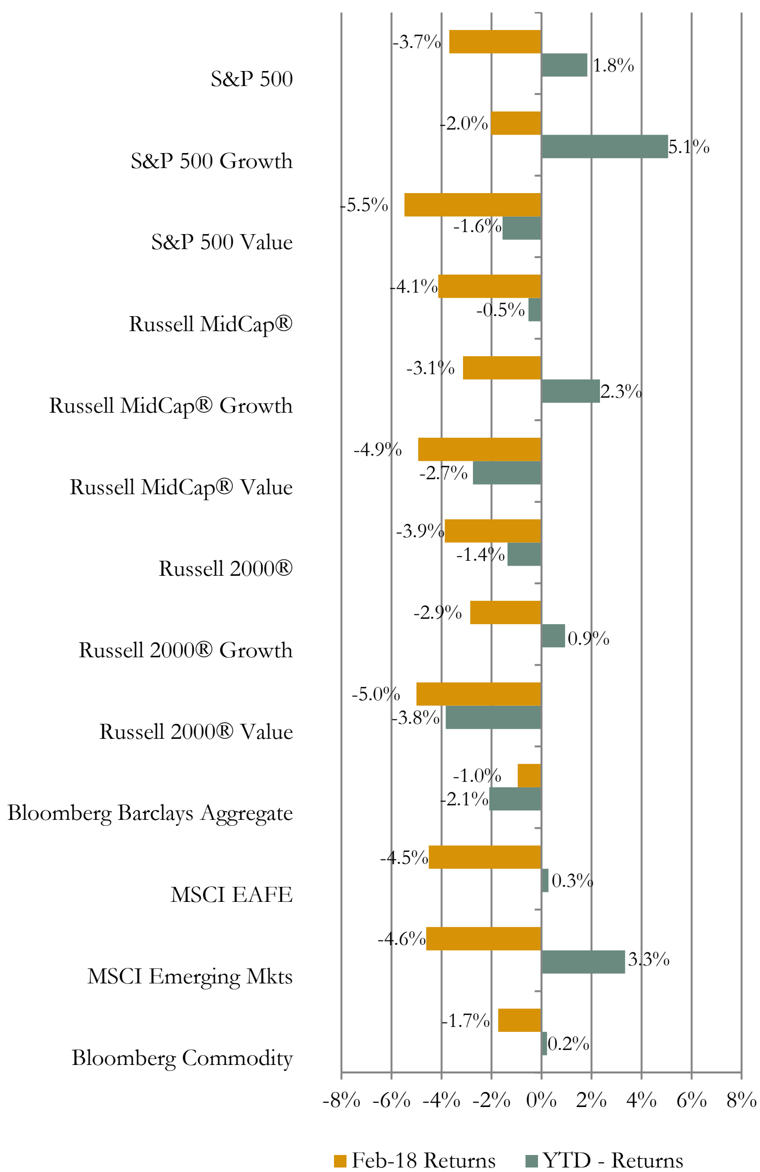
Monthly Market Summary – February 2018

Market sentiment shifted abruptly in early February. After the unusually calm markets of 2017, volatility has returned. For example, equity markets experienced several sharp intraday advances and declines throughout February. The S&P 500 index had 12 sessions with moves up or down of over 1%, which is the most days in a single month with such large moves in two years.

During the first trading days of the month global equity markets declined sharply with the major U.S. equity market indices reaching correction territory on February 8. A correction is defined as a drop of 10% from the recent peak. The S&P 500 index had not experienced a correction since February 2016. The early February sell-off was broad-based with every sector declining. But it was not only equity prices that declined. Global bonds, commodities, and even gold declined. The yield on the U.S. 10-year Treasury bond moved as high as 2.91% as bond prices declined and the price of West Texas Intermediate (WTI) crude oil fell to under $60 per barrel. The catalyst for the global sell-off is not known with certainty. The U.S. employment report that showed a sharp pick-up in wage growth and sparked concern that the Federal Reserve (Fed) may accelerate the pace of interest rate hikes was one factor. Other fuel for the sell-off was the increasing concern about U.S. budget deficits and the larger amount of Treasury bonds that will need to be sold at a time when the Fed is reducing the amount of bonds it will hold on its balance sheet. Market participants worried that in order to entice enough buyers to absorb all the new bond issuance, yields will have to rise, which will lead to higher borrowing costs throughout the economy. Systematic trading (computer trading based on algorithms) and an unwinding of short volatility trades also contributed to the rapid sell-off.

Market Indices – February 2018



A partial recovery occurred mid-month after the S&P 500 index declined to hit its 200-day moving average. The broad-based rally was boosted by data such as a cut to the first quarter gross domestic product (GDP) estimate by the Atlanta Fed and strong corporate earnings reports. Global equities, bonds, and oil rebounded as well. However, financial markets turned lower again in the last days of the month. Equity markets declined again in part due to the upbeat first testimony by new Fed chair Powell that had investors wondering if the Fed may raise rates more frequently than previously expected. Crude oil prices sank late in the month after an unexpectedly strong increase in inventories.

After setting new all-time closing highs in January, major U.S. equity indices had their worst month in over a year. Large-capitalization (cap) stocks outperformed small-cap stocks and both outperformed mid-cap stocks. Even though the tone of the equity market changed in February, the outperformance of growth stocks over value stocks across the market cap spectrum continued due to the outperformance of information technology (tech) stocks. The tech sector was the only one of the 11 sectors in the S&P 500 and Russell Midcap indices to eke out a positive return gaining just 0.1%. In the Russell 2000 index of small-cap stocks both the tech and telecommunication services sectors had a positive return of less than 1%. The energy sector was by far the poorest performing sector for the month across the market cap spectrum. The energy sector had a return of -11% in both the S&P 500 and Russell Midcap indices and -12% in the Russell 2000 index.

Both emerging markets equities and developed international equities underperformed U.S. equities on a U.S. dollar basis for February. The MSCI Emerging Markets (EM) and MSCI EAFE indices had a return for the period of -4.6% and -4.5% respectively. Currency moves had a negative impact on foreign equity returns for U.S. investors. The local currency return was -3.9% for the EM index and -3.3% for the EAFE index. Just as in the U.S., growth stocks in both the EM and EAFE indices outperformed value stocks, although the difference in returns was small. European equity markets experienced a broad–based decline in February despite generally positive economic and earnings news due to fears about the global ramifications of events in the U.S. The European region index declined almost 7% for the month. The Japanese equity market performed better but still declined almost 2% for the month. Among emerging markets, Poland had the lowest return, down almost 10%. China was one of the weakest performing emerging market countries with the China index declining more than 10% at one point during the month but recovering to close the month with a return of -6.4%. Some of the reports from China are beginning to show a slowdown in economic activity. For example, the official manufacturing gauge hit an eight-month low in February. Russia was one of the few countries to post a positive return for the month boosted by the continued recovery in that economy.

U.S. bond market returns were mostly negative for February leading the Bloomberg Barclays U.S. Aggregate Bond index to post a return for the month of -1.0%. Yields rose as prices declined across the maturity spectrum and across all fixed income sectors on concerns that an overheating economy is pushing up inflation and may cause the Fed to become more aggressive in its interest rate policy. Another reason for the increase in yields was the February Treasury bond auction. The Treasury Department auctioned $258 billion in new bonds. Yields rose as the market absorbed the new bond supply. The 2-year Treasury note yield hit the highest level in 10 years at 2.27%. The 10-year bond yield rose to 2.95%, a four-year high. Yields came down slightly at the end of the month after the fourth quarter GDP growth rate was revised lower to 2.5%. The 10-year Treasury bond yield ended the month at 2.87%, which was up considerably from the year-end 2017 yield of 2.40%. As usual in a rising yield period, longer maturity bonds had larger price declines than shorter maturity bonds.

The Bloomberg Commodity index had a return of -1.7% for February. The energy sub-index had the largest decline for the month as both oil and natural gas prices fell as production and inventories increased. The price of WTI crude oil started the month at $64.82, fell to $59.20 during the equity market correction period and recovered to end the month at $61.53. The industrial and precious metals sub-indices each declined over 2%. Gold declined as the U.S. dollar advanced. The agriculture sub-index had the best performance due to a strong advance in the grains index.

Vogel Consulting, LLC (Vogel) Tactical Recommendations

We have expected that volatility would pick-up and we expect that the markets will have various bouts of up and down periods during 2018. However, at this time fundamentals still appear to be generally positive as far as 1) corporate earnings and forward guidance companies have been providing on earnings calls, 2) strong labor markets and consumer confidence readings that should be supportive to consumer spending and housing markets, and 3) manufacturing and service sector indices that remain firmly in expansion territory. We will be watching for signs that the economic or earnings outlook is changing. A new risk came to the forefront as the calendar turned to March as President Trump talked about new trade tariffs which shocked global markets. Global government leaders, corporate executives, and investors are concerned that a trade war could develop and hurt economic growth and boost inflation. However, details are not yet known. So we are maintaining our tactical asset allocation recommendations for the time being.

We continue to recommend an equal weight to U.S. large-cap, mid-cap, and small-cap stocks and to developed international equities. We recommend an overweight to emerging markets equities. We continue to favor equities over bonds and retain our underweight recommendation for fixed income investments. Our underweight recommendation is because the return expectation for bonds is modest due to the prospects for yields to move higher (and prices lower) if inflation picks-up and the Fed continues to hike its policy rate as it has suggested or if the Fed accelerates the pace of rate hikes. Within fixed income we continue to recommend a focus on short to intermediate term bonds. We also continue to favor non-Treasury bonds for the yield advantage they provide. We continue to favor hedge fund strategies over fixed income for the lower expected volatility portion of portfolios but also recommend an underweight allocation to hedge funds. Since our expectation is for a moderate rate of inflation to continue, we recommend an equal weight to real assets. We continue to recommend using periods of market strength to raise any cash needed to support spending needs over the coming 12-24 months.