

July 2018

## Intermission Break

As we pause between Acts One and Two of the 2018 investment performance, it is time to review the themes we identified at the beginning of the year. The year 2018 has been dramatically different from 2017 thus far. Market volatility has been greater in both the stock and bond markets, the US dollar has strengthened unexpectedly over the past few months, and most financial markets have delivered negative returns during the first six months of the year.

Through June 30, the S&P 500 stock index is barely positive, while the Dow Jones Industrial Average actually declined from where it began the year. Foreign stock markets – which were ahead of the US just two months ago – posted negative results for the first six months, largely due to the US dollar's rally since late April. Meanwhile, bond markets have offered no haven for investors this year. Investment grade bonds remain underwater for the year, while returns on high yield bonds are essentially flat year-to-date.

The S&P 500 ended the first half of the year up **+2.6%**, while smaller company stocks (as measured by the Russell 2000 index) gained **+7.7%**. International stocks began the year poised to benefit from the solid economic recovery taking place in Europe and Asia. However, after the recent rally in the US dollar since April, the gains investors earned in the first quarter turned into losses more recently, with international developed markets down **-2.7%** and emerging markets bearing the brunt of trade tariff rhetoric, declining **-6.7%** in the first half of 2018. Bond markets have failed to provide meaningful support to portfolios this year. The Barclays Aggregate index of investment-grade bonds has declined **-1.6%**, while other sectors such as inflation-indexed and high yield bonds have been virtually flat. Emerging market US-dollar debt has sold off recently due to the rally in the US dollar over the past two months. However, these assets have outpaced traditional investment-grade portfolios for the past year and a half.

Asset Class	Category	Index	June 2018	YTD Return 6/30	Total Return 2017
Equity	US Large Cap	S&P 500	-0.1%	2.6%	21.8%
	US Small Cap	Russell 2000	-0.1%	7.7%	14.6%
	International Developed	MSCI EAFE	-1.0%	-2.7%	25.0%
	Emerging Markets	MSCI EM	-3.5%	-6.7%	37.3%
Fixed Income	US Investment Grade	Barclays US Agg	-0.0%	-1.6%	3.5%
	US Inflation-Indexed	Barclays US TIPS	0.7%	-0.0%	3.0%
	US High Yield	Barclays US Corp High Yield	0.5%	0.2%	7.5%
	EM US\$ Debt	JPM EMBI Global	-1.4%	-5.2%	9.3%
Cash	US T-Bill 90 day	US T-Bill 90 Day	0.3%	0.8%	0.9%

Source: Morningstar database, total returns in US dollars.

## Mid-Year Review of Investment Themes

As the year 2018 began, the following investment themes guided management of our clients' portfolios. Below is a review of how our positioning for these themes has played out in the first half of the year.

**Theme 1:** Hand off from monetary to fiscal policy, with increasing interest rates

**Theme 2:** Maintain equity risk levels, but hand off to greater diversification

**Theme 3:** Expect lower returns in 2018

### THEME 1

Hand off from monetary to fiscal policy, increasing interest rates.

For Theme 1, we have indeed handed off to fiscal policy. Interest rates have risen in conjunction with faster nominal economic growth. The benchmark Treasury ten-year began the year yielding **2.41%**, peaked at **3.10%** on May 17th, and drifted back down to **2.85%** at the end of June. Our portfolio positioning has helped clients avoid most if not all of the losses in Fixed Income markets this year. We managed to reduce allocations to long-term holdings and have favored floating-rate and inflation-indexed bond portfolios over traditional investment-grade holdings. We anticipate further reductions to any remaining long-term bond exposure, in light of the recent strength in long-term Treasury bonds since late May, and would recycle the proceeds into short-term fixed income holdings.

### THEME 2

Maintain equity risk levels, but hand off to greater diversification.

As intended, we have maintained overall equity allocation levels per each client's long-term target allocation. We have been steadily broadening the mix of equity investments by increasing small US company holdings, and adding to international

and emerging markets. This positioning has been a mixed bag in 2018. Small US company stocks have outpaced those of large companies this year, while non-US markets have declined in US dollar terms. The recent sell-off in foreign markets should provide the opportunity to sell higher-priced US large companies and reinvest in non-US stocks at lower valuations. We will continue to fine-tune the equity allocation this year amid further market volatility. We anticipate that moving portfolios toward a more diversified equity composition will take several months more this year.

### THEME 3

Expect lower returns ahead in 2018.

Thus far in 2018, Theme 3 is playing out almost according to script. The year 2017 was one of the least volatile years since WWII, as the S&P 500 delivered a total return of **+21.8%** and suffered a mid-year decline of no more than **-3%**. Historically, such smooth years as 2017 have been followed by

***"The more volatile the markets are for this year, the more opportunity our clients will have to move portfolios toward a more diversified composition."***

years with the US stock market experiencing an average decline of **-12%** and returning just **+5%** for the year. Well, from Jan 26th to Feb 8th, the S&P declined **-10.2%** in price and it has delivered a total return of **+2.6%** through the first half of the year. We expect returns in the latter half of 2018 will continue to be meager and are positioned for this environment by keeping bond maturities short, diversifying equity allocations, and making greater use of alternative absolute return strategies that generate income and returns that are largely not correlated to the stock and bond markets.

## Investing at a Crossroads

Investors find themselves at a crossroads today, given the mixed signals of performance across various markets during the first half of this year. As we think about the potential outcomes for the rest of 2018, we remain mindful that stock markets once again could flirt with a correction (decline of **-10%**) later this year. Geopolitical risk threatens to accelerate in the second half, with Special Counsel Mueller's investigation likely to unfold, international trade negotiations continuing, and the November midterm elections all influencing market volatility. However, corrections aren't cause for panic. They occur too frequently (at least once per year) to accurately predict a bear market. More concerning is the prospect for an "inverted yield curve," a situation in which yields of long-term bonds (Treasury 10-year note) are lower than those of short-term bonds (Treasury 2-year note).

In a healthy economy long-term debt typically has higher returns than short-term debt. This simply reflects the price investors place on the time value of money, with inflation and future economic growth requiring longer term returns to be higher. When markets anticipate lower growth in the future for whatever reason (tight Fed policy, a shrinking

Federal budget, reduced consumer spending or a housing slowdown), the normal state of affairs is flipped. Thus, an "inverted yield curve" results with short-term debt offering higher returns than long-term debt.

As discussed in our December 2017 Market Insights, future stock returns have not fared well when the difference between long and short term interest rates was very low. Over the past thirty years, when the difference was in the **0-1%** range, the US stock market gained **+4.6%** on average over the following year. An inverted yield curve proved to be much worse. US stocks declined by **-11.6%** on average over the following year, and **-0.3%** over the following two years, when the yield curve was inverted.

Since 1955, an inverted yield curve has preceded every US recession six to eighteen months before the downturn. And only once was an inverted yield curve followed by an economic slowdown rather than a full-blown recession, in 1966-67.<sup>1</sup> Right now, the yield curve is quite flat but hasn't inverted. As of June 30th, the difference between Treasury 10-year and 2-year yields stood at 33 basis points (**+0.33%**). Still positive, but with little breathing room.

### HISTORY OF INVERTED YIELD CURVES AND ECONOMIC RECESSIONS *Last 40 Years*

Dates of inverted Yield Curve	Inverted Yield Curve Depth	Months Prior To Recession	Start of Recession	End of Recession	Length Recession	Real GDP Decline
Sep. 1978 - Apr. 1980	(2.13%)	14 months	Jan. 1980	Jun. 1980	6 months	-2.2%
Sep. 1980 - June 1982	(1.36%)	10 months	Jul. 1981	Nov. 1982	16 months	2.7%
Jan. 1989 - March 1990	(0.32%)	18 months	Jul. 1990	Mar. 1991	8 months	-1.4%
Feb. 2000 - Dec. 2000	(0.41%)	13 months	Mar. 2001	Nov. 2001	8 months	-0.3%
Feb. 2006 - May 2007	(0.14%)	22 months	Dec. 2007	Jun. 2009	18 months	-5.1%
<b>Averages</b>	<b>(0.87%)</b>	<b>15 months</b>			<b>11 months</b>	<b>-1.3%</b>

Source: National Bureau of Economic Research, FRED Economic Database St Louis Federal Reserve, Webster Private Bank calculations. Inverted Yield Curve Depth is the lowest level that difference between interest rates on 10-year and 2-year Treasury notes reached.

<sup>1</sup> Economic Forecasts With The Yield Curve, Economic Letter, Federal Reserve Bank of San Francisco, March 5, 2018.

## Conclusion – How We Are Positioned

We look for the Federal Reserve to continue raising interest rates in 2018 and into at least the first half of 2019. Meanwhile, the recent pick-up in inflation should push longer-term yields higher. Overall consumer inflation (CPI) is now running at a **+2.9%** annual rate, well above the Federal Reserve's target of **2%** for annual inflation. Recently, strong demand from US corporate pensions has likely driven up prices of long-term government debt. Corporate pension plans have until September 15th to deduct **35%** of their plan contributions, after which the tax deduction rate drops to **20%**. According to the Wall Street Journal, many have front-loaded future contributions this year, as an arbitrage against the Tax Cuts and Jobs Act of 2017.

We remain on guard for a potential storm of events that could send long-term rates sharply higher – the withdrawal of pension fund demand for Treasury bonds; sales of Chinese holdings of US securities in response to tariffs and to defend the value of the yuan; tighter labor markets and higher wages; and, significantly higher prices for autos, consumer goods and food as a result of new import tariffs. As we have pointed out this year, long-term bonds no longer provide the same amount of ballast to portfolios that they did in the past. At yields of less than **3%**, long-term government securities won't rally as much when stock markets correct, especially if economic growth and inflation expectations continue to rise. The old, conventional definitions of "safe" assets may fail to protect.

In Fixed Income allocations we have shortened the maturity profile by increasing allocations to short-term investment-grade bonds, floating-rate debt and

inflation-indexed debt. We will likely continue to pursue this approach of holding enough dry powder in short-term securities or those less sensitive to interest rates.

We have been diversifying the mix of equity allocations away from almost exclusively large US company stocks and into small US company stocks, international markets and emerging markets stocks as well. Thus far in 2018, this has proved to be a mixed bag – US small company stock returns have led those of US large companies, while international and emerging markets have lagged behind. In some cases, we may use the US market's rally to rebalance equity portfolios into cheaper non-US markets, thus enforcing a "sell high – buy low" process. The more volatile the markets are for this year, the more opportunity our clients will have to move portfolios toward a more diversified composition.

Finally, we have created a small yet meaningful allocation to absolute return mutual funds that derive income from investment strategies that remain largely uncorrelated to the US stock market. These holdings also serve as a store of dry powder to support our client's portfolio values and become a source of funds for investment if we see Equity investments trading at more attractive values in the future.

As usual, the investment outlook seems unclear when short-term results are flat or seem directionless. We welcome your insights and concerns, always. Please contact your Webster Private Bank Portfolio Manager at any time to discuss your personal investment portfolio.

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