BRIEF MARKET INSIGHTS

February, 2018

A Note on the Stock Market Volatility:

As most of you know by now, equity markets around the world dropped meaningfully in the last few days, led by the U.S. stock market. The declines now measure over 8.0% from the all-time highs experienced at the end of January, erasing the previous gains for this year. As we have often cautioned clients, on average the stock market experiences a correction (typically defined as a drop of at least 10% from its high) at least once a year. The last such market correction, however, was in early 2016 and investors enjoyed a remarkably uninterrupted run-up since then, with major market indexes hitting new historic highs almost monthly. Before yesterday, the S&P 500 had gone over 400 trading sessions - the longest period in 20 years - without a pullback of at least -5%. Despite the last few days of heightened trading activity, we believe that nothing has fundamentally changed with respect to the U.S. or to global economies within just the last week, nor to corporations' financial strength or potential rates of earnings growth. With 54% of companies in the S&P 500 Index having now reported their Fourth Quarter earnings, overall per share profits are running 14% ahead of the prior year.

An explanation for this drop seemed to emanate from the potential of accelerating inflation and pushed interest rates higher. The catalyst may have been a combination of a Friday surprise report from the BEA that indicated wages in the form of hourly earnings were growing at 2.9% versus a year ago - and perhaps signaling higher inflation than the U.S. Federal Reserve expected. We on the other hand view a steepening yield curve as a more supportive development, allowing high income generation for bond holders and confirming the sustainability of this economic expansion. However, the speed of the recent back up in interest rates obviously concerned market participants who had forgotten that markets do go down as well.

So, has the "goldilocks" economy, with low inflation supporting bond prices and high profit margins bolstering equities, disappeared forever? We think these forces will continue for some time longer. However, the third leg of the chair appears to have finally given way as the unprecedented period of extremely low volatility has come to an end. To get more bearish on markets at this juncture, investors would have to conclude that the central banks around the world are now shifting their monetary response from normalization of interest rates to a tightening mode and giving investors the excuse to continue taking profits. The risk to markets historically has been associated with rising inflation, declining corporate margins and higher volatility. The profit picture still looks particularly good and there appears to be little evidence that wage pressure is eating away at corporate profitability.

Volatility, however, is now up and creates the uncertainty as to the sustainability of the economic expansion. Valuations are now more supportive, as markets have readjusted to the uncertainties of the back half of the business cycle. Globalization has most certainly thrown more noise into the equation, but the current price to earnings ratio of 17 times for the U.S. market on a trailing 12-month basis versus 19.2x just a week ago is within historic levels. In terms of structural forces, particularly globalization and new digital technologies, typical inflationary forces are still distorting the macroeconomic cycle.

We remain in the camp that the U.S. economic expansion continues and projected tax savings on corporate earnings could lead to forecasts for 2018 as high as +20% growth over last year. As long-term investors, we believe that in spite of a dramatic sell-off we are not overly concerned that it is signaling a fundamental shift in capital markets that would be cause for reconsidering the overall exposure of your investment portfolios. We thank you for your continued confidence and welcome any questions or concerns that you may have about recent market movements relative to your investment portfolio.