Stocks' Winning Streak Snaps; Volatility Returns

By R. Kevin O'Keefe

Stocks broke their winning streak in the first quarter as volatility returned. Worries about inflation, the threat of trade war with China, and the specter of new regulations on tech firms eig the market. Economic data remained positive as the Fed's new Chairman Jerome Powell moved to raise the Fed Funds rate again.

Many investors enter the second quarter apprehensively, reflecting the retreat of tech stocks as well as increasing worry about the effects of rising interest rates on market valuations and volatility.

The S&P 500 fell 0.8%, its first quarterly loss since 2015. The Dow Jones Industrial Average dropped 2% over the same period while the Nasdaq Composite gained 2.8%.

Major stock indexes are still up in the double digits percentage-wise over the past 12 months, while the economic outlooks remain mostly positive. Both domestic and international economies are expected to continue to expand throughout the year, helped by the $1.5 trillion tax-cut package which is expected to accelerate corporate earnings growth and prolong the U.S. economic expansion which began in 2009.

Quarterly Performance Benchmarks

Passive Benchmarks*	Q1-2018	YTD	1 Year	3 Year**	5 Year**
S&P 500 Index	-0.76	-0.76	13.99	10.78	13.31
MSCI KLD 400 Social Index	-0.21	-0.21	14.03	9.63	12.39
DJIA (reinvested dividends)	-1.96	-1.96	19.39	13.48	13.32
S&P MidCap 400	-0.77	-0.77	10.97	8.96	11.97
Russell 2000 (Small Cap)	-0.08	-0.08	11.79	8.39	11.47
MSCI EAFE (Europe, Australasia, Far East)	-1.53	-1.53	14.80	5.55	6.50
MSCI Emerging Markets	1.42	1.42	24.93	8.81	4.99
Bloomberg Barclays Aggregate Bond	-1.46	-1.46	1.20	1.20	1.82
Morningstar Mutual Fund Benchmarks					
U.S. Large Cap Growth	4.98	4.98	26.12	12.90	16.34
U.S. Large Cap Value	-3.13	-3.13	8.76	9.85	10.69
U.S. Mid Cap Growth	3.36	3.36	20.82	8.54	12.77
U.S. Mid Cap Value	-1.62	-1.62	7.68	10.09	13.22
U.S. Small Cap Blend	-1.58	-1.58	9.76	7.45	11.01
Foreign Large Blend	-0.85	-0.85	15.19	5.77	6.25
U.S. Real Estate	-6.65	-6.65	-2.30	1.47	5.71
Intermediate-term Bond	-1.33	-1.33	1.32	1.29	1.75

* Sources: Morningstar
**3-Year and 5-Year returns are average annual returns for that benchmark.

Performance data presented reflects past performance. Past performance is no guarantee of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Information has been obtained from a source considered to be reliable; however, neither First Affirmative nor its agents can guarantee the accuracy of the numbers reported.

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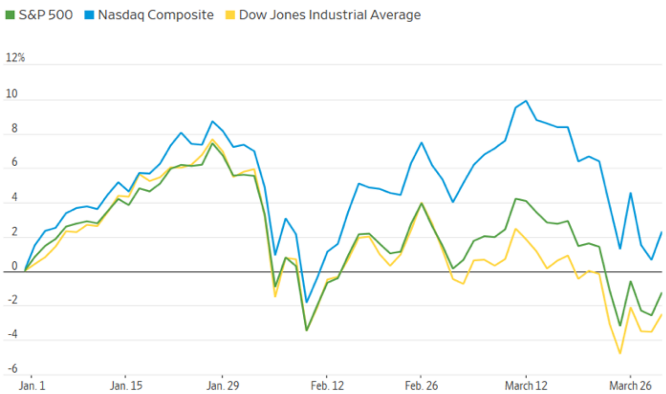
But there is growing doubt as to whether the tax cut will be sufficient to keep the expansion going. As investors prepare for further increases in interest rates some economists are cautioning that the pace of the global economic expansion may slow. The global bull market owes much of its historic run to the lack of competition from cash and bonds. Investors seeking decent returns have had few options available to them except for risky assets, i.e., stocks. As interest rates rise, a growing concern is whether the effect will hinder economic activity.

Chronology

The market ended the quarter quite differently than it began. Stocks soared in January with the S&P 500 jumping more than 5%, setting records almost daily. Global economic strength was the fuel for the optimism that led investors to pour a record amount of money into equity mutual funds and exchange-traded funds.

Index performance, year to date



Source: FactSet

But stocks fell in February. Interest-rate fears combined with signs that the ultra-low volatility phenomenon of 2017 was ending, and stocks have struggled to regain any momentum since. The last time the S&P 500 rose more than 5% in January but closed the quarter with a loss was in 1980.

The Economy

The economic outlook continues to be positive, but the uncertainty over the White House's trade policies and the path of interest rates are concerns.

According to FactSet, corporate earnings among S&P 500 companies are expected to post 17% growth in the first quarter vs. the first quarter of last year, which would be their best results since the first quarter of 2011.

Interestingly, some of the companies whose stock price declined the most in March are expected to post the fastest rate of earnings growth. S&P 500 materials-sector stocks fell when it was feared that increasingly protectionist trade measures would slash profits of companies dependent on steel and aluminum imports; however, the materials sector companies are expected to deliver earnings growth of 44% from this time last year, according to FactSet. Technology firms are also expected to do well. Analysts estimate first-quarter earnings growth of 23% for the S&P 500 technology sector, despite having struggled to find solid footing in recent weeks.

Consumer spending throughout the rest of this year is expected to continue strong. The threat of a sharp rise in inflation hasn't materialized yet. Several measures of inflation, including the Commerce Department's personal-consumption expenditures price index, have come in below the Fed's 2% target. Wage growth also has been slow, and the labor market remains strong.

Focus on Funds

If you haven't checked to see how your mutual funds performed in the first quarter, prepare yourself. Most lost money. After a long winning streak during which most funds moved ever higher quarter after quarter, investors are rediscovering volatility.

It took only a few wild weeks to wipe out what had been the stock market's best start to a year in decades.

In February, the wildness was due to worries about rising inflation and the likelihood of rising interest rates. By March, the narrative morphed into fear that the world's biggest economies were hell-bent on all-out trade war.

What has made the market's recent volatility harder to swallow is that the conservative part of investors' portfolios—the part that is supposed to perform well when stocks wobble—have also had a rough go of it.

Items of note that characterized last quarter:

- Technology-heavy stock funds were among the best performers, despite how much they have skidded in recent weeks. The average large-cap growth stock fund gained 7.5% in January alone, for example.
- As the quarter drew to a close, Facebook stock suffered its worst week in nearly six years on worries that the scandal involving its customers' private information could hurt its bottom line.
- The majority of bond funds lost money, due mainly to some of the same worries that afflicted stocks in early February: fears of inflation and rising interest rates. Although interest rates are expected to keep climbing, bonds can still be considered the safer part of a portfolio.

Volatility Roars Back: Biggest Quarterly Rise Ever

The Cboe Volatility Index, or "VIX," surged about 80% during the first quarter, following a multi-year period of relative quiet characterized by loose central-bank policies and steady global economic expansion.The sudden rise in volatility reflected growing investor concerns about inflation, rising interest rates and global trade tensions. The U.S. stock market officially entered correction territory during February, while fears of a trade war continued to trigger stock market spasms throughout March.

Investors, not traders

At First Affirmative, our clients are not investment professionals. We are not trying to turn you into investment professionals. Nor are you traders, seeking to "beat the market." You are long-term investors seeking to accomplish various long-term financial goals while using capital for the greater societal good. Our goal is to partner with you toward that end and, as part of the process, improve your experience as consumers of financial services. The drumbeat of financial news might lead you to think that the latest headlines should somehow matter to you; that perhaps you should actually act on all this information—but most of what passes for financial news is not particularly useful to most investors.

What matters to most investors is to achieve your financial goals. Some of your goals may be near-term, some intermediate-term and some long-term—and the investment strategies for achieving goals with different time horizons are quite different. Money that is being saved for near-term goals should be deposited in safety-of-principal vehicles, such as savings and checking accounts, money-market funds, CDs, etc. The stock market is simply too risky a place for short-term investing.

Fortunately, most investors understand that money invested for long-term goals—i.e., not to be needed until decades into the future – should largely be invested in stocks. Of course the value of a stock portfolio will bounce around, and occasional large drawdowns are to be expected. Price volatility comes with the territory; periodic declines are the price you have to be willing to pay for the superior returns over the long term.

It's the intermediate-term that's tricky. How should you invest money that will likely be withdrawn in the next 5-15 years? This is where more vigilance is needed. A balanced portfolio is probably the way to go, and the shorter the time horizon, the less the exposure to stocks. The non-stock portion of the portfolio should be a mix of bonds and cash equivalents, and the shorter the time horizon, the shorter the duration or maturity should be. Unless you're using a "set-it-and-forget-it" vehicle such as a target-date fund (which have become very popular among 401(k) plan participants) or a target-range vehicle such as many 529 College Saving Plans offer, this means reviewing your asset-class mix periodically and adjusting as appropriate.

Market peaks and bottoms are always evident in hindsight, but they are never knowable in real time. Bubbles expand far beyond reasonable valuations, and although they sometimes burst with catastrophic results, they often don't, finding instead interesting ways—exasperatingly long sideways markets, for example—to frustrate rational investors who expect the market to eventually prove them right. The reality is that markets are not only hard to predict in the short-to-intermediate term, but they are necessarily so. If stocks weren't risky they wouldn't offer superior long-term return potential. There is no such things as a low-risk, short-term, high-expected return investment. It doesn't exist. And so you have to choose your priorities. If your time horizon is long enough (decades long), and you can stomach the ups and downs along the way without agonizing over whether you need to bail out, then the long-term superior rewards from a diversified portfolio of stocks are absolutely achievable. But most of us aren't wired that way, and so most of us need to include some ballast to temper the volatility, so we can sleep at night, and so that we don't succumb to the urge to bail out at the worst possible time.

A diversified portfolio of stocks is still likely to outperform other asset classes over the long term. It's counterproductive to think about how much stocks will return in 2018 or 2019. If you're investing properly, what matters is whether you're accumulating shares over a long period of time at various prices. The essential question is this: do you believe that many years from now the stock market will be many times higher than it is today? If so, then invest accordingly. Maybe even view market downturns as opportunities to buy more shares while they're "on sale." But don't ever believe that timing the market is where you should put your focus. The fact that stock indexes globally are near all-time highs is proof that markets have always recovered from bear markets and subsequently gone on to reach new highs.

Does this necessarily mean that in the future stocks will generally behave as they have behaved in the past; i.e., outperforming cash and bonds over the long term? No, it does not. But the preponderance of evidence says that that's the way to bet.

Fixed Income Commentary

Provided by Wasmer Schroeder and Company

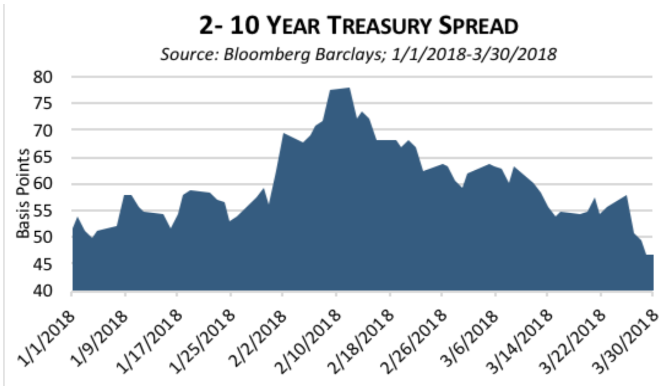
A Little less conversation...

..a little more action. Congress here in the U.S. did their part just before year end by finally passing the Tax Cuts and Jobs Act after much debate. The fiscal stimulus embodied in this legislation moved the bond market early in the year in a major way. The U.S. 10-year note started the year at 2.41% but made a bee line for 2.95% on the back of first quarter 2018.

The Federal Open Market Committee (FOMC) was busy. New Chair Jerome Powell and the reconstructed voting membership raised the Federal Funds rate in March as was widely expected. This move, as well as some well telegraphed comments pointing to further action later this year, led to more flattening of the U.S. Treasury curve, a trend we expect to see continue throughout 2018. Interestingly, the other major Central Banks in the developed world talked more and acted less in the first quarter. We expect more action later this year, especially from the European Central Bank. It is interesting that our Fed's more aggressive stance has not caused the U.S. dollar to appreciate more. We will be watching this relationship closely this quarter as a stronger dollar would by extension remove even more pressure from the inflation picture (and by the way, despite continued hand wringing, there were still no substantive signs of inflation seen in the first quarter).

Bond markets were not immune to the violent price action seen in equities starting in early February. This was especially true in the corporate market, where correlations to the stock market are intuitively higher.

The government related sector had a positive effect on performance in the quarter. Treasuries were the best performing index sector in the fixed income market during the 1st quarter. Agencies were strong performers as well and spreads remain only slightly over U.S. Treasuries. They benefited from the flight to quality bid we saw at the end of the quarter. We continue to favor bullets over callable and as such, we do not expect significant changes to the agency allocation moving forward. The mortgage market had the opposite performance of the corporate market; they had a tough January but performed well after the initial selloff.



Conversations among the world's Central Bank steering committees, legislative bodies grappling with fiscal challenges, and electorates facing important, potentially power shifting votes will clearly continue to drive our markets throughout the remainder of 2018. We believe that heightened levels of volatility will continue to be the norm rather than the exception. We also believe that this will probably continue to keep Treasury rates more or less range bound this quarter, although we do expect the yield curve to grind flatter as the FOMC continues its removal of accommodation.

Tax Exempt Market

Municipal bonds were largely swept up in the negative price action stemming from the sell-off in the U.S. Treasury market, particularly during the first two months of the quarter. And while March delivered a much-needed rally, the -1.11% total return posted by the Bloomberg Barclays Municipal Bond Index ended up as the worst first quarter of performance for munis in 22 years (first quarter of 1996: -1.20%). Understanding that the tax exempt bond market has stumbled out the gate this year, it is worth noting that the muni market eventually clawed back from that rough start in 1996, returning 4.43% for all of 1996. So, though rates were higher then, we can point to history being on 2018's side in terms of the market's ability to end the year in the black.

While the muni market's performance during the quarter was primarily driven by Treasuries, we did continue to benefit from the technical trifecta of low supply, consistent fund inflows and stable credit quality. Supply fell by 29% in the first quarter of 2018 compared to the first quarter of 2017 at $61 billion versus $86 billion last year; if December 2017 had been a normal month of issuance (instead of a record high month) then our first quarter supply figures would probably look flat year over year. Still, the low issuance period associated with the Great Recession in 2008 and the 10-year anniversary of the Build America Bonds (BAB) program in 2009 and 2010 doesn't look great for deal volume over the next 12 to 24 months.

Municipal bond funds saw net inflows in every week of March, with the average inflow over the final 8 weeks of the quarter coming at $152 million. So retail demand continues to be quite strong, particularly when you consider the negative performance during the quarter (which normally contributes to net fund outflows) and lower tax rates for banks and insurance companies.

Over the coming quarter, we expect continued low supply and ultimately negative net supply out of the municipal bond market. Investor demand will likely remain strong, and the short end of the curve in particular seems well positioned to outperform Treasuries given where muni-to-Treasury ratios ended in March. April tax season could test the market's liquidity but any impact will be temporary.

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