FROM THE DESK OF BOB CENTRELLA, CFA: *April 11, 2018*

2018 Q1 Summary & Outlook

Spring here on the east coast is still fighting to arrive as winter won't let go of its hold. Brings back memories of when I was in High School and College in Scranton playing baseball. The March and April games could be torturous at times. It would be so cold with flakes in the air that you could barely grip the baseball to throw and when hitting if you didn't hit it square your hands would be numb for 10 minutes after. Personally, I'm ready to hit some golf balls and jump on the bike for a ride. Enough of the cold!

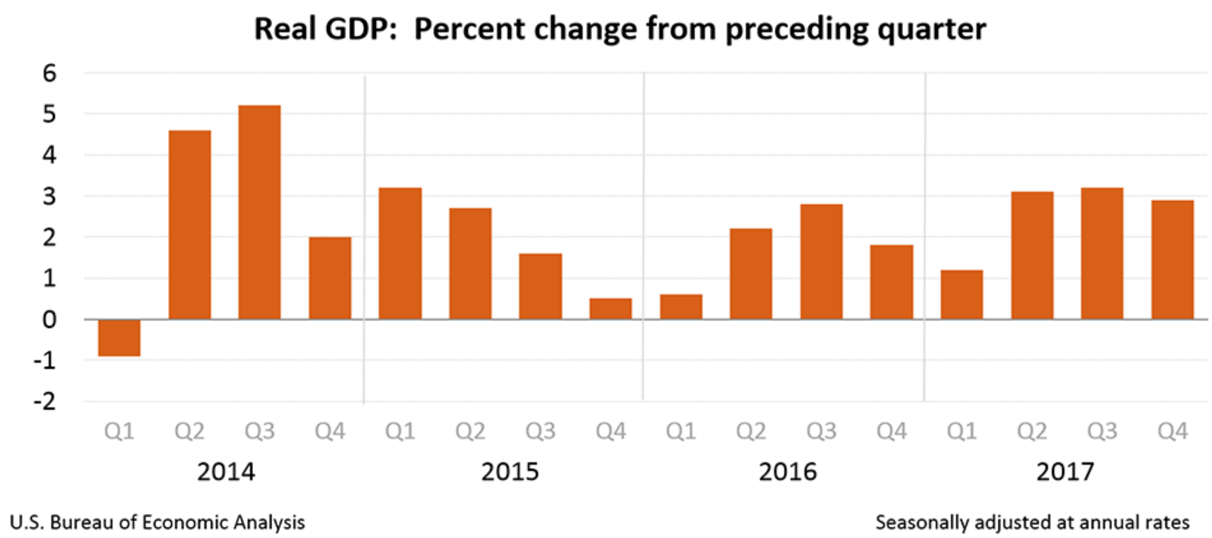
Speaking of numbing, the stock market numbed a lot of investors in Q1 and took a lot of us for a ride. The first quarter saw an increase in volatility in both the news and the markets. For instance, the S&P 500 had a daily gain or loss of > 1% 23 times in 90 days this year compared to only 8 in all of 2017. As we know investing involves both risk and return. Well, this year the focus on risk has definitely returned in Q1. (Now that is quote-worthy!)

When you look at the raw market numbers it doesn't look awful. For all Q1, the Dow Jones Average lost 2.5% on a price basis while the S&P 500 declined 1.23%. This was the first time in 10 quarters (2015) that either the Dow or the S&P declined for the 3-mo period. The NASDAQ was able to rise 2.3% thanks to early gains by FANG stocks that weren't totally wiped out. As a refresher, stocks soared in January with the S&P up 7.5% at the peak on tax cut and economic optimism setting daily records -- only to tumble by more than 10% in February into a correction as interest rate jitters hit the markets and volatility reared its head. It remained sluggish through March as trade war worries surfaced and Amazon and Facebook came under fire for increased regulation and a data breach taking down tech stocks. Below is a table showing how various asset classes fared in the quarter. Looks like investors have an appetite for Cocoa!

Asset Class	***Q1-18 %***	***Asset Class***	***Q1-18 %***
Cocoa	35.10%	S&P Midcap 400	-1.15%
Brazil Bovespa	11.73	**S&P 500**	**-1.23**
Mexican Peso	8.31	Natl Muni Bond	-1.63
Nymex Crude	7.48	Vangrd Tot Bond	-2.01
Japanese Yen	6.08	**7-10 Yr US Treas**	**-2.25**
UK Pound	3.73	Dow Jones Indus	-2.49
Euro	2.67	US Dollar Index	-2.59
FTSE Italy MIB	2.55	France CAC 40	-2.73
NASDAQ	2.32	Stoxx Europe	-4.71
Swiss Franc	2.14	Nikkei 225	-5.76
Gold	**1.26**	German DAX	-6.36
Russian Ruble	.87	Coffee	-6.38
Hang Seng	.58	Natural Gas	-7.45
Small Cap 600	.24	FTSE 100	-8.21
1-3 Yr US Treas	-.35	Lean Hogs	-20.24

ECONOMY

Q4 real GDP increased 2.9% and for all of 2017 growth was about 2.6% but above 3% since the end of Q1. The US economy is still plodding along in a stable fashion with unemployment at 4.1% for the last 6 months, but inflation is starting to heat up. If the economy grows through 2018 and 2019, it will be the first decade of growth without a recession since at least the 1850s! We still have some ways to go but the momentum is positive for now unless the Fed overshoots with rate hikes and causes a recession – which typically happens. As a reminder, for the last 20 years annualized real GDP growth has averaged 2.27%.



There are a lot of crosscurrents that drive the economy which I won't go into and Trump trade policies may have a negative effect on the economy offsetting some of the tax cuts. An infrastructure plan could give some positive momentum to 2019 as well. Overall the US and Global economies appear to be in decent shape. A big wildcard is the tightening of monetary policy that is starting here in the US and may move overseas. We shall need to keep an eye on this. But for now, the economic trends are still positive in the US.

BONDS

As mentioned above and in my year-end letter, one risk is that there are some signs that inflation is picking up a bit slightly above the Federal Reserve's target of 2%. The Federal Reserve has indicated that 2 more rate hikes are forecasted for 2018 and possibly 3 in 2019. If inflation moves higher due to the tightened labor force and rising wages, then further rate hikes could roil the markets. Bond yields moved higher since 12/31 with the 10-yr UST going from 2.41% to as high as 2.95% before moving back down to about 2.8% today. This caused some of the selling of stocks in February as investors pondered a 10-yr above 3%. Personally, I found it to be an over-reaction as a 10-Yr at > 3% was common up until around 2008 when rates moved down during the financial crisis. Over the years, stocks still managed 8-9% compounded gains with rates much higher. Meanwhile, the 2-yr UST has been the most sensitive to rising rates moving over 100 basis points (1%) to 2.26% since mid-2017. The 6-month T Bill yield of 1.91% surpassed the dividend yield on the S&P 500 for the first time since 2008. But putting all that in context, the 10-yr UST is still 200 basis points below its average yield of 4.86% over the last 30 years. Rates are still low relative to history.

One thing to keep an eye on is the flattening yield curve. The spread between 5- and 30-Yr and 2- and 10-Yr maturities (5/30 and 2/10) is at a level not seen since 2007. Much of this flattening may be due to geopolital issues and there was a slight inversion this week at short maturity ranges in the bond futures. Inverted yield curves, where short term rates are higher than long-term rates, generally are a leading indicator of recession.

Having said that, I believe the Fed will raise rates at least 2 more times in 2018 and inflation will remain around 2%. I had previously talked about a range of 2.2% to 2.95% for the 10-yr as likely for 2018 but am leaning towards the higher end. I still wouldn't be surprised to see the 10-yr at 3.0%-3.25% in 2018. But the 10-yr remains a safe-haven for global investors which can keep the rate depressed and possibly cause the spread to continue to flatten.

Outside the US, economic growth is mostly solid. Easy monetary policy is still there but the ECB and other Central Banks are looking at tightening and raising rates. Low rates outside the US could keep the 10-yr relatively attractive compared to other developed countries but it is possible rates rise around the world.

So, my recommendation for fixed income is still to be in short to medium term securities (6-mos to 2 yrs.) so you can reinvest maturing bonds into higher yields including Treasuries, Corporates, Agency and some floating rate debt. Yields are between 2.25% and 3% for higher quality debt. I'm still wary on high-yield as spreads have tightened and with US rates moving up, HY debt becomes less attractive. I'd stay clear of longer-term maturities as you risk price erosion and capital depletion and rates aren't attractive enough yet. I also recommend buying individual bonds rather than passive ETFs. The passive ETFs have considerably more risk of depreciation as individual bonds can be held to maturity. Look for 2018 to be flat overall, but still necessary part of a balanced portfolio as a hedge. A shorter-term portfolio as I described can return 2% or so until rates become more attractive.

STOCKS

Last quarter I tried to answer the question on whether stocks were overvalued. I said that I didn't think so although the market wasn't inexpensive. With the recent market pullback while earnings estimates have increased, the S&P is now valued at a little over 16x forward earnings compared to 18.4x just 3 months ago. And as bad as the last 2 months felt, due to the early gains in January we are still only down slightly YTD. What's driving the volatility are headwinds of rising rates, the FBI Russian investigation, trade war fears, possible Syrian conflict, and the aforementioned Facebook and Amazon issues. Notice I didn't mention the economy or earnings. That's because those 2 fundamental items are solid. So, it's headline fears that are driving volatility.

Another thing I talked about in my last letter was the lack of skepticism as investors were bullish. That too has changed with over 2/3 of investors bearish or neutral based on the latest AAII investor poll. That's good as it opens the potential for positive surprises. So, as we head into Q1 earnings season over the next several weeks, I think the market is setting up for a little rally if earnings are as solid as they have been the last several quarters. The market will continue to battle the headwinds but eventually fundamentals tend to win out.

This is what I said in my Annual letter 3 months ago, "*I'm going to go out on a limb and say that we will have a down month or 2. But by the end of 2018, barring an unforeseen political or geopolitical event, I look for double digit returns in stocks."* So, we just had 2 down months, and we might get another 1 or 2 by the end of the year. That's normal! But I still believe that by the end of this year, stocks will far outperform bonds and we should see a healthy gain near or above historical averages (barring an unforeseen geopolitical event). Again, not all stocks will react equally, so it should be stock pickers year. There are now some bargains out there. Over 300 of the 500 stocks in the S&P are now down 10% or more from their 52-week highs.

As the recent declines in technology shares highlighted, it is good to be diversified in your sectors. I continue to like exposure to financials, industrials, energy and technology stocks balanced out with the other more stable consumer sectors. On the oil front, the price of WTI is currently near $67, up 10% from the beginning of the year. With oil in the $60's or higher, Energy stocks should come back into favor. Regarding foreign stocks, with Global GDP accelerating in 2018, I recommend exposure to international stocks through broad-based ETFs as the easiest way to own companies rather than individual equities unless you have the time to do the research. Emerging market stocks also look attractive, so I would take a diversified international approach as well. Finally, I also like exposure to Mid and Small cap stocks which are less sensitive to trade concerns.

SUMMARY

In summary, Forza's recommendation remains consistent as before – we still like equities, are cautious on bonds but would maintain both in the overall allocation of assets for balanced portfolios. On a fundamental basis, we prefer equities to bonds and would have exposure to international stocks.

Let's hope some warmer weather also brings a brighter outlook for stock gains. Have a great rest of the Spring and Summer. As always, feel free to email me or call at 908-344-9790.

-Bob