Executive Summary:

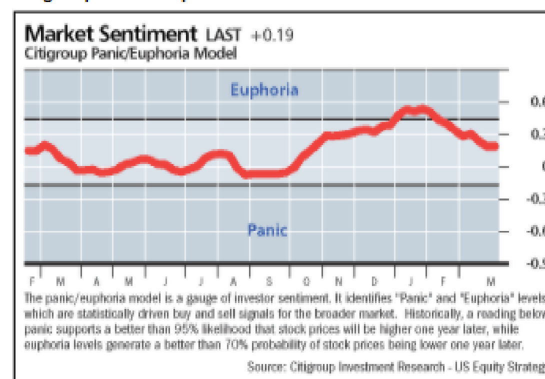
- **Volatility Returns.** Volatility returned in Q1 with stocks falling sharply after peaking in January. A long winning streak in stocks came to an end with the Dow Jones Industrial Average declining 2.5% for its first quarterly loss in more than two years and the S&P 500 falling about 1%.
- **Fretting Over the Fed.** Economies both here and abroad continue to expand, but if this strength takes up more slack and drives a sustained increase in inflation the risk of recession induced by higher interest rates will rise.
- **Trump, Tariffs and Trade.** Adding to volatility during the quarter was the announcement of various tariffs by President Trump. Harkening back to an era no one wants to relive, comparisons to the 1930s and the Smoot-Hawley tariffs were pervasive.
- **Tech Corrects.** Technology stocks have been the big winners on Wall Street. The Tech sector was up almost 39% in 2017, the best among S&P 500 sectors. But, sentiment on technology stocks changed quickly when privacy concerns arose over the use of consumer data at Facebook.
- **Earnings and Outlook.** First quarter earnings season should kick off what is expected to be a robust year for corporate profits. While late in the economic cycle, we are hard pressed to be anything but constructive on equities even with the expectation that volatility will be more pronounced in the future.

"For Every Action There is an Equal and Opposite Reaction." Newton's Third Law

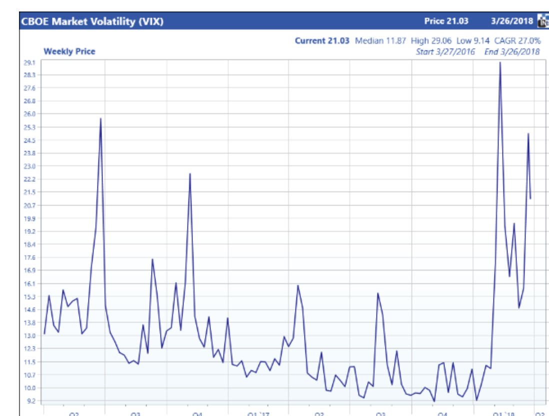
Volatility Returns. We have long felt that the stock market and the behavior of stocks have tendencies that resemble the laws of physics. The most obvious is gravity—stocks that move higher and go "parabolic" are often said to have defied gravity. The share price of these companies often declines in a manner consistent with the increase, meaning that the faster the stock went up, the faster it will go down correcting in price. Another concept common in investing is reversion to the mean. If a trend in a business extends above the long-term average, that trend will usually move below the average thus restoring the data point to its long-term mean.

Throughout 2017, clients and commentators marveled at the relative calm in the markets.

Citigroup Panic/Euphoria Model



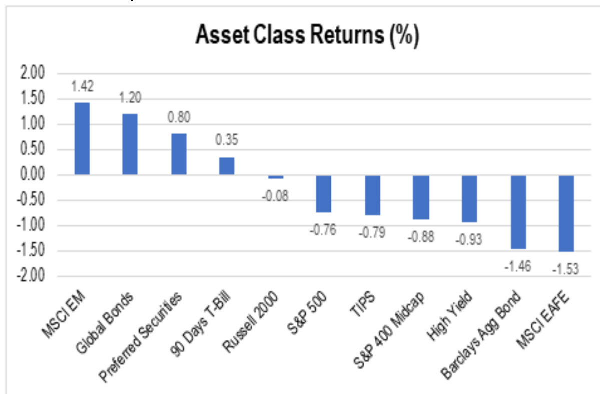
Stocks levitated higher with the S&P 500 posting a positive return in each month of the year. Stocks continued on their merry way over the holidays and into the new year posting a gain of nearly 7% in January. Investor sentiment became quite euphoric (see chart above), money was flowing back into equities, and the valuation on the market was elevated, trading at nearly 20x forward earnings (after incorporating the benefits of the new tax law into corporate profits). The bulls were stampeding and it was at this point—on Groundhog's Day to be exact—when volatility returned and stocks fell sharply, correcting nearly 10% in about a week.



Source: Intrinsic Research

The chart on the previous page shows that there were only a couple of tepid spikes in the volatility index or VIX last year. Contrast that to the dramatic surge in the VIX during the first quarter. There have already been 11 *days* in 2018 where the S&P has declined 1% or more. There were six trading days in Q1 when the S&P gained or lost 2% or more. Last year, there was not a single day where the S&P gained or lost 2% or more. The Dow now stands 9.1% off its record close and the S&P is off 8%.

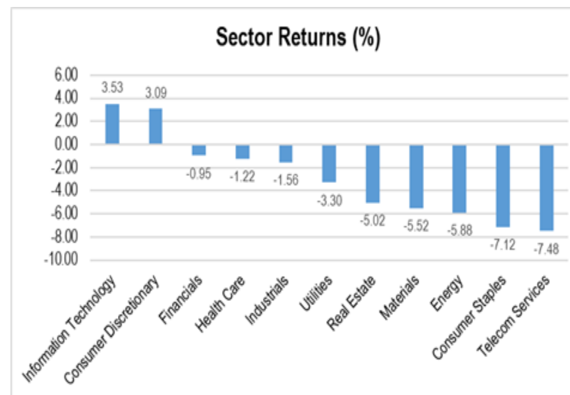
A long winning streak in stocks came to an end in Q1 with the Dow Jones Industrial Average declining 2.5% for its first quarterly loss in more than two years and the S&P 500 falling about 1%. This was the first time in ten quarters that both the Dow and the S&P posted a quarterly loss. While struggling late in the quarter on technology-related concerns, the Nasdaq still ended up 2.3%.



Source: Federal Reserve Bank – St. Louis

Performance across asset classes was generally around breakeven. Stocks were slightly negative--emerging markets being the exception posting a gain of nearly 1.5%--with fixed income markets also under some pressure—high yield fell not quite a percentage point and the broader Barclays Agg Bond Index declined 1.5%.

Just two of eleven sectors in the S&P were positive in the quarter, Technology with a 3.5% gain and Consumer Discretionary with a 3.1% advance. Financials, Healthcare and Industrials were only slightly negative with more pain being felt in interest rate sensitive sectors like Utilities, down 3.3%, Real Estate, down 5%, and Telecom down 7.5%. Despite the price of oil being firm in the mid-$60 per bbl range, the Energy sector continued to underperform with a 5.9% decline in Q1, the sector's worst quarter in three years.



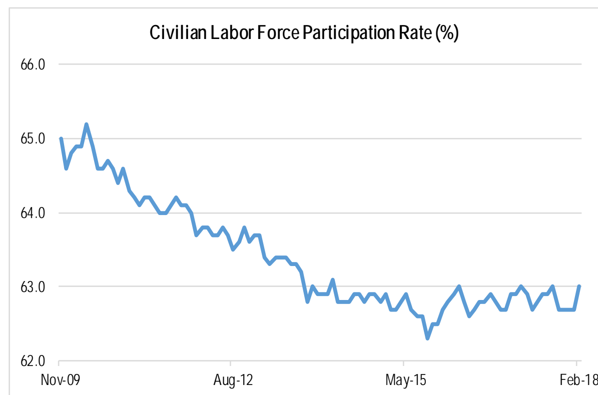
Source: Federal Reserve Bank – St. Louis

Fretting Over the Fed. The proximate cause for the correction in stocks was the January jobs report, which showed an uptick in the rate of wage growth. Investors (or algorithms or both!) became immediately concerned that rising wage inflation would cause the Federal Reserve to increase interest rates more aggressively thus choking off the economic expansion (already the second longest on record) in exchange for snuffing out rising flames of inflation.

Rising wages and a healthier consumer are good for the economy, but they are not necessarily good for the stock market. Add to the conversation that we have a new sheriff in town--Jerome Powell new Chairman of the Federal Reserve--and uncertainty over what path the Fed might take has taken center stage.

If we were writing a screen play, at this point we would likely insert: *Fade to the February jobs report*: Stocks rallied sharply on the February jobs report (released in early March) when wage growth came in below expectations calming some of the anxiety over the Fed and its future path. A surprise component of the February jobs report was a rise in the labor participation rate. The labor participation rate had fallen since the 2008 financial crisis, and the narrative was that the rate was unlikely to improve due to disaffected workers, misaligned skill sets, and an aging population. The uptick in February changed the narrative with the focus on the amount of slack that might still be present in the

labor force despite a stated unemployment rate of about 4%, and the positive implications this has on the outlook for inflation.



Source: Federal Reserve Bank – St. Louis

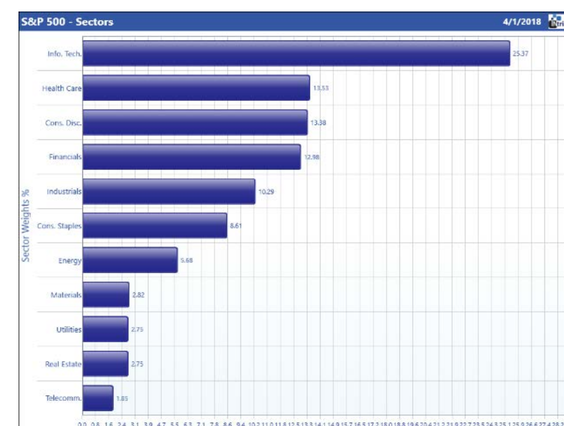
In recent quarters we have referred to a process of normalization. Specifically, we are referring to the Fed raising interest rates from so-called emergency levels to more normal ranges as the economy improves. Indeed, economies both here and abroad continue to expand, but if this strength takes up more slack and drives a sustained increase in inflation, the risk of recession induced by higher interest rates will rise.

Trump, Tariffs and Trade. Adding to volatility during the quarter was the announcement of various tariffs by President Trump. Trade issues and potential protectionist measures were a heated topic during the 2016 campaign, but the market seemed caught off guard by the announcement of tariffs on steel and aluminum imports, which were preceded in January by tariffs on washing machines and solar panels. Harkening back to an era no one wants to relive, comparisons to the 1930s and the Smoot-Hawley tariffs were pervasive.

It is beyond the scope of this commentary to delve too deeply into the economics of trade policy. Regarding market psychology, rising protectionism sparked fear over an all-out trade war with countries like China and potential alienation of our allies, notably Canada and Mexico. Fear and uncertainty do not compel investors to take more risk, quite the opposite.

Protectionism adds to concerns over rising inflation. Regarding steel and aluminum tariffs specifically, it is unlikely these tariffs will add meaningfully to inflation. The U.S. imported $39 billion of iron and steel in 2017 and $18 billion of aluminum. That equates to 2% of total imports and 0.3% of GDP. If the tariffs were fully implemented, they would boost inflation by 5 basis points, according to BCA Research. While the U.S. does have a large trade deficit with China, steel specifically is not the culprit. The U.S. is not even in the top ten markets for Chinese steel exports, although it is apparent that excess capacity in China affects the global market for steel.

Tech Corrects. Technology stocks have been the big winners on Wall Street. The Tech sector was up almost 39% in 2017, the best among S&P 500 sectors. Tech stocks recently comprised about 26% of the S&P 500--in the late 90s the sector accounted for 35% of the index—and at the end of February Apple, Amazon, Microsoft, Facebook and Alphabet made up 15% of the index. To be sure, cloud computing, artificial intelligence, data storage, and driverless cars are all fascinating developments that have strong growth prospects and will help shape the future. But, sentiment on technology stocks changed quickly when privacy concerns arose over the use of consumer data at Facebook.



Source: Intrinsic Research

Concerns over privacy and social media are not new, but when they are centered on the largest social media company with over 2 billion users after a big run up in the stock, Facebook shares became vulnerable to a correction. Facebook is down over 20% from its high of nearly $200 and has fallen 9.5% on a year-to-date basis.

Source: Intrinsic Research

Moreover, bad news seems to be spreading affecting other widely-owned issues. Production problems with the Tesla Model 3 has that stock down about 17% YTD. An unfortunate fatality of a pedestrian being hit by a driverless vehicle has sent high flyers like Nvidia well off their highs. Technology stocks have led the market higher, and many of these leaders came under fire at the end of the quarter.

Tech's leadership in recent years has driven a large outperformance of growth stocks broadly when compared to value stocks. In an economy growing around 2%, investors have bid up prices of fast-growing companies because growth has been scarce. This is not to imply that all growth stocks are overpriced. The valuations on companies like Amazon, Netflix, and Tesla are hard to figure, but these companies have large market opportunities. The valuations on Apple, Google, and Microsoft, however, appear far more reasonable, in our view.

That said, the degree of outperformance in growth stocks over the past decade is noteworthy. The chart below depicts the cumulative performance of the Russell 1000 Growth Index and the Russell 1000 Value Index. Since the financial crisis, value stocks have underperformed growth stocks, and the gap has widened significantly in recent years.

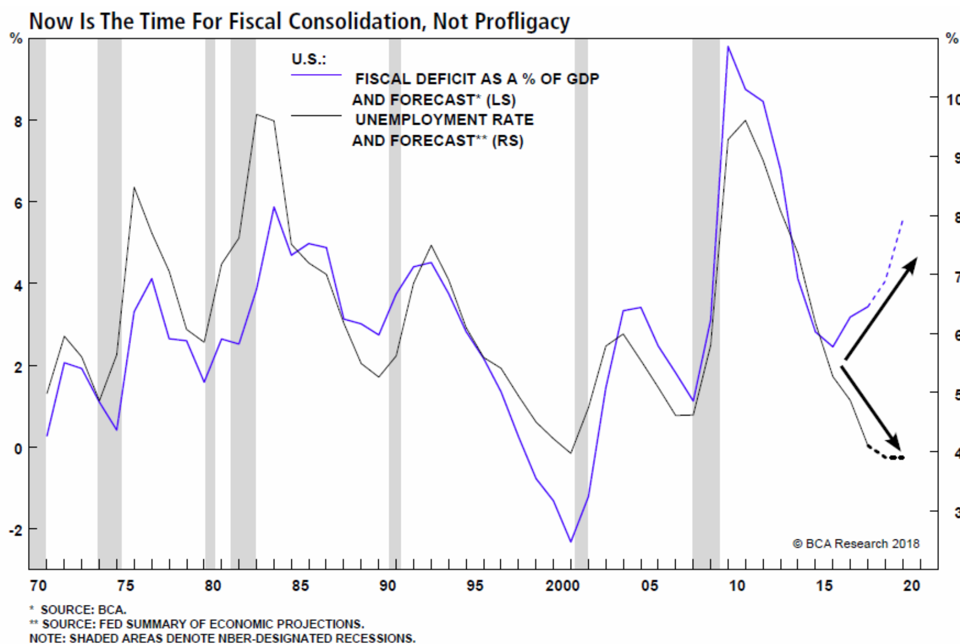
Source: Intrinsic Research

At Heritage, we have a value bias to some of our holdings. In small cap for example, we employ a manager with a value style. A value style tends to favor companies with attractive valuations and strong balance sheets albeit with modest growth rates. It may therefore be considered a more conservative investing approach. The performance of this manager and any manager with a value style, or tilt, to their portfolio will be influenced by the factors discussed above. Moreover, a value style inherently requires patience for the market to realize the value that a manager may believe exists in an individual stock. We do not believe that the merits of value investing have diminished and instead feel the pendulum has swung too far in favor of growth stocks and that investors will likely revert to value investing in coming years.

Earnings and Outlook. First quarter earnings season is right around the corner, and this should kick off what is expected to be a robust year for corporate profits. According to Thomson Reuters, S&P 500 earnings are projected to grow nearly 18% this year, implying earnings of around $155 for the index and a price-to-earnings multiple of 17x. While this multiple is slightly above the ten-year average of 15x and the 20-year average of 16x it is modestly *below* the rate of earnings growth.

We are indeed late in the economic cycle, but with earnings growth improving, we are hard pressed to be anything but constructive on equities even with the expectation that volatility (and thus the potential for larger interim drawdowns) will be more pronounced in the future.

In fixed-income, it seems clear that we are in a rising rate environment. As obvious as that statement might be, we should note that the ten-year Treasury rate was falling late last week. The



combination of Fed tightening influencing the short end of the yield curve and rising inflation and better economic growth influencing the long end should conspire to put upward pressure on interest rates. We would not be surprised if the ten-year yield breached 3% on its way to the 3.25% range this year.

President Trump signed the Tax Cuts and Jobs Act into law just before Christmas. Earnings estimates for public companies have been revised higher, but the timing of this rather large fiscal stimulus program has some Fed watchers concerned. As our colleagues at BCA Research point out, this fiscal stimulus may be arriving when the economy least needs it. With the stated unemployment rate suggesting that the economy is already at full employment, additional stimulus may drive an even tighter labor market accelerating wage growth and consequently induce the Fed to move policy more aggressively.

It is unusual for the government to be pouring on fiscal stimulus at a time when the economy is strong and unemployment low. Typically, a good economy helps drive deficits lower leaving the government with flexibility to respond to a recession with fiscal stimulus. Unless economic growth surprises to the upside, using fiscal stimulus to counteract the next recession will be more challenging in the future.

One area of fixed-income where we did make a change in the quarter was high yield. We sold our high yield exposure believing that spreads had tightened to a point such that investors were not being adequately compensated for the risk. At the current time, we prefer to focus business risk exposure in the equity market.

Persistent weakness in the US Dollar is a bit vexing. Interest rates in the U.S. are higher than most other countries, which would typically augur for a stronger dollar. Economic growth in the U.S. is improving, but activity in the Eurozone and Emerging Markets is also strong with many of these areas earlier in their recovery than the U.S. Better relative growth outside the U.S. likely explains dollar weakness.

In closing, we want to reiterate our appreciation for the trust our clients have bestowed upon us. As we move forward, we are committed to retaining your confidence and serving your specific needs.

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