Lowe, Brockenbrough & Company

First Quarter 2018

Commentary

The Long Game

We've counseled in the last few quarterly commentaries that investors should expect lower prospective returns. You can expect good returns when valuations are low, margins are depressed and the Fed is easing. That's simply not where we are right now. The easy money's probably been made. You won't find many pundits willing to argue that point. But there's a critical time element implied that, perhaps, isn't in big enough print: **we're talking about years, not quarters**. Equity markets stumble along a path roughly marked by corporate earnings growth. It's a strong relationship, but only when viewed long-term. Quarter-to-quarter and even year-to-year, the correlation is harder to see. Perhaps 2018 will be as strong as 2017. Perhaps not. Like next month's weather, we really don't know. What we're saying is, when you look back from, let's say, five years in the future, returns will likely have been more muted. Between now and then, however, there will have been a whole lot of sunshine and rain. That's guaranteed. For sanity's sake, keep in mind it's a long game we're playing.

U.S. equity markets ended the first quarter down slightly after an exceptionally strong January. The excitement over tax reform and follow-through from last year probably spiked January higher, but the market works more like a discounting machine than a counting machine. Trump signed the pro-business bill in late December. With no better news plausibly coming, the January surge was vulnerable to a correction, which was long overdue. As traders say: sell the news. All that was needed was a spark.

That the markets were enjoying one of the longest periods of extremely low volatility on record remains a mystery. But that all ended, at least for a while, on February 2nd, with a stronger than expected employment report. Not to rehash everything we wrote in the mid-quarter piece titled The End of Goldilocks?, but the markets had become quite comfortable with moderate economic growth—not too hot, not too cold. If too hot, the Fed would need to raise rates to slow inflation; too cold, and recession risks would rise. With global economic indicators signaling the first synchronized expansion since the Great Recession, combined with tax cuts and deficit spending, investors began to fear "too hot". The 10-year Treasury note yield pushed towards 3% and stocks reacted violently. The move was juiced by a risky esoteric financial instrument that delivered gains if volatility stayed low and massive losses if it spiked. Long droughts end unexpectedly and sometimes spectacularly, and so it was with the low volatility trade. We're not sure what those folks were thinking.

After quickly falling into correction territory, equity markets spent most of February and early March recovering ground, only to be smacked down again by Trump's tariff threats to steel and aluminum producers specifically, and to the Chinese trade surplus more broadly. From our perspective, this looks like textbook Trumpian negotiating tactics: start with a growl and end with a grin. With the steel and aluminum threat, the White House first came with a broad warning, then later clarified that there could be exceptions. Trump then excluded every one of our close allies except Japan. As for China, the trade surplus is part structural and part calculated manipulation, but their measured response to Trump's threats

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The Long Game *(continued)*

indicates they know it's part of the show. And it could get results. Importantly, we don't believe there's much of a chance of anything worse than trade skirmishes. There is simply no empirical evidence or economic orthodoxy to support trade wars. There are cool heads in Congress; they'll find their voice, if necessary.

Before we end, we offer a couple of thoughts on market leadership. FANG (Facebook, Apple, Netflix and Google), the cloud (Amazon, Microsoft, Intel, NVIDIA, Broadcom, etc), and a few others like Tesla, have muscled this market along over the last few years. Nearly all are counted among the most innovative and successful companies ever created, and a few are larger than anything else ever incorporated. They are the Generals. The people love the Generals, and they're heavily invested in them. Any stumbles would be unwelcome. In late March, Facebook's handling of user data came under fire. Damage control was poor—the Zuckerberg in tee shirt persona was suddenly not reassuring, and the stock quickly dropped 15%. The consequences weren't surprising. Investors lightened up on the Generals, and the first quarter's fate was sealed.

So it goes. We got a little ahead of ourselves; the 10-year Treasury note pushed up against 3%; the President's gotten around to China; and we entrusted our personal information to a multi-billionaire teenager (at least he looks like a teenager). Was there more to it than that? Maybe. It all comes back to growth. The economy's spent years underwhelming us with 2% growth. It's just not been strong enough to stir up excess, and without excess this cycle could set longevity records. But growth has improved this year and it could be durable. We'll have to see where this goes, but at the moment, things seem fairly normal, plus or minus, so we're not changing our allocations.

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The Financial Markets

- After stock prices surged in January, volatility returned to equity markets despite signs that the U.S. economy appears poised for stronger growth in 2018.
- For the first quarter, the S&P 500 Index closed down -0.8%. The Dow Jones Industrial Average fell -2.1%, while the Nasdaq Index finished up 2.6%. The Russell Mid-Cap and Small-Cap indices edged down -0.5% and -0.1%, respectively.
- Technology was the only positive sector for the first quarter, while Consumer Staples, Telecom and Energy were the worst performing sectors.
- The MSCI All Country World ex-US Index of developed and emerging markets fell -1.2% during the quarter, while the MSCI Emerging Markets Index rose 1.4%. Among the strongest international markets during the quarter were Ireland (+13.4%), Brazil (+12.5%) and Russia (+9.6%).
- The Bloomberg Commodities Index fell -0.8% during the quarter. Brent Crude Oil rose nearly 4% during the quarter. Copper fell over 8%, while Silver dropped nearly 4%. Gold was up nearly 2% as a safe haven trade.
- The CBOE Volatility Index or VIX (a popular measure of the stock market's expectation of volatility implied by S&P 500 Index options) rose from 9.77 at the beginning of January to 19.97 at the end of March. Days after Jerome Powell was sworn in as the new Fed Chairman in early February, the VIX spiked to 37.32 while stock prices swooned.
- The Federal Reserve raised short-term interest rates another 0.25% in March and signaled that it intends to continue on a path of normalizing interest rates.
- The 10-year Treasury Note yield climbed to 2.77% by the end of March on worries that stronger economic growth would push inflation higher.
- Bitcoin prices ended 2017 at $13,805 after reaching $19,193 on December 16. Bitcoin fell further and finished the first quarter at $6,946.

The Economy

- Real gross domestic product (GDP) increased at an annualized rate of 2.9% in the fourth quarter of 2017, led by the strongest consumer spending in three years. Economic growth for the full year 2017 improved to 2.6% versus 1.8% in 2016.
- Non-farm payrolls increased by 103,000 in March, depressed by inclement weather. Nonetheless, employment gains remain solid with a three-month average gain of 202,000. The unemployment rate was unchanged at 4.1% for the sixth consecutive month. Average hourly earnings increased 2.7% year-on-year.
- In January, the Case-Shiller National Home Price Index showed a 6.1% annual gain. The national index is now 7.6% above its prior peak. The 20-City Composite posted a 6.3% year-over-year gain, with prices at record levels in nine metro areas. Low inventories of homes for sale continue to buoy prices.

Commentary

The Economy *(continued)*

- The ISM Non-Manufacturing Index (NMI) fell 0.7 points to 58.8 in March from the February level of 59.5 but remains above the December level of 55.9. The ISM Manufacturing Index also slowed in March (59.3) from February (60.8). With levels well above 50, both segments of the economy continue to indicate solid growth.

Future Prospects and Portfolio Strategy

- Macro-Economic Indicators (+): While domestic leading economic indicators continue to point to strong U.S. economic growth, the pace of growth in Europe and China appears to have slowed somewhat. Only time will tell if this is normal fluctuation or a trend. It should be noted that China's growth is particularly volatile as it appears to be caught in an exaggerated cycle alternating between stimulus and austerity. We remain in the camp that global growth is adequate, if not healthy.
- Interest Rates/Credit (+): The Federal Reserve will continue removing monetary accommodation by hiking short-term interest rates and paring its bond holdings. Long-term yields will have difficulty climbing much above 3% unless inflation expectations increase. The yield curve has flattened with the 2yr/10yr spread at about 50 basis points. Credit spreads remain narrower than average, an advantage to issuers of debt.
- Valuation (N): With the pullback in stocks, the S&P 500's forward price-to-earnings ratio is one point above its long-term average of 16. This is a benign reading given healthy earnings and the current low inflation, low interest rate environment. Free cash flow yield, another reliable measure of valuation, is about 4%. This matches its long-term average and is attractive relative to 10-year Treasury Note yields of less than 3%.
- Sentiment (N): The return of volatility to the markets in the first quarter of 2018 has dampened overheated investor bullishness. The most recent U.S. Advisory Sentiment readings are at levels last seen in September 2017 - not yet considered at favorable levels, but certainly out of cautious territory for now.
- Summary: The long absence of volatility ended spectacularly this quarter. Is something fundamentally different? From our perspective, the answer is no. The news this quarter wasn't any more consequential than that of numerous previous quarters, with the exception of the President's unique approach to the trade debate. And, from our perspective, an actual trade war doesn't seem likely. If anything at all changed during the quarter, it was a firming of the view that economic growth, especially here in the U.S., could be sustained at a modestly higher rate than that of the last several years. Keep in mind, there have been repeated false starts to higher growth ever since this recovery started in 2009. Certainly, tax cuts and increased government spending are stimulative, but the Fed is raising rates: a counter weight. Even assuming that somewhat higher economic growth is in the cards, this cycle would only just now start to resemble past expansions - not a bad thing at all. So, we don't believe the return of volatility portends anything other than the return of volatility. Everything else seems rather normal. Accordingly, our equity allocations remain in line with strategic targets, while fixed income portfolios maintain shorter durations than benchmarks with allocations at or below long-term targets.

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