Braver®
Capital Management
An **ADVISER INVESTMENTS** Company

Quarterly Outlook

APRIL 2018

In early 2018, volatility returned to U.S. and foreign stock markets. As uncomfortable as that may feel, what we're experiencing today is a return to a more normal investing environment following a remarkably placid 2017. Yet, despite descending into correction (10% or more below a prior high) territory in February, the major U.S. markets have generated only small declines for the year through March.

For long-term investors like us, the reemergence of stock market volatility creates wealth-building opportunities and reinforces our core investment philosophy—identify and quantify your risk comfort zone and investment goals, then invest in a well-defined and disciplined strategy that can see you through turbulent times.

Multiple factors are likely to sustain such turbulence. We see no let-up of ongoing political and geopolitical dramas surrounding Special Counsel Robert Mueller's investigation, Brexit implications and the intentions of despotic regimes from North Korea to Iran. Fears more closely related to the economy and the stock market also linger, including the possibility of rapidly rising inflation and a faster pace of Federal Reserve interest-rate hikes, tariff posturing and trade-war nervousness, and stock valuation concerns. Looking ahead, we expect this fear-driven skittishness, expressed in daily volatility, to persist and possibly increase even before we get to a rancorous midterm election in November.

THE FACTS CONTINUE TO REVEAL AN EXPANDING GLOBAL ECONOMY.

Rest assured that we are not watching passively from the sidelines. To ensure that our fundamental strategies account for not just the facts we know, but also our knowledge of how fear can drive markets in the near-term, we continue to review our risk-aware asset allocation. We also monitor the risk management track record of each of our tactical strategies. If facts warrant further risk mitigation, we'll act in accordance with our investment views to make sure our strategies are aligned with their objectives.

As always, our focus is on fundamental facts, not on headline fears and panicky pundits. The facts continue to reveal an expanding U.S. and global economy, improving corporate earnings and low interest rates. Consumers, the backbone of the U.S. economy, are fully employed and beginning to benefit from rising wages. So while investment gains may be harder won and the environment is less comfortable, we are optimistic, though less so than in past quarters, about the potential for stock market gains over any meaningful investment timeline.

First Quarter Review

After a string of nine consecutive calendar quarters of gains, the U.S. stock market took a step back over the first three months of 2018, as the Dow Jones Industrial Average declined 2.0% and the S&P 500 index slipped 0.8%. Meanwhile, the MSCI U.S. Broad Market index was down 0.6% year-to-date, bolstered in part by the performance of mid- and small-cap stocks, which showed slightly stronger (but still negative) returns compared to large stocks. If we adjust our rearview to 12 months, it's been a very solid period for U.S. stocks, with

U.S. and Developed Foreign Stock Markets Take Step Back

	Q1	12 MO.
MSCI Emerging Markets	1.4%	24.9%
MSCI U.S. Broad Market	-0.6%	13.8%
S&P 500	-0.8%	14.0%
Bloomberg Barclays U.S. Agg. Bond Idx.	-1.5%	1.2%
MSCI EAFE	-1.5%	14.8%
Dow Jones Industrial Average	-2.0%	19.4%

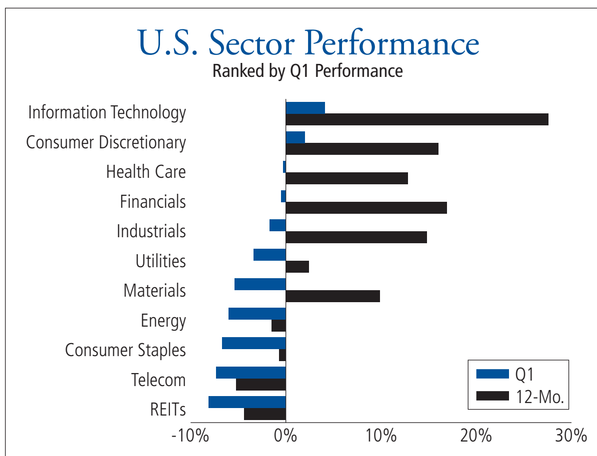
Note: Performance numbers are total returns, reflecting reinvested dividends through 3/31/18. Source: Morningstar.

returns ranging from 13.8% for the broad market to 19.4% for the Dow.

Foreign developed market stocks, represented by the MSCI EAFE index, have roughly matched the U.S. stock market—declining 1.5% year-to-date and gaining 14.8% over the last 12 months.

By far the strongest performing segment of the global stock market has been the emerging markets. The MSCI Emerging Markets index is the lone benchmark in the table above in positive territory year-to-date, and its 24.9% return over the last 12 months is also at the top of the rankings.

Only two sectors of the U.S. stock market finished the quarter in positive territory; technology and consumer discretionary stocks gained 4.1% and 2.0%, respectively. The tech sector held on to gains year-to-date despite a rough month in March (the sector index fell 3.3%) during which revelations about misuse of Facebook user data by Cambridge Analytica sparked consternation worldwide and led to talks of increased regulation of the social media industry. Despite March's woes, tech is the top performing sector over the last 12 months, with a 27.6% gain, followed by financial (up 16.9%) and consumer discretionary (16.0%) stocks.



Source: Morningstar.

REITs (real estate investment trusts) and the telecom sector, both sensitive to interest rates, showed the largest declines in the first quarter, -8.1% and -7.3%, respectively. They are also the worst-performing sectors over the last 12 months; REITs are down 4.4% over that period, while telecom stocks have fallen 5.2%.

The broad U.S. bond market declined 1.5% in Q1 as rising interest rates pushed prices down. While shorter-maturity bonds felt less of an impact, they still showed modest losses; long-maturity bonds, with the greatest sensitivity to interest-rate moves, fell more. The yield on the benchmark 10-year Treasury bond rose from 2.40% at the end of 2017 to 2.74% by quarter's end.

Our Outlook

As we enter the second quarter, fear of rising inflation may continue to take a back seat to the tariff skirmishes and their potential to trigger a trade war with our partners in commerce, China in particular. And while we won't actually know if tariff posturing

THE MARKET IS PRONE TO PRICING IN TRADE-WAR PROBABILITIES ON NEARLY A DAILY BASIS.

is leading us into a full-blown trade war until after the allotted commentary and hearing periods have elapsed and any subsequent negotiations have or have not been resolved (which could last into the summer or even the fall), we already know that the market is prone to pricing in its probability more or less on a daily basis.

But while headlines spotlight the billions of dollars of goods impacted, our analysis suggests that what has been proposed so far represents a tiny slice of the global economy. Though it's estimated that the direct economic impacts could be minimal, broad-based trade wars have typically been harmful to the countries involved, with few winners.

Self-interest suggests there's a better way forward for all sides, but we are cognizant of the fact that this administration is not known for diplomacy and

that China is a communist country whose president-for-life doesn't have to answer to what is in the best interests of his people, only that which empowers his politburo. Know that we take the potential for a trade war seriously and will be monitoring it (as well as the host of other factors that could disrupt the markets) closely.

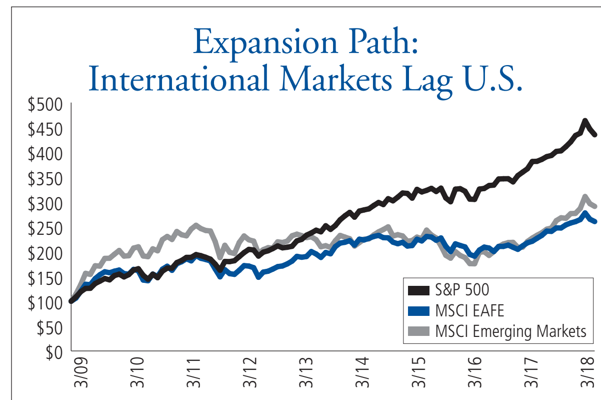
Ultimately, we think the outcome of this ongoing verbal conflict will be a compromise that allows both sides to claim victory and economic growth to continue. If worse comes to worst, we also know that tariffs can be removed just as easily as they are applied.

We pay far greater attention to more concrete factors when forming our investment outlook: Corporate earnings, interest rates and the health of the U.S. consumer. Together, they add up to a picture of prosperity and the potential for further economic and market expansion.

Stock market valuations by most measures are still expensive, even after the recent correction. That said, as is often the case with fear-based selling, broad swaths of the market sold off regardless of companies' fundamentals, creating relative bargains for our portfolio managers and strategies to invest in. The trend of corporate earnings growth appears intact, and initial estimates are for a 17.1% increase in Q1, which would represent the highest quarterly growth rate in seven years. Some of this is attributable to the broad corporate tax cuts passed by Congress at the end of 2017, which increase companies' profitability. We also expect that consumer tax cuts could lead to increased spending, further driving earnings higher. And a new wave of corporate stock buybacks funded with increasing cash holdings will help lift earnings per share.

Of course, we will keep you up to date on our views of first-quarter earnings and the trends we're observing in our weekly and monthly email updates. If corporate earnings continue to climb, stock valuations will become more reasonable, which could help extend the bull market. Even at elevated prices, the intermediate-term growth potential for stocks still makes them more attractive than bonds.

As noted, in Q1 developed foreign stock markets fell in concert with U.S. markets. However, valuations overseas have not yet reached "expensive" territory, and the recent pullback continues to make them appear cheap compared to U.S. stocks. The fact that the economic expansion, central bank policy shifts and stock market gains in Europe and Japan have lagged behind ours over the past several years leads us to expect that these markets will provide growth opportunities in the years ahead. The same goes for investments in emerging economies.



Note: Chart shows hypothetical growth of $100 in each index from the end of February 2009 through March 2018.

Liquidity remains high, and the new chair of the Federal Reserve, Jerome Powell, who succeeded Janet Yellen in February, doesn't appear to be much different from his patient, data-dependent predecessor. At his first meeting leading the central bank, as expected, the fed funds rate was hiked 0.25% to a range of 1.50%–1.75%, which is still low by historical measures. Since then, Chair Powell has stated that the Fed is likely to deliver more rate hikes this year. He has also said that a strengthening economic outlook could mean they take a more active hand in raising rates. The Fed's main role is to safeguard full employment and price stability. With employment technically "full" and wage growth showing some modest improvements after years of nearly no movement, we think the Fed's plans are reasonable.

STOCK MARKET VALUATIONS ARE STILL EXPENSIVE, EVEN AFTER THE RECENT CORRECTION.

Inflation, the Fed's other main concern, is present at a 1.8% year-over-year headline rate (as measured by the central bank's preferred gauge, the personal consumption expenditures index), but it hasn't showed any signs of heating up. Add in fiscal stimulus in the form of tax cuts and this is an opportunity for the Fed

to build up a store of dry powder by hiking interest rates now so policymakers have the ability to begin a new round of stimulus if and when needed.

Rising interest rates have helped generate more income for bond investors, but the broad bond market has yet to see the growing income component offset short-term price declines. Rising yields eventually accrue to investors' benefit, but it is always the case that prices move faster than income builds—this does not mean that bonds are now a poor investment, however. Bonds remain a valuable risk management tool for investors, as they can reduce a portfolio's volatility and provide defense against stock market pullbacks.

Looking ahead, we are confident that our fundamental portfolios are well-positioned to address and manage higher levels of volatility, and that our tactical strategies are responding as designed to the current environment. If you have questions about how our strategies are invested or how they've been behaving, please give us a call. Thank you for your continued trust and partnership.

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