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WEALTH ADVISORS

MARKET AND ECONOMIC OUTLOOK

April 2018

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Volatility Returns as Rates Rise and Talk of a Trade War Unsettles Markets

The new year blew in like a nor'easter, breaking the unusual calm and tranquility that investors enjoyed over the previous year. By March 1, the S&P 500 had already experienced more trading days of 1 percent movement than in all of 2017 (Bloomberg). While stock prices were gyrating, bond investors felt some pain via rising rates and renewed inflation concerns. And although the first quarter's volatility is unsettling, we would note that, in fact, this is more "normal" market action than the benign conditions of 2017. There are multiple risks, some of which we note below, that may continue to create price swings.

Positives	Negatives
Employment is strong	Future returns (for the next 7 to 10 years) from stocks and bonds are expected to be lower than long-term historical averages
Housing market is firm	Geopolitical risks, e.g., North Korea; terrorism
Near-term risk of recession in the United States appears low	Policy uncertainty in the U.S., with "trade wars" a specific concern
Consumer and small business confidence is high	Uncertainty of the effects of global central banks removing monetary stimulus measures
U.S. corporate earnings are firm and expected to increase with tax reform	Very mature bull market with high valuations creating a "head wind" for the markets

Total Returns (%) as of March 31, 2018

Index Name	Capital Market Segment	First Quarter 2018	Trailing 12-months
Bloomberg Barclays U.S. Aggregate	U.S. Broad Market Bonds	-1.5	1.2
S&P 500	U.S. Large Cap	-0.8	14.0
Russell 2000	U.S. Small Cap	-0.1	11.8
MSCI EAFE*	Non-U.S. Developed Markets	-1.5	14.8
MSCI EM**	Emerging Markets	1.4	24.9
Hypothetical 60/40 Portfolio***	Diversified Mix of Indexes	-1.0	9.4

** Europe, Australasia, and Far East ** Emerging Markets*
**** 40% Barclays U.S. Aggregate, 32% S&P 500, 7% Russell 2000, 16% EAFE, and 5% EM*
An investor cannot invest directly in an index, and the hypothetical portfolio is not intended to reflect any specific portfolio managed by CLA Wealth Advisors. An unmanaged index does not reflect any expenses that may be associated with an actual portfolio.

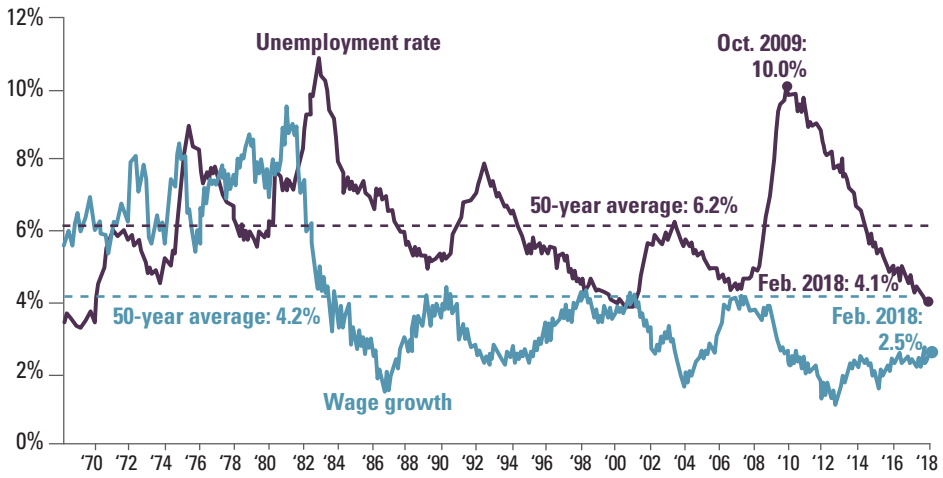
Source: Morningstar

Stocks start 2018 strong, then stumble late in the quarter

Buoyed in part by enthusiasm over the new tax plan, large company stock prices got out of the gate strong in January, with the S&P 500 gaining more than 5.5 percent. This marked the 15th consecutive positive monthly return for the bellwether large cap index. The tone changed by the end of January, when yet another strong employment report sparked concerns about the potential for rising wages to stoke inflation. The win streak would end in February, followed by another down month in March, resulting in a net return of -0.8 percent for the S&P for the first quarter.

Civilian Unemployment Rate and Wage Growth

Private production and nonsupervisory workers, seasonally adjusted



Source: Bureau of Labor Statistics, FactSet, J.P. Morgan Asset Management
Guide to the Markets — U.S. *Data are as of March 31, 2018.*

Even tech stocks slipped lower

Even the red hot technology sector, which we wrote about in the July 2017 *Market and Economic Outlook*, sold off in March. Tech titan Facebook, facing backlash over a data breach and privacy concerns, was hit especially hard and finished the quarter down nearly 10 percent. Weakness in the technology sector, and the FAANG stocks specifically (Facebook, Apple, Amazon, Netflix, and Google [Alphabet, Inc.]), may be a bad omen for the market. Just five FAANG stocks make up 11 percent of the S&P 500, nearly two times what they represented in 2013, when Facebook first joined the index (Dow Jones S&P, March 31, 2018).

Elsewhere in the U.S. stock universe, small cap shares were little changed, finishing down -0.1 percent for the quarter. Publicly-listed real estate stocks were the worst performers; the interest-rate-sensitive sector sold off as rates rose, finishing down nearly 7 percent for the quarter.

International stocks inch downward, too

International (developed markets) stocks finished slightly to the downside in the first quarter, -1.5 percent, as measured by the MSCI EAFE stock index. The continued weakness of the U.S. dollar once again benefitted investors in international stocks (see the table, which compares the first quarter 2018 returns of the major developed equity markets in U.S. dollars compared to the respective local currencies).

First Quarter Returns, Four Largest MSCI EAFE Countries
Europe, Australasia, and Far East

		Market Total Returns %	
Country	**Index Weight**	**U.S. Dollar Terms**	**Local Currency Terms**
Japan	25%	-0.8%	-5.6%
U.K.	17%	-4.5%	-7.9%
France	11%	0.3%	-2.0%
Germany	10%	-3.6%	-5.9%

Source: MSCI and Morningstar

Emerging market stocks posted a positive return, with the MSCI EM index up 1.4 percent. China, the largest (by far) component of the index, posted a positive return in U.S. dollar terms, despite continued concerns about a credit bubble. The returns of the other large emerging market countries were mixed.

First Quarter Returns, Five Largest MSCI EM Countries
Emerging markets

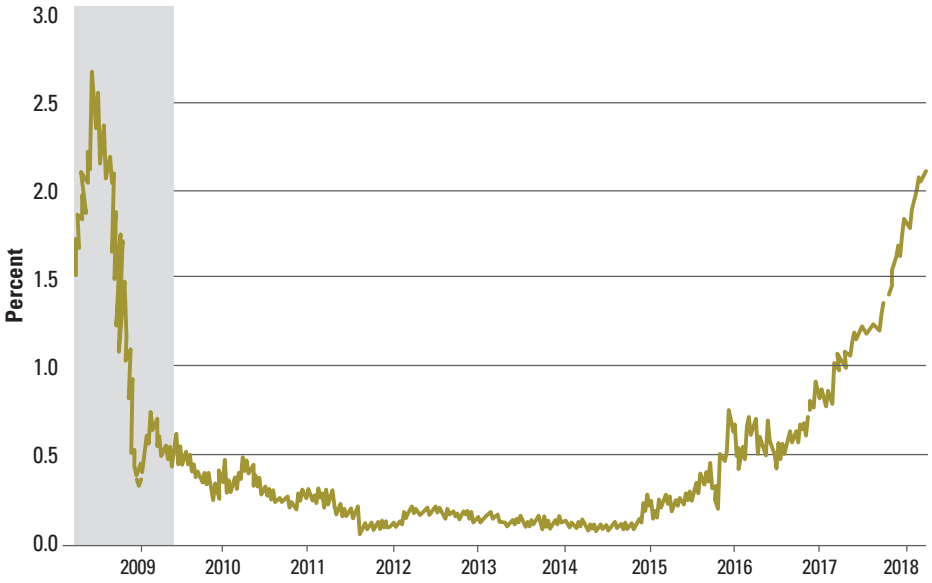
Country	Index Weight	Total Return %
China	30%	3.1%
South Korea	15%	0.7%
Taiwan	12%	5.9%
India	8%	-5.4%
Brazil	7%	11.0%

Source: MSCI and Morningstar

Bonds at highest levels since the financial crisis

The bond market also got off to a stormy start this year, with the Bloomberg Barclays U.S. Aggregate Index losing 1.5 percent. The yield of the bellwether 10-year U.S. Treasury rose to nearly 3 percent in February, before finishing the quarter at about 2.75 percent. The shape of the yield curve, which measures the difference (or "spread") between shorter and longer-dated maturities, "flattened" slightly. The yields on the long-end curve — bonds that mature in 20+ years — remained fairly stable while some pain was felt by shorter-maturity bond holders, as rates rose while prices fell.

One-Year Treasury Constant Maturity Rate



Shaded area indicates U.S. recession.
Source: Board of Governors of the Federal Reserve System

LIBOR continues upward impact on international borrowing costs

Another somewhat obscure though important benchmark interest rate, the London Interbank Offered Rate (LIBOR), has increased dramatically in 2018. The LIBOR measures the rates at which international banks will borrow from each other. It is linked to $350 trillion of assets worldwide (Bloomberg) and affects adjustable rate mortgages and many other types of loans.

LIBOR rates increased for a remarkable 37 consecutive trading days to the end of quarter (the longest such streak in more than a decade) with the three-month LIBOR starting the quarter at 1.7 percent and finishing at 2.3 percent (Bloomberg). Some market analysts view this increase as signaling nervousness about risk assets (such as stocks and bonds).

The Federal Reserve (Fed), under a new chairperson, Jerome Powell, continued its slow-but-steady monetary tightening policy by announcing a quarter-point rate rise on March 21. The market expects (and has, in Wall Street lingo, "priced in") two more quarter-point rate rises through the course of year. If the Fed deviates from this — either providing more or fewer rate rises — it may create volatility in the bond market. For its part, the Fed has sought to telegraph its rate rises, and is seeking to achieve a "normalization" of short-term rates, which, by their definition, means raising the Fed Fund Rate (currently 1.75 percent) up to 3 percent by 2020.

Tariffs and the specter of a trade war

For some time the positives and negatives table that leads off each *Market and Economic Outlook* has included "policy uncertainty [regarding] trade" on the negative side. It is here we can call on one of the tried and true investment axioms: markets hate uncertainty. Certainly, with regard to something as vital as global trade, a lack of clarity or hints at protectionist policies may unsettle markets.

This concern about trade policy was piqued when the president tweeted in the early morning hours of March 2, 2018, stating "trade wars are good, and easy to win." Very few economists or investors would be inclined to agree with this statement, and it certainly increased concern among global investors. But it wasn't clear if the president was simply using blustery language or if he would follow through with major trade policy changes. Turns out he did follow through by announcing plans to enact import tariffs of 25 percent on steel and 10 percent on aluminum. Several allies, including Mexico, Canada, and European Union nations, were temporarily exempted from these tariffs. The administration would go on to announce a package of tariffs and trade penalties specifically targeting China.

Analyzed in a vacuum, the effects of these tariffs would be rather minimal. A report from Vanguard (*How Likely is a Global Trade War?* March 23, 2108) estimated that steel and aluminum combined represent less than 2 percent of total U.S. imports. In a report dated March 7 (*How U.S. Tariffs Will Impact Steelmakers and Steel Users*), Morningstar opined that the U.S. aerospace industry, and Boeing specifically, wouldn't be greatly affected, as steel and aluminum make up a relatively small portion of aircraft costs. The report said the aircraft builders would likely be able to pass those increased costs along to purchasers.

So, too, U.S. automakers might not be drastically impacted; analysts estimated that the tariffs could increase the average price of a light vehicle in the U.S. by about 1 percent. And as for the tariffs targeting China, the initial package would affect a relatively small fraction of the trade between the U.S. and China.

Uncertainty along the supply chain

Samantha Metcalf, CLA's industry leader for manufacturing and distribution, looks at the question from the perspective of the manufacturers within the supply chain producing parts for end products like aircraft and automobiles.

"Depending where you are in the supply chain, trade tariffs could be expected to have a negative or a positive impact," Metcalf says. "Many of our clients are in the supply chain contract manufacturing parts for their respective industries, and they are already seeing increases in the cost of raw materials mainly due to the uncertainty around the tariffs and future trade disputes. The unanswered question is whether they will have the ability to pass those costs on to their customers."

She added that some CLA clients are already expressing uncertainty about what the coming months will bring. "This can cause a business owner to make more conservative decisions on expansion, infrastructure, hiring, and other investments based on that uncertainty."

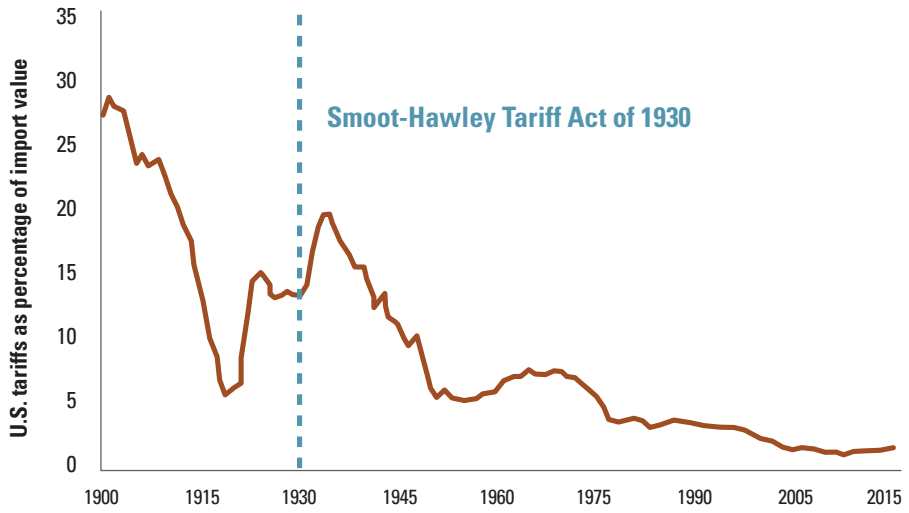
Metcalf pointed to record growth in manufacturing in February, but with the uncertainty caused by the unsettled trade situation, caution could hamper what looked like strong and sustainable growth.

A historical perspective on protectionism

Given the reports of minimal impacts, why are the administration's proposed tariffs such a concern to the markets? The United States, like many members of the European Union, has a long history of avoiding protectionist practices such as high tariffs. The chart below highlights this fact. Many will also point to the

Smoot-Hawley Tariff Act, enacted with the admirable goal of protecting American jobs and farmers from foreign competitors, as playing a key role in creating conditions for the Great Depression.

Historic Impact of Trade Tariffs



Source: U.S. International Trade Commission

The pernicious thing about tariffs is not their immediate effects, but the reactions and counter-actions that may follow, perhaps leading to a true trade war. The market and economic risks of a trade war include:

- **Recessionary** — Rising political uncertainty may hurt corporate and consumer confidence
- **Inflationary** — Trade penalties and barriers ("deglobalization") may make companies less efficient, leading to higher prices and lower productivity
- **Geopolitical** — Trade wars may fan the flames of geopolitical tensions, increasing the risk of military conflict

China is the world's second largest economy and a significant trade partner. Two particular examples may underscore the point: General Motors sold more cars in China than in the United States last year; and more than 310 million Chinese use iPhones, doubling our U.S. number (Deutsche Bank). According to the U.S. Bureau of Economic Analysis (BEA), the total sales of U.S. firms in China was $372 billion in 2015. Meanwhile, the BEA estimates that China sold $402 billion of goods and services in the United States, suggesting a net balance of -$30 billion from a U.S. perspective. Both countries clearly have a lot at stake.

Beijing's inevitable response to the U.S. tariff gambit came in early April. China's Ministry of Commerce announced plans to impose a 25 percent tariff on U.S. agricultural imports, including soybeans, wheat, corn, and beef. These were among more than 100 products, ranging from aircrafts to industrial chemicals. Analysts believe China essentially sought to match the aggregate amount (about $50 billion) affected by the U.S. tariffs.

The markets were clearly unsettled by the official Chinese response, with equity markets selling off and agricultural commodities being hit hard. Soybeans are a particular point of potential strife for U.S. farmers, as China is the world's largest importer.

On an encouraging note, as of this writing, both Washington and Beijing have sought to tone down the trade sabre rattling, and markets have calmed. We are hopeful that a worst-case, all-out trade war can be averted.

Focusing on what you can control and recognizing some key risks

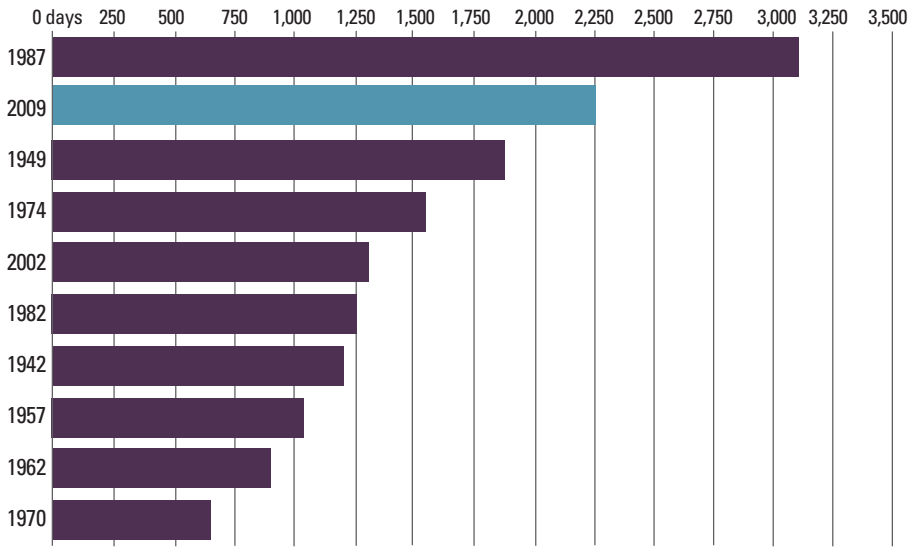
Danish philosopher and theologian Søren Kierkegaard stated: "Life is understood backwards, but must be lived forwards." Although he was referencing the weightiest of human dilemmas when he wrote this, one can apply the same thinking to investing. Only with benefit of hindsight can one construct a narrative of what happened and why in the capital markets. The future, meanwhile, remains unknowable, making it impossible to guess at the short-term moves in asset prices. We can, however, apply our knowledge, wisdom, and experience to helping our clients navigate the risks and opportunities in the markets.

Having just discussed one potential threat to the global markets, (i.e., trade wars) we would like to touch on some other risks we observe:

- **An old (or perhaps we should say, mature) bull market** — The Dow Jones Industrial Average, as of January, achieved the longest bull market in history (Leuthold Group). With an uptrend stretching 107 months, the Dow's bull run has gone on much longer than the long-term, median bull market length of 41 months. Meanwhile, the S&P 500 has recorded its second longest bull market ever.

Longest S&P 500 Bull Markets

Length in trading days



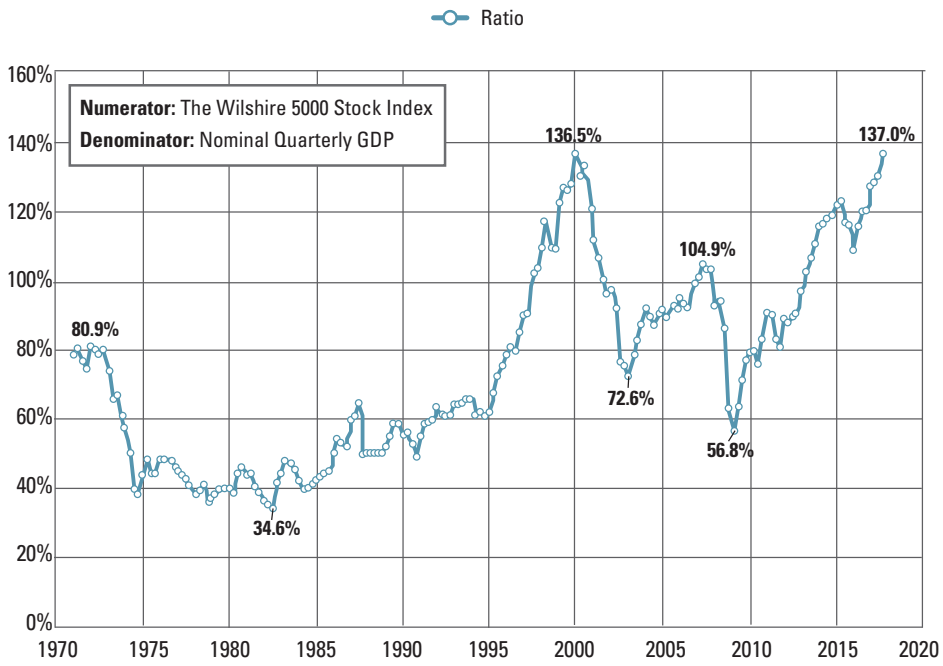
Note: Data for current bull market through March 8

Source: FactSet

- **Valuations are rich** — As we detailed in the October 2017 issue of *Market and Economic Outlook*, it's difficult to find any valuation metrics that imply stocks are cheap or even fairly valued, but many indicate stocks are richly priced relative to historical averages. One such example is seen in the chart below, which divides the market capitalization of the broad U.S. stock market by gross domestic product. This metric has registered its highest reading ever.

Stock Valuations

Market capitalization of broad U.S stock market divided by GDP

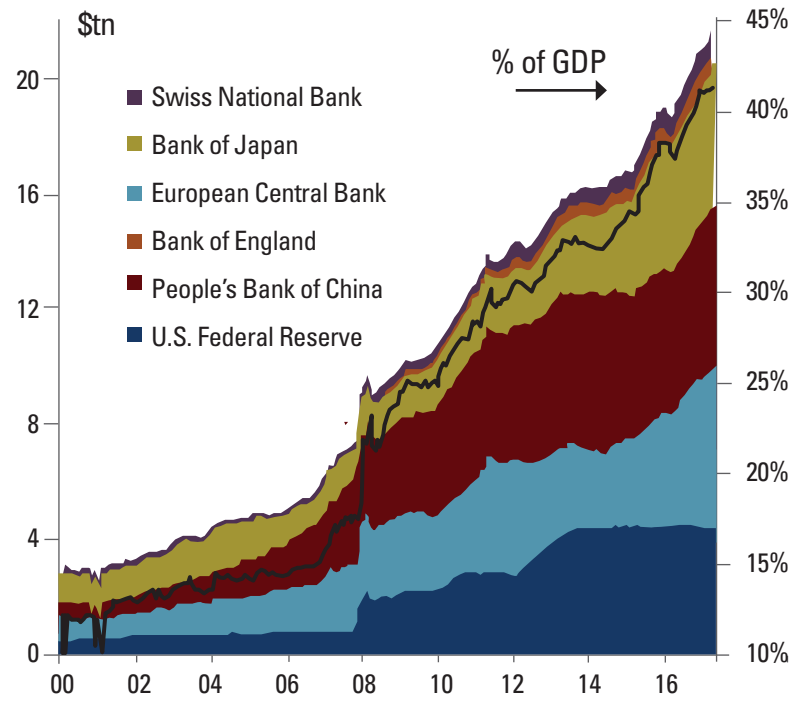


As of March 2018 with Q4 GDP estimate.

Source: advisorperspectives.com/dshort

- **Global central banks are unwinding their balance sheets** — The six biggest central banks, Swiss National Bank, Bank of England, Bank of Japan, People's Bank of China, European Central Bank, and the U.S. Federal Reserve, have begun to "unwind" their balance sheets. As you can see in the accompanying graphic, central banks have an astounding $20 trillion on their balance sheets. Much of these assets were accumulated by "printing" money (increasing the money supply) and purchasing publicly-traded securities in the wake of the great financial crisis in order to buoy asset prices. The Fed has begun to shrink its balance sheet. As other GCBs follow suit and move away from the extraordinary monetary stimulus of recent years, it is an open question as to what this may mean for the global capital markets. There is no historical precedent to look to, and there is a risk that markets may be destabilized.

Global Central Bank Balance Sheet Assets



Source: National central banks

Recession Dashboard

Start of Recession	Yield Curve	Inflation Trends	Job Creation	Credit Platform	ISM* Mfg.	Earnings Quality	Housing Market
November 1973	↓	↓	↓	↓	↓	----	↓
January 1980	↓	↓	↓	↓	↓	----	↓
July 1981	↓	↑	↑	↓	↓	----	↓
July 1990	↓	↓	↓	↓	↓	↓	↓
March 2001	↓	↓	↓	↓	↓	↓	↔
December 2007	↓	↓	↔	↓	↓	↓	↓
Present	↑	↔	↑	↑	↑	↑	↑

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

** Institute of Supply Management*

Sources: Standard & Poor's, Federal Reserve, Bureau of Labor Statistics, National Statistical Agencies, National Bureau of Economic Research, Institute of Supply Management, Census Bureau, Haver Analytics, Credit Suisse (as of March 8)

There are risks, but a recession is likely not imminent

Although risks abound, there is much positivity to look to in the United States and around the world. Corporate earnings and economic growth are rather robust. Some notable investors, such as Rick Riede, BlackRock's global chief investment officer for fixed income, are quite optimistic and go so far as to state that "[the United States] could create 5 percent GDP this year" (March 30 interview, Fox Business). A broader view of economic indicators does not imply that a recession is imminent. Compare the current state of many key indicators with their condition prior to previous downturns.

We seek to focus on those things that we can, at least to some extent, control. No one can predict or control trade policies, random, short-term gyrations in market prices, and geopolitical surprises. Advising clients on how to achieve proper diversification and assume prudent amounts of risk are things that, in our view, are more fruitful areas to focus our attention.

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