	-7.18%	0.32%	7,056.61
EURO STOXX (Europe)	-2.69%	2.91%	373.99
Nikkei 225 (Japan)	5.07%	15.43%	21,454.30
Hong Kong Hang Seng (China)	0.93%	28.90%	30,093.38
EEM (Emerging Markets)	2.46%	24.84%	48.28
Commodities/Other			
Oil (WTI)	7.75%	24.86%	64.94
Gold	1.74%	6.11%	1,325.48
Trade Weighed Dollar	-1.38%	-8.19%	86.27

Market Environment Summary

March 2018

- Our outlook for rising interest rates remains in place, with economic fundamentals including employment, manufacturing, and investment continuing along a steady upward path.
- The Fed hiked rates in Q1, with a plan for 2 or 3 more hikes in 2018, and has recently increase their potential for hikes in 2019. The market has moved closer to 2018 targets, but not 2019.
- Despite the Fed actions to date, the Fed remains very stimulative and has been communicating their intention to continue hiking to avoid perception they may be falling behind the curve.
- The global economy has been on a synchronized upswing, although Q1 has moderated somewhat. Europe and Japan central banks remain highly stimulative and the US has just had a massive tax cut.
- Yields on 2 year notes continued to rise in Q1 to their highest level since 2008, and longer term rates have finally begun to rise as well. Bond markets generated negative returns except floating rate securities.
- After rising about 6% in January to new record highs, equity markets suffered an official correction of a 10% decline. Growth Stocks still continued to perform better than Value.
- International Equities, specifically Japan, China and Emergin markets remained positive in Q1.
- The US dollar has continued to decline in Q1 despite higher rates and increased inflation.
- Oil prices continued to climb into the mid $60's as demand and OPEC production cuts has offset increased production in the US.

Market Environment Summary

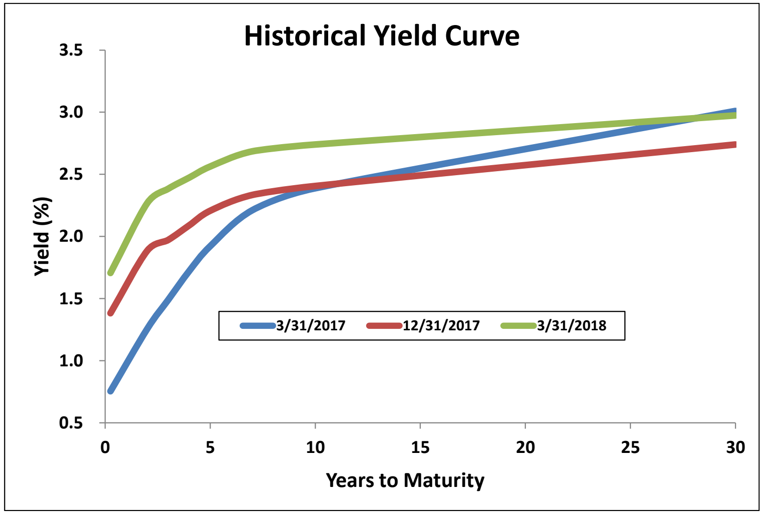
March 2018

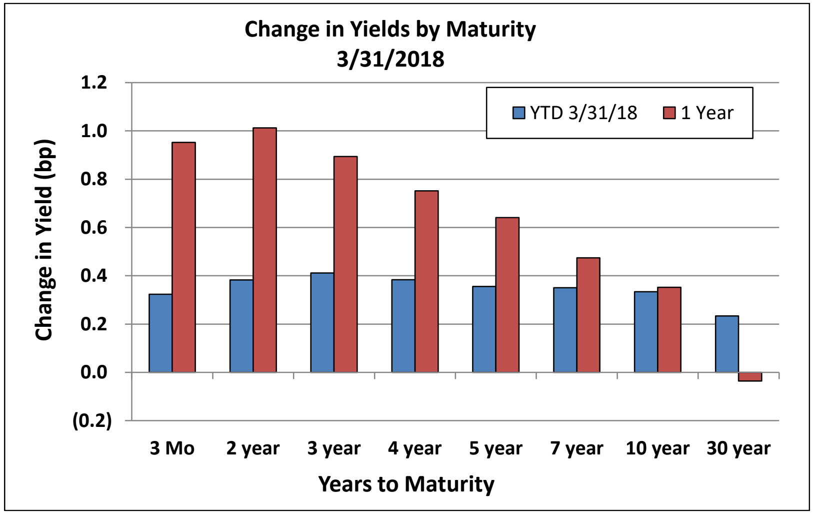
- Our expectations are for rates to continue to move higher, with 3 Fed tightening moves in 2018, pushing short rates higher. We also continue to feel that long rates will move higher with 10 year Treasury note reaching 3.25 - 3.5% range in 2018. The market continues to under appreciate this risk.
- Driving the rate rise includes strong employment with newly apparent wage pressures increasing, all key inflation measures moving to, and through 2%, strong corporate earnings and equity market prices, significant fiscal stimulus, pro-growth policy shifts, and global economic growth.
- The Fed may raise rates further and sooner than the market is currently expecting and is executing its plan to reduce balance sheet assets. Bond markets yields are still not factoring in all of these factors.
- Given the broadness of the economic growth, the economy is on a more self sustaining level of activity, less dependent on low rates for stimulus, and may withstand a higher rate environment than it could 3 years ago. The equity market may be able to withstand a 50-100 basis points higher interest rate environment but will likely experience increased volatility along the way.
- Growth stocks may continue to benefit from the environment, while dividend paying stocks such as REITS and utilities may continue to be challenged by the higher market levels of interest rates.
- Corporate tax cuts will benefit many companies, certainly in the long run, while some companies may take some short term "one time" charges due to changing tax rules. Many companies have increased wages and have announced new investment. Credit risk has been reduced, with some exceptions.
- Housing and consumption has remained strong while investment continues to drive economic activity.

Market Review

Yield Curve – March 2018

- Interest rates rose across all maturities in Q1 amid more aggressive Fed tightening and "Fedspeak" as the economic growth and inflation outlook were upgraded.
- Short rates have risen by a full percentage point over the past year to the highest level since 2008.
- We expect the Fed to continue tightening in 2018 and short rates continue to rise, but also for long term rates to rise much more significantly as well. Longer rates will primarily be driven by higher inflation, and higher government debt issuance.





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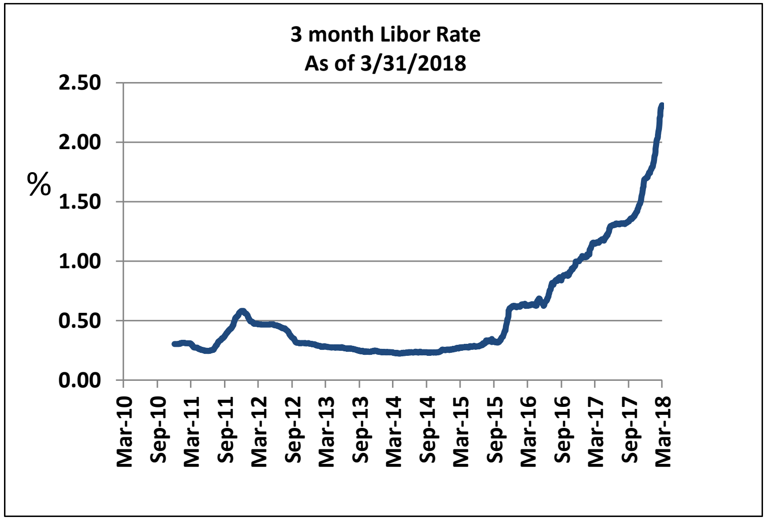
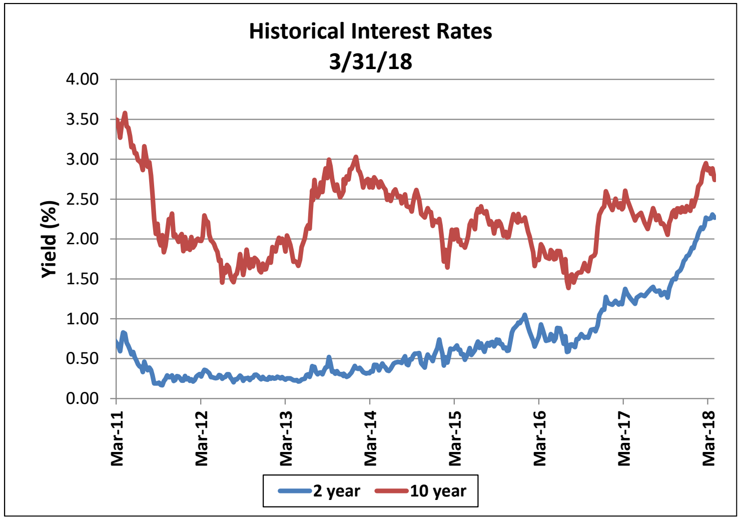
Market Review

Yield Curve – March 2018

- Reflecting the actual and increased expectations of Fed tightening, 3 month libor has risen significantly.
- Most floating rate notes are benchmarked off of libor, and have performed well in Q1 and over the past year as coupons have adjusted upward with stable prices in the rising rate environment.
- The yield curve has continued to flatted with short rates rising more than long rates. With continued economic growth, rising inflation, and increased net issuance, longer rates are likely to rise as well.
- We do not agree that the flatter yield curve may signal an impending recession, as correlation is not causation. Many technical factors such as policy and global cash flows artificially influence the curve.





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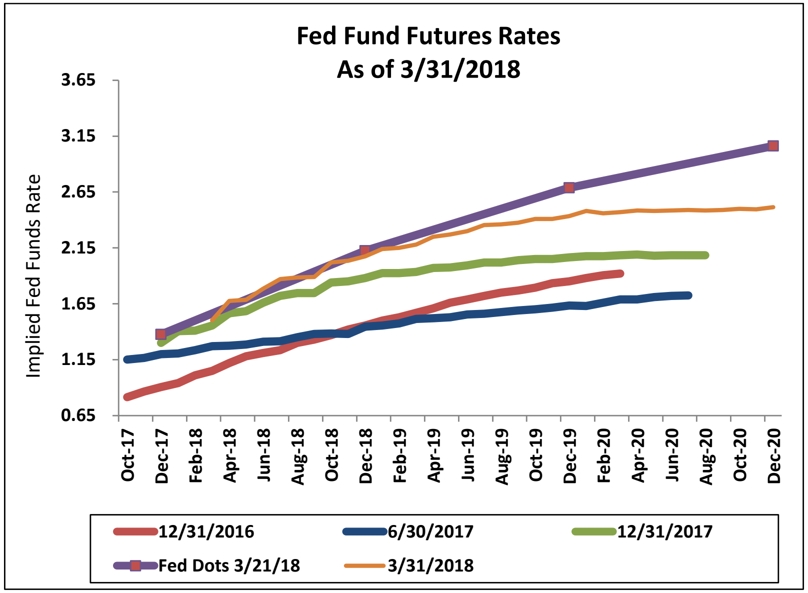
Market Review

Monetary Policy – March 2018

- The Fed hiked rates again in March, significantly upgraded their economic outlook for 2018, and significantly increased their projections for the Fed Funds rate.
- The markets have made a major adjustment towards the shorter term Fed targets, however continue to price in a lower future Fed Funds rate.



Federal Reserve Economic Projections As of 3/31/2018					
Change in GDP		**2018**	**2019**	**2020**	**Longer Run**
March 2018 Projection		2.6 - 3.0	2.2 - 2.6	1.8 - 2.1	1.8 - 2.0
December 2017 Projection		2.2 - 2.6	1.9 - 2.3	1.7 - 2.0	1.8 - 1.9
Actual Q4 2017	**2.6%**				
Unemployment Rate					
March 2018 Projection		3.6 - 3.8	3.4 - 3.7	3.5 - 3.8	4.3 - 4.7
December 2017 Projection		3.7 - 4.0	3.6 - 4.0	3.6 - 4.2	4.4 - 4.7
Actual Q4 2017	**4.1%**				
PCE Inflation					
March 2018 Projection		1.8 - 2.0	2.0 - 2.2	2.1 - 2.2	2.0
December 2017 Projection		1.7 - 1.9	2.0	2.0 - 2.1	2.0
Actual Q4 2017	**2.1%**				
Core PCE Inflation					
March 2018 Projection		1.8 - 2.0	2.0 - 2.2	2.1 - 2.2	
December 2017 Projection		1.7 - 1.9	2.0	2.0 - 2.1	
Actual Q4 2017	**1.8%**				
Projected Policy Path- Fed Funds					
March 2018 Projection		2.1 - 2.4	2.8 - 3.4	3.1 - 3.6	2.8 - 3.0
December 2017 Projection		1.9 - 2.4	2.4 - 3.1	2.6 - 3.1	2.8 - 3.0

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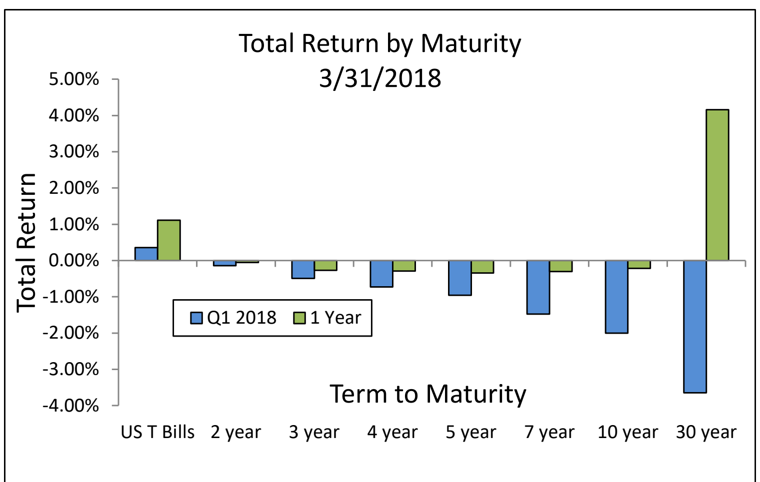
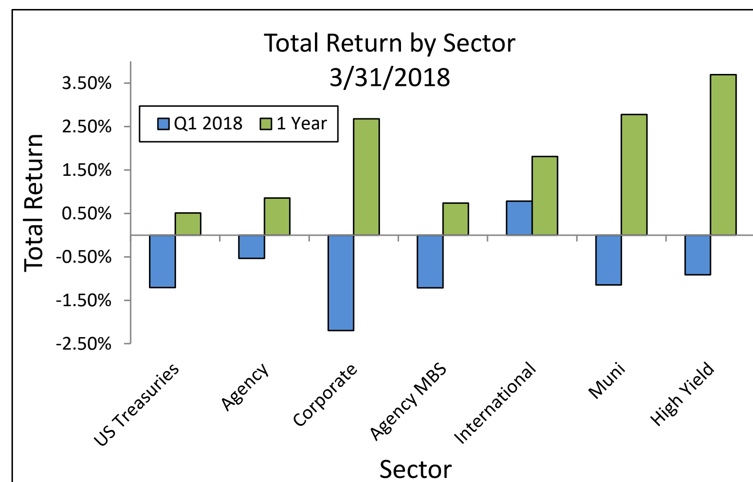
Market Review

Yield Curve and Sector Returns – March 2018

- Total returns across the maturity spectrum were negative in Q1, and over the past year except the 30 year maturity. Also, most all US bond markets posted negative returns in Q1.
- Corporate bonds have been the best performing sector over the past year, however risk premiums widened amid the volatility and fixed rate corporate bonds underperformed in Q1.
- International interest rates were relatively stable and generated slightly positive returns in Q1.
- Floating rate notes have performed well (+.50%) in Q1 as income adjusted upward with short term interest rates.





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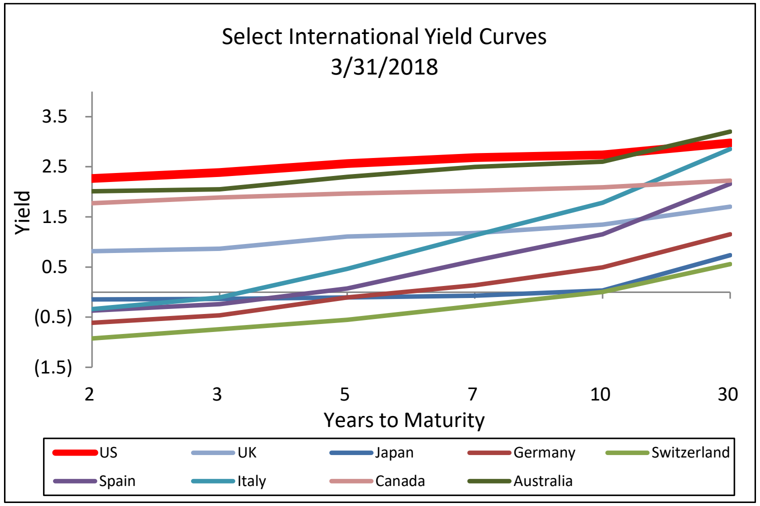
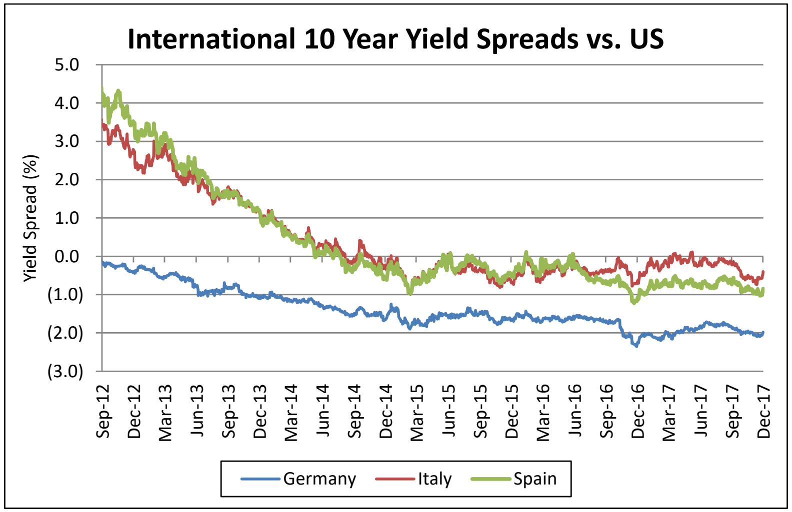
Market Review

International Yield Curves– March 2018

- The US continues as one of the highest yielding developed countries, and the yield spread over Europe resumed widening in Q4 as US rates rose.
- The European Central Bank continues aggressive monetary policy, but has recently begun to reduce quantitative easing amid stronger economic growth. The Bank of Japan has targeted a 0% 10 year note yield rather than letting it drift negative.
- Foreign purchases of US Treasuries has recently been significant, keeping longer term US rates down.





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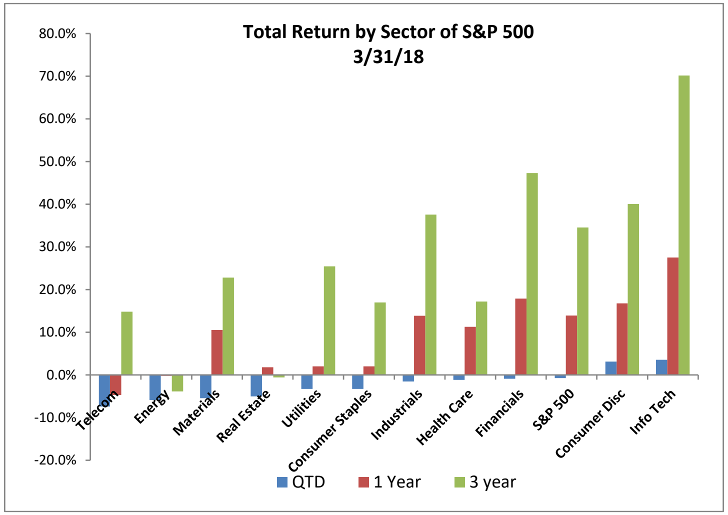
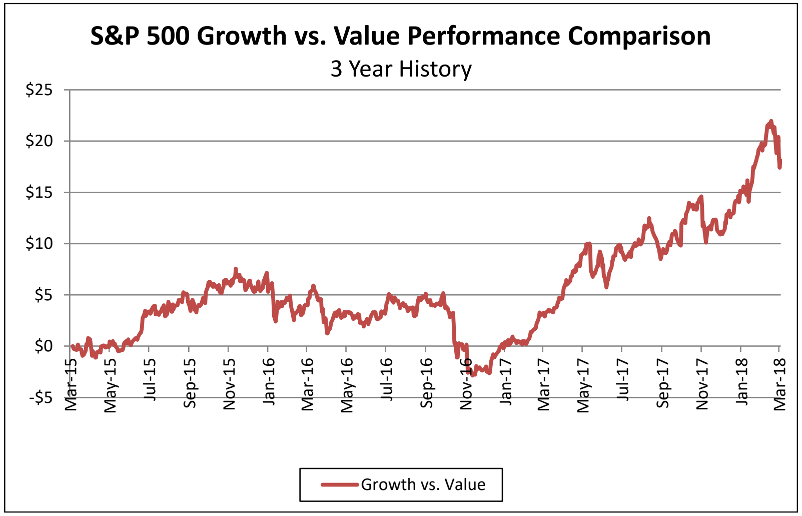
Market Review

Equity Market Returns - March 2018

- In the equity markets, the technology sector continues to lead gains, even in Q1, reflecting innovation and high expectations of business investment going forward.
- Financials have continued to make gains reflecting reduced regulatory burden, lower tax rates, higher interest rates, and higher expected growth.
- The energy sector is down again in Q1 and over the past year, however is poised to recover if oil prices can maintain higher levels established this year.
- Reflecting the improving economic environment, growth stocks have continued to outperform value.





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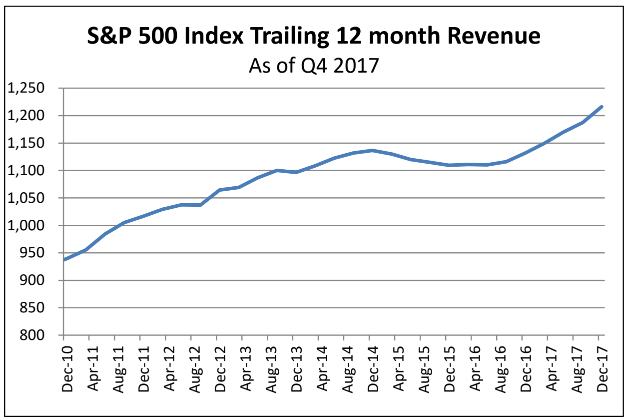
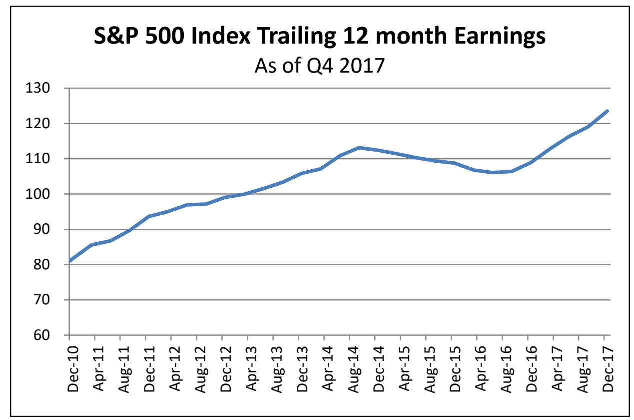
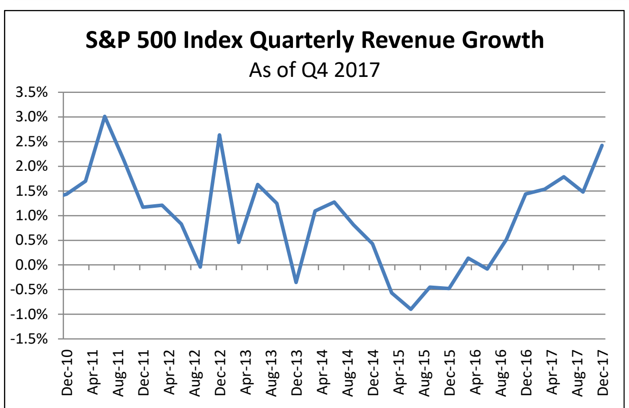
Economic Environment

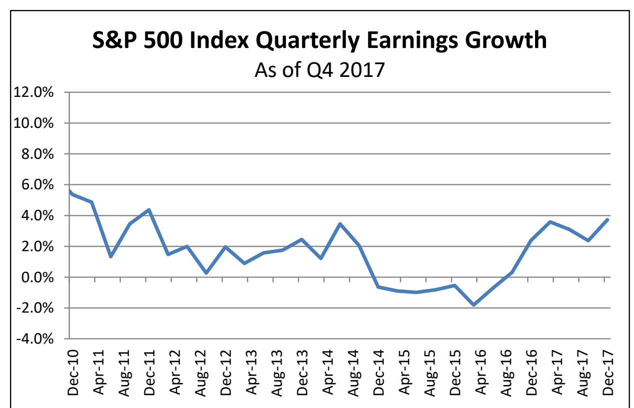
March 2018

- As reported during Q1, top line revenue growth continued to gain momentum and drive earnings growth rather than cutting expenses. This is expected to continue as Q1 earnings are reported.
- The negative impact of the energy sector on overall earnings from 2015/16 has recovered and normalized.





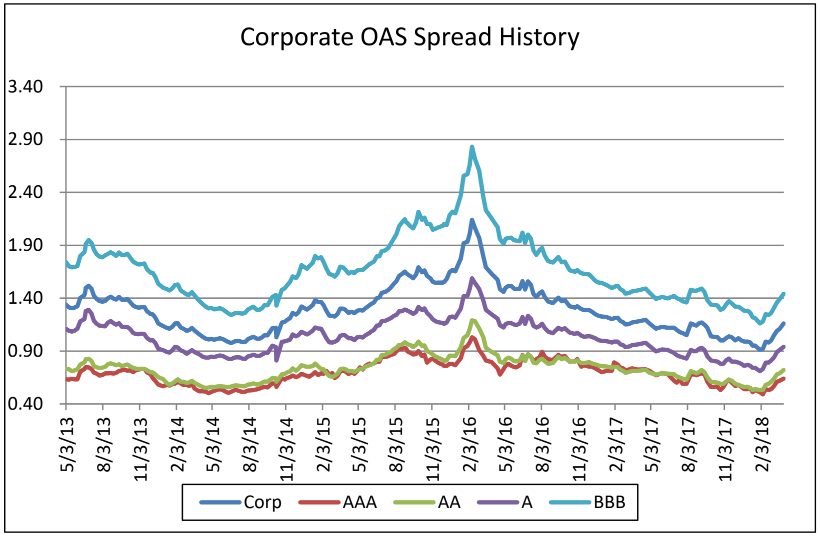


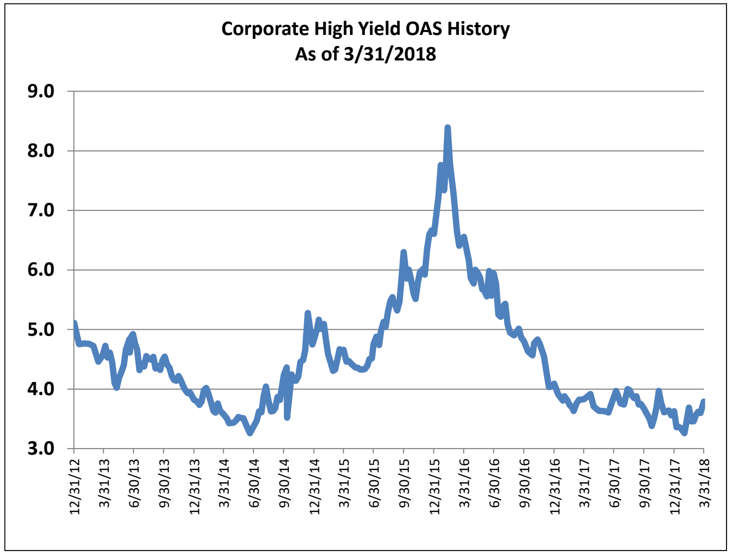


Market Review

Corporate Yield Spreads – March 2018

- Amid the stock market correction and increased volatility, corporate yield spreads widened from historically tight levels.
- Spread widening was a function of market volatility rather than increased credit risk as fundamentals continue to support current levels.
- Tight spreads will limit diversification of interest rate risk in corporates, as was evident in Q1, and risk of duration extension in MBS (convexity risk) is growing.

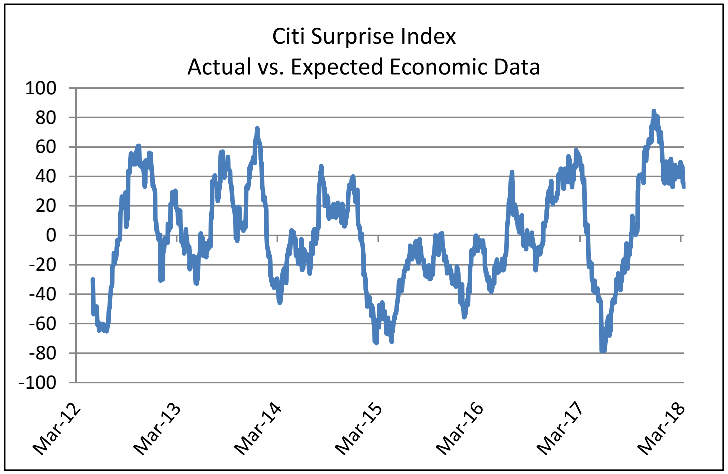




Economic Environment

March 2018

- The US economy continues to performing better than expectations, despite a slight moderation in Q1, as measured by the Citi Surprise index, which measures actual economic data relative to economist and market expectations.
- The economic data continue to be moderate but solid, and gaining strength. Economic growth has been broad based, indicating it is becoming self sustaining.
- Virtually all countries – Developed and Emerging – are experiencing growth. Inflation has also been picking up on the back of extended and extreme stimulative monetary policy, following in the US footsteps.



GDP YoY % Change			
	Current	One Year Ago	Change
US	2.60	1.80	0.80
Eurozone	2.70	2.00	0.70
Germany	2.90	1.80	1.10
France	2.50	1.20	1.30
Italy	1.61	1.10	0.51
UK	1.40	2.00	(0.60)
Canada	3.40	2.10	1.30
Mexico	1.52	3.28	(1.76)
Australia	2.40	2.50	(0.10)
Japan	2.00	1.50	0.50
China	6.80	6.80	0.00
Russia	0.90	0.40	0.50
Brazil	2.12	(2.49)	4.61

Inflation YoY % Change			
	Current	One Year Ago	Change
US	2.40	2.40	0.00
Eurozone	1.40	1.50	(0.10)
Germany	1.60	1.60	0.00
France	1.60	1.10	0.50
Italy	0.90	1.40	(0.50)
UK	2.70	2.30	0.40
Canada	2.20	1.60	0.60
Mexico	5.04	2.60	2.44
Australia	1.90	1.50	0.40
Japan	1.50	0.20	1.30
China	2.10	0.90	1.20
Russia	2.40	4.30	(1.90)
Brazil	2.68	4.57	(1.89)

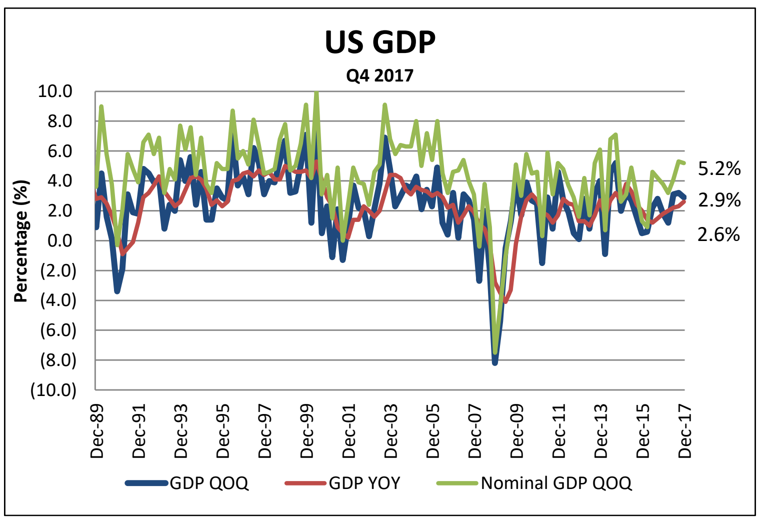
Economic Environment

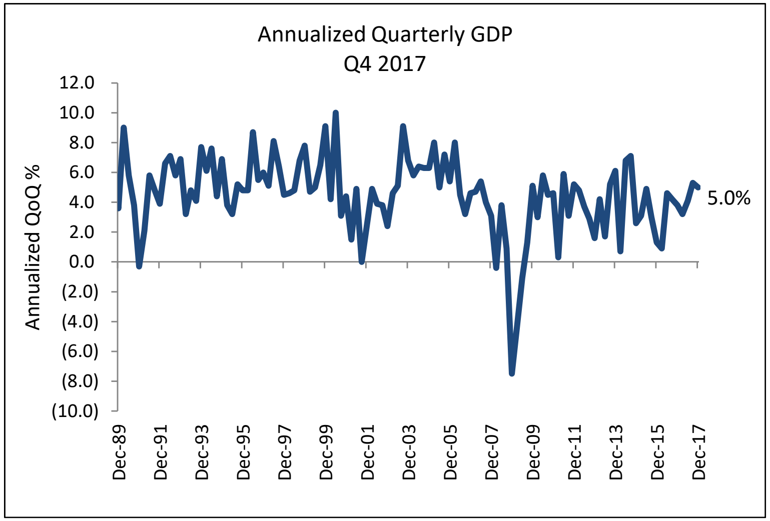
March 2018

- Economic activity has been solid recently, maintaining a pace above 2%, and Q4 annualized GDP at 2.9%. Q1 is expected to come in lower than other quarters, as usual, at around 2%.

- Nominal GDP has reached 5% again and poised to grow.

- There is potential for the economy to revisit a similar environment to the mid 1990's.





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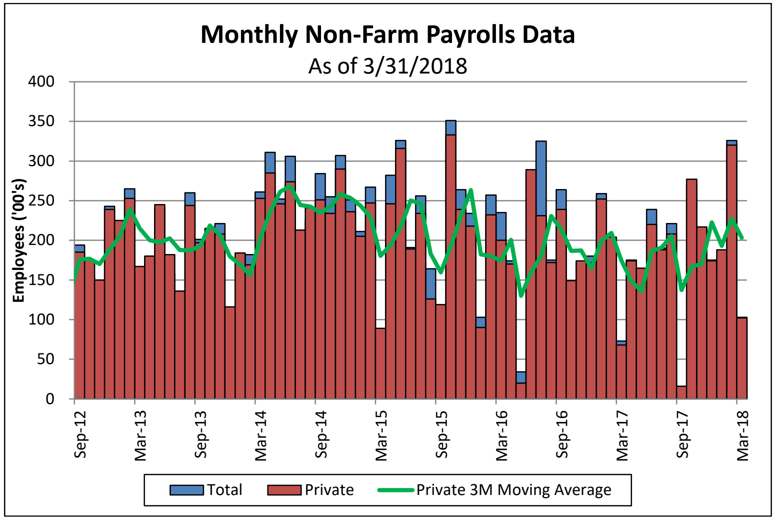
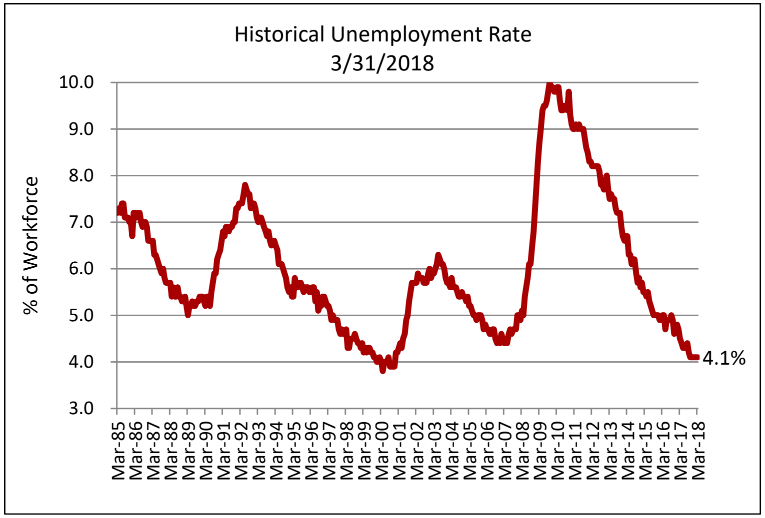
Economic Environment

Employment – Monthly Payrolls – March 2018

- Non-Farm payrolls moderated in March but maintained a steady and healthy pace in Q1 with 3 month average near 200k.
- The labor participation rate has continued to improve from its low historical rate of just over 62%.
- Weekly initial unemployment claims are running around 230,000, low by historical measures.
- The unemployment rate has maintained a 4.1% rate as the increase in payrolls is being matched by an increase in new entrants to the labor force.





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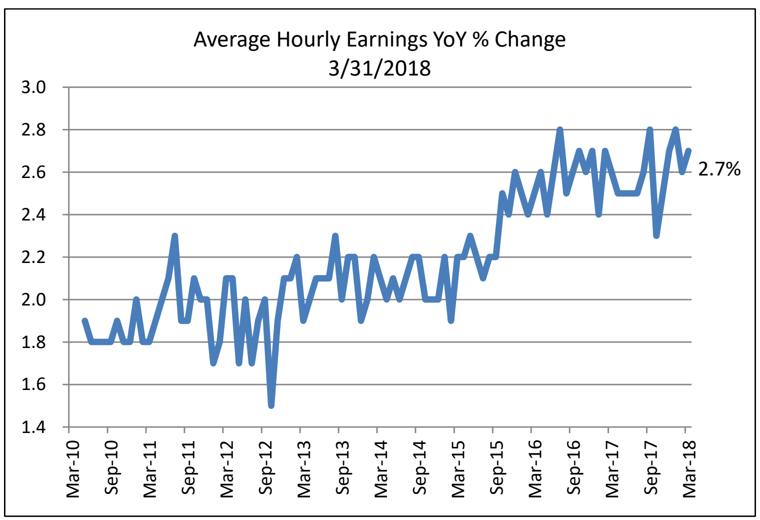
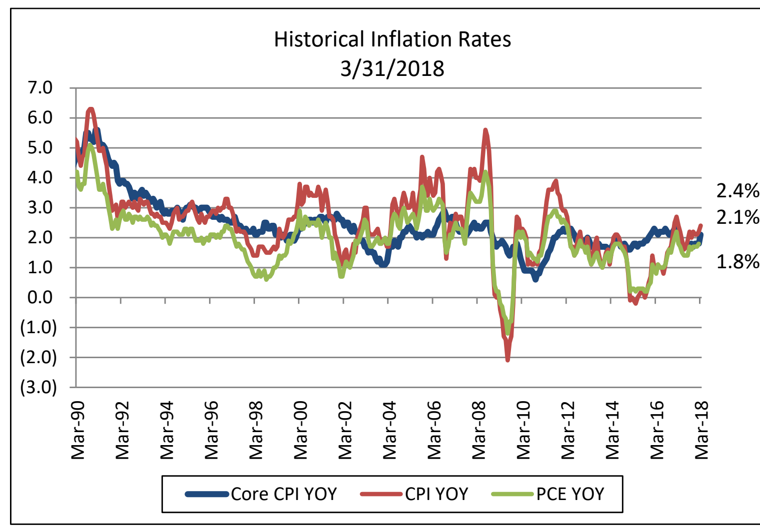
Economic Environment

Employment and Inflation – March 2018

- Average hourly earnings have been volatile recently, but has maintained a higher level, indicating possible wage pressures at long last. Corporate announcements of wage hikes will contribute.
- CPI has returned to a level above 2% after the fall and rise of Oil and rolling off of one time effects (cell plans) one year ago. Core inflation that has been maintaining around the 2%.
- The YOY Personal Consumption Expenditure Index (PCE), the Feds favored inflation gauge, has also moved back toward the 2% level.





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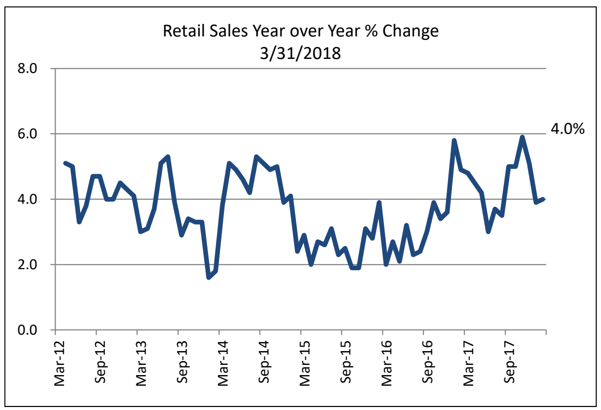
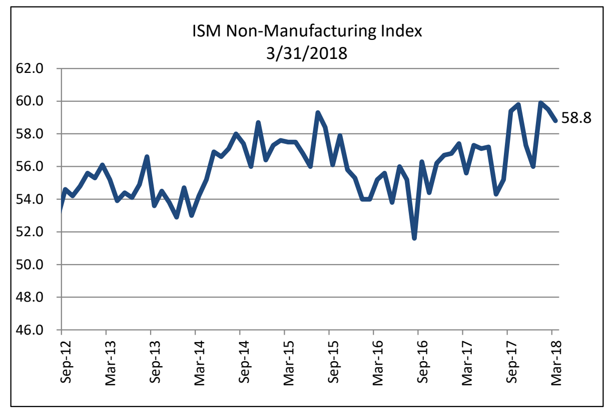
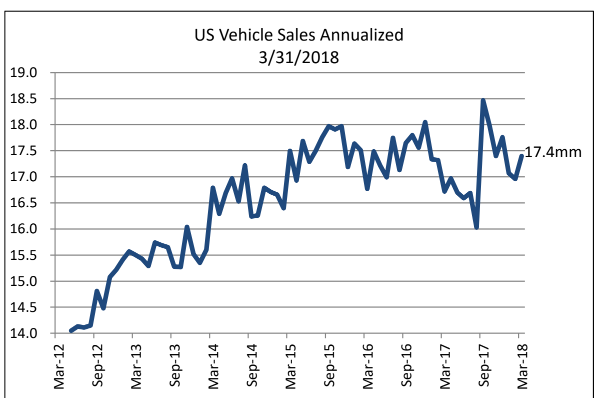
Economic Environment

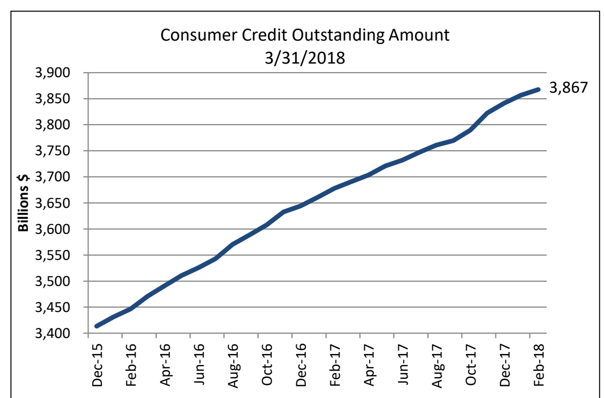
Consumption – March 2018

- Growth in consumption has continued strong in Q4, however auto sales have moderated.
- Indicators such as the service sector index remain positive despite a recent decline.
- Consumer credit outstanding continues to grow with the savings rate declining.









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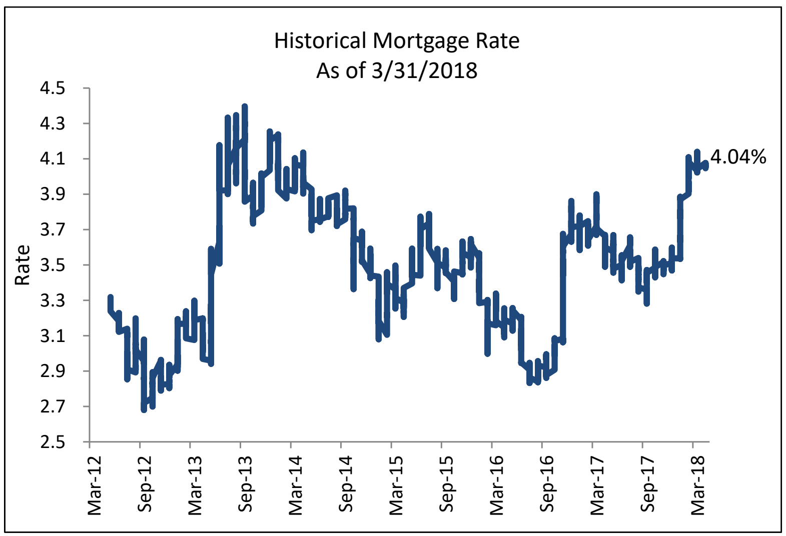
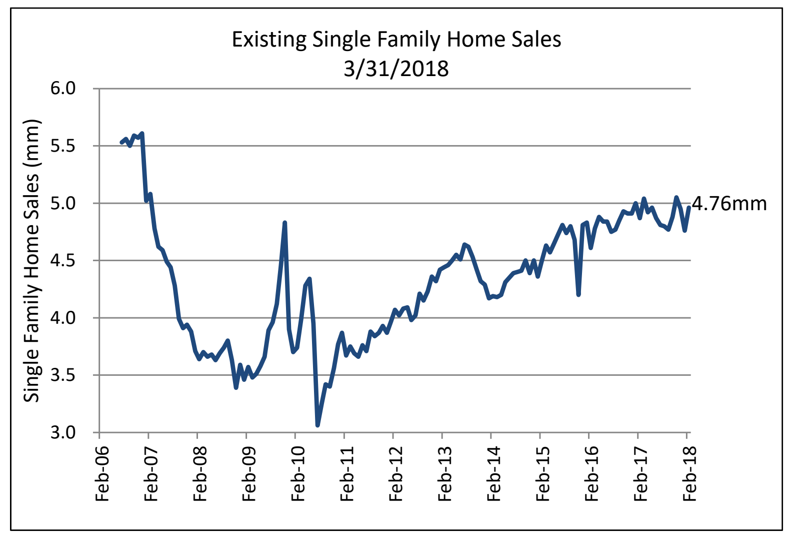
Economic Environment

Mortgage Rates and Housing – March 2018

- The Mortgage commitment interest rate has remained steady at higher levels reaching the 4% level. A significant majority of the mortgage universe is now out of the refinance window.
- Despite the higher level of mortgage rates, home purchase activity has remained solid.
- The broad based employment gains and overall income growth has supported the housing market and may continue to even as rates rise.





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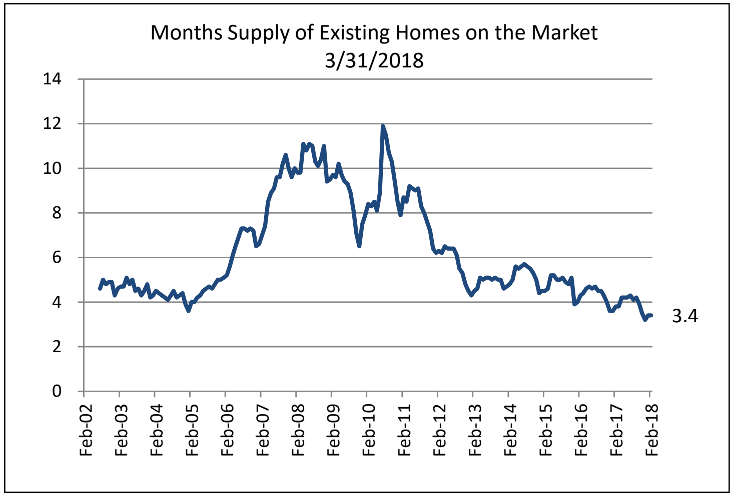
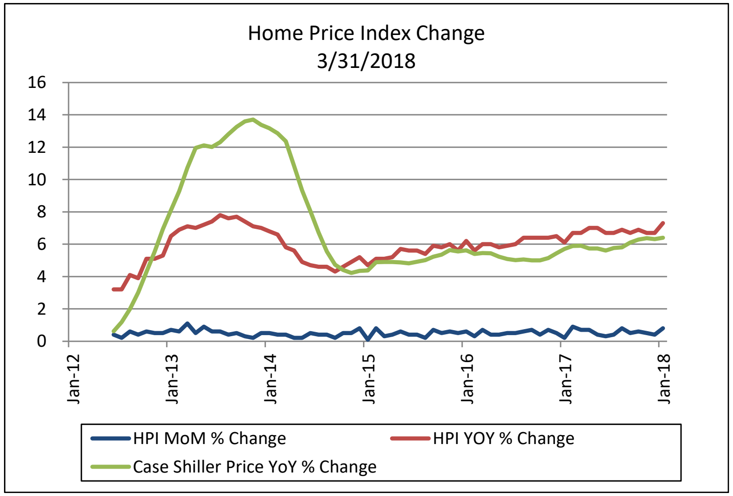
Economic Environment

Mortgage Rates and Housing – March 2018

- The healthy pace of housing activity has significantly reduced the number of homes for sale on the market.
- Continued demand with steady low rates has provided for continued steady increases in the Home Price Index, bringing home prices back to historically high levels.
- The continued growth in employment continues to translate into greater household formation and home sales.
- The increase in housing activity seems to be rippling through to higher overall consumer demand and economic growth. (see Home Depot)





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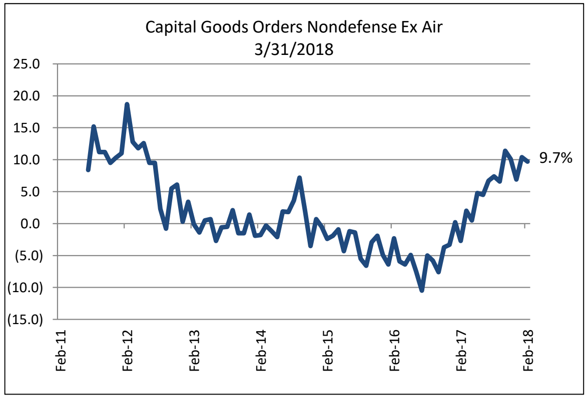
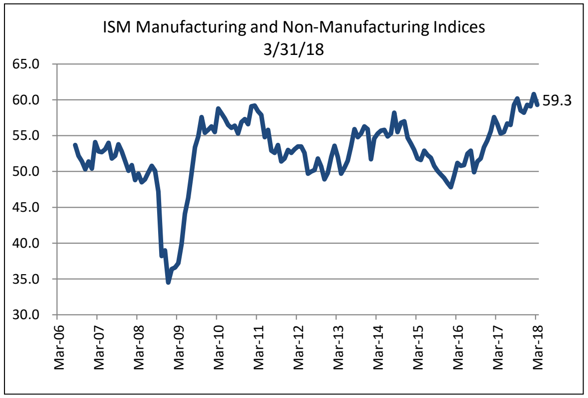
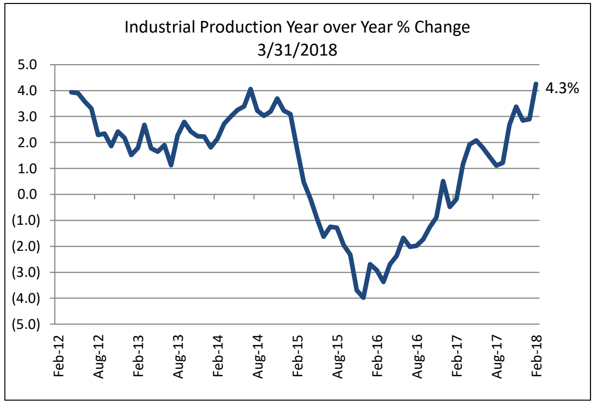
Economic Environment

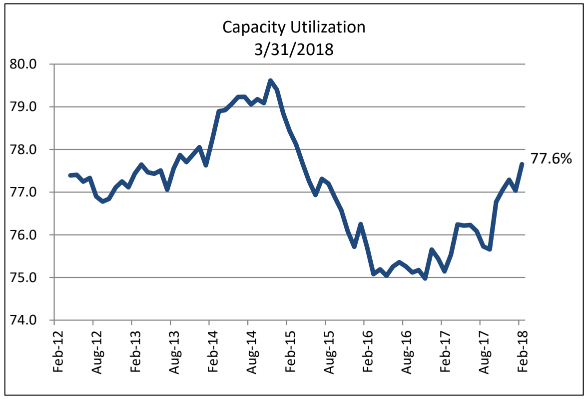
Investment – March 2018

- Core capital goods spending has rebounded significantly as corporate America has increased investment plans. The tax package has already resulted in significant additional investment plans.
- Manufacturing index has remained well above the 50 level that divides expansion/contraction, with industrial production and capacity utilization showing a growing manufacturing sector.









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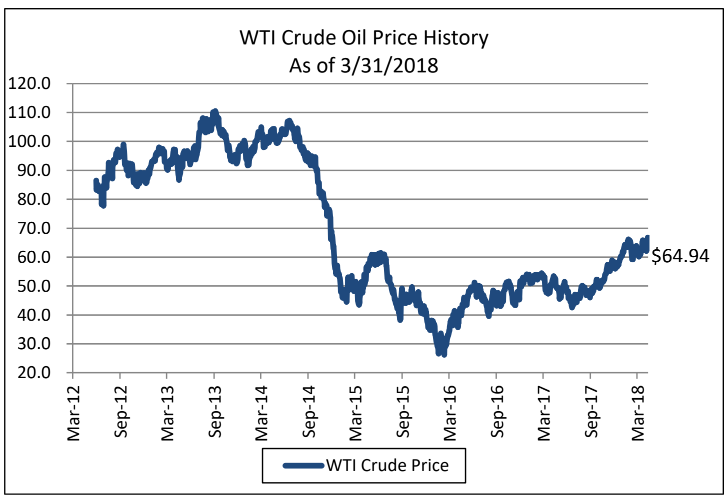
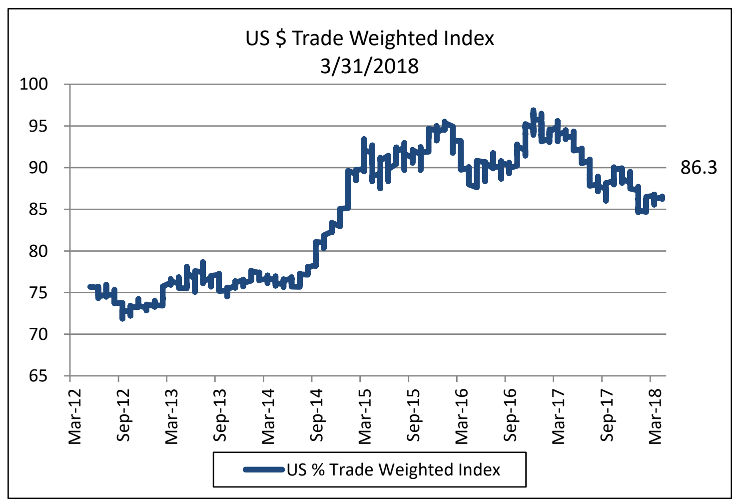
Economic Environment

March 2018

- Two recent significant issues continue to be the price of oil and the value of the dollar.
- The price of oil has firmly established levels in the mid $60's as OPEC production cuts and robust demand have offset significantly increase shale production in the US.
- The dollar declined steadily during 2017 despite steadily rising interest rates and strong economic growth.
- It may be difficult for the dollar to weaken further, and may begin to turn unless Europe and Japan growth accelerates and policy changes to push those interest rates higher.





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Market Environment Summary

March 2018

- Risk was not rewarded in Q1 as a stock market correction, higher interest rates, and increased volatility caused price declines in most financial assets.
- Fed policy remains highly accommodative, however the Fed has been clear in communicating their intention of steady rate increases throughout 2018 and 2019.
- The higher level of employment and income together with stronger corporate investment and earnings may enable the economy and equity markets to withstand a higher interest rate environment.
- US and Global economic activity is on a synchronized growth trajectory, and inflation is finally accelerating.
- The US economy is growing and is expected to continue on a strong growth path with significant tax cuts helping, however recent trade tariff announcements and trade agreements present risks.
- Oil prices have taken another leg up to the mid $60's due to growth expectations and OPEC supply cuts offsetting significantly increased US production.
- Credit risk premiums widened amid the market volatility, but may be supported by fundamentals.
- Growth stocks continue to perform better than value as higher rates challenge dividend payers such as utilities and REITs.
- Higher interest rates, trade agreements, and geopolitical risks may increase market volatility.