MARKET Insights

April 2018

Quarterly Review – In Like A Lamb, Out Like A Lion

The Old Farmer's Almanac used to say that weather in the month of March was "in like a lion and out like a lamb." Investors might think the opposite was true this year, as stock prices fell abruptly in the second half of March 2018. US stock markets, as measured by the S&P 500 index, ended the first quarter of the year down **-0.8%**. Bond markets also declined in the quarter, with the Barclays US Aggregate Bond index down **-1.5%**. Losses were delivered in almost every major asset class, except for emerging markets stocks, absolute return funds and commodities. Interest rate sensitive industries, such as utilities and real estate, witnessed sharp declines, as those sectors in the S&P 500 fell **-3.3%** and **-5.0%** in the quarter, respectively.

Financial markets have faced several headwinds this year: a drop in the US dollar versus other major currencies, a persistent rise in interest rates across almost all maturities, and an escalation of trade barriers between the US and major partners such as Canada, Mexico, Europe and China. The data privacy scandal at Facebook recently has had a ripple effect on tech giants like Google, Amazon and Apple, companies that make up a large portion of the US stock market.

Most of the quarter's losses for the stock market occurred in March, when the S&P 500 index declined by **-2.5%**. Since 1976, the S&P 500 index in March has been positive in nearly 7 out of 10 years, returning an average of **+0.6%** for the month. This was the first down March for the stock market since 2009.

MARKET RESULTS IN 2018 AND 2017, BY ASSET CLASS

Asset Class Returns		Year To Date Through March 31	2017
Equities	US Large Cap	-0.8%	+21.8%
	US Small Cap	-0.1%	+14.6%
	Intl Developed	-1.5%	+25.0%
	Emerging Markets	+1.4%	+37.3%
Fixed Income	Investment Grade	-1.5%	+3.5%
	High Yield	-0.9%	+7.5%
Alternatives	Absolute Return	+1.7%	+8.4%
	Commodities	+2.2%	+5.8%
	REITs	-8.1%	+5.1%

Source: Morningstar database, total gross returns in USD as of March 31. US Large Cap is S&P 500 index, US Small Cap is Russell 200 index, Intl Developed is MSCI EAFE index, Emerging Markets is MSCI EM index, Investment Grade is Barclays US Aggregate index, High Yield is Barclays Corporate US High Yield index, Absolute Return is CS Equity Market Neutral index (through March 26), Commodities is S&P GSCI index, REITs is MSCI US REIT Diversified index.

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How We Are Positioned for 2018

We began the year with three major investment themes for 2018. Thus far, barely three months into the year, our positioning appears to be appropriate for the current market environment.

THEME 1 — Hand-off from monetary to fiscal policy, increasing interest rates.

As expected, interest rates rose in the first quarter, with the 10-year treasury yield moving from **2.41%** at the beginning of the year to a high of **3.00%** as of April 24th. We expect yields to move higher throughout the year. We have shortened maturities and increased allocations to short-term investment grade bonds, floating-rate and inflation-indexed debt so as to better position clients for the current environment.

THEME 2 — Maintain equity risk levels, but hand off to greater diversification.

We have maintained overall equity levels of investment per each client target allocation. In some cases, we used the market's rally in January to rebalance equity portfolios that had drifted well above their target levels, thus enforcing a "sell high" process. We have been selectively diversifying the mix of equity investments by increasing small US company holdings, and adding to emerging markets stocks as well. The more volatile market environment this year provides opportunities to fine-tune the equity allocation and move portfolios toward a more diversified composition.

THEME 3 — Expect lower returns ahead in 2018.

Thus far, both the stock market and bond market are delivering on this front. The last time that both the bond market and stock market posted negative results for the quarter was nearly ten years ago, in June-September 2008. As we noted in January, it is uncommon for the stock market to deliver double-digit results with little volatility. Both market history and common sense tell us that calm periods of high returns don't persist forever. They are typically followed by more volatile periods of modest returns. We are navigating this evolving environment by keeping bond maturities short, diversifying equity allocations, and making greater use of alternative absolute return strategies which may benefit from increased stock volatility and offer returns that are not directly correlated to stock and bond markets.

What Should Investors Expect, Or How Much Noise Is Normal?

Financial markets in 2018 will be more volatile than last year, so our clients should expect to see more variation in the values on their account statements. Yet, how much volatility is "normal"? According to Strategas Research Partners, since 1982 the stock market (S&P 500) has experienced average daily volatility of **+/-1.2%**. The most volatile year was 2008, when the market moved by **+/- 2.8%** per day on average. Last year was the least volatile: the stock market moved by **+/- 0.5%** per day on average. Thus far in 2018, the market has moved by **+/- 1.4%** per day on average, which is close to the long-term rate of daily fluctuations. While the recent

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bout of volatility may feel extreme, we believe that 2018 is closer to normal than 2017. Investors shouldn't be alarmed by the recent gyrations.

We believe it is much more important for clients to understand how the variability of their portfolio values compares with their chosen investment objective. The question to ask oneself is: "is this volatility normal for how my account is invested?" Any investment strategy requires some degree of risk, even if that risk is the transitory nature of financial market pricing. For instance, a portfolio with a long-term allocation that is 60% Stocks and 40% Bonds would be expected to deliver a monthly return of **+0.8%** on average, with a standard range of **+/- 2.7%** (standard deviation) around that average. Such a portfolio would exhibit a negative monthly return **34%** of the time, or about 1 in 3 months, with a standard decline of approximately **-1.9%**. The table here shows the expected negative outcomes by month and quarter, according to various stock/bond portfolio allocations. We encourage clients to review this table along with their account statements to understand how much normal variability is in their portfolios.

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ODDS OF MONTHLY AND QUARTERLY DECLINES BY STOCK/BOND PORTFOLIO MIX

	Stock/Bond %	100/0	80/20	60/40	40/60	20/80	0/100
MONTHLY	Frequency of a Decline	36%	35%	34%	33%	29%	32%
	Standard Decline	-3.2%	-2.6%	-1.9%	-1.3%	-1.0%	-0.9%
	For a $1M Portfolio	-$33,000	-$26,000	-$20,000	-$14,000	-$10,000	-$10,000
QUARTERLY	Frequency of a Decline	29%	27%	25%	24%	20%	22%
	Standard Decline	-4.4%	-3.3%	-2.3%	-1.4%	-0.9%	-1.1%
	For a $1M Portfolio	-$45,000	-$34,000	-$23,000	-$15,000	-$10,000	-$12,000

Source: Morningstar database, total returns, as of March 31. "Stocks" is S&P 500 index, "Bonds" is Barclays US Aggregate index. Calculations assume perfect monthly rebalancing, with returns gross of any fees or expenses. Dollar values rounded up to the nearest $1,000.

Conclusion – A New Macro Roadmap Ahead

The macro landscape has shifted over the past year, from slow, uneven economic growth with low inflation to higher growth that is more broadly shared globally. This has allowed the Federal Reserve to gradually raise overnight interest rates, and may lead other central banks, such as the European Central Bank and the Bank of Japan to tighten monetary conditions as well. More consistent economic growth supports corporate profits and the stock market, but rising interest rates could lead to further stock market volatility, as companies and investment strategies that thrived in the era of cheap money face a reckoning over the coming years.

What this means is that long-term bonds may no longer provide the same amount of "shock absorption" to portfolios that they did over the last decade. Long-term government bonds won't rally as much when stock markets correct, because economic growth and inflation expectations likely will continue to rise, and central banks will continue to respond to the environment by raising interest rates to keep the global economy from overheating.

As the global economy evolves, so does the strategy required to manage risk. "Buy and hold" investors may be in for a shock as the old definitions of "safety" fail to protect. We will continue to actively manage client investment allocations across all major asset classes, according to the investment objectives for each and every portfolio we manage. As variables such as interest rates, economic growth, inflation and volatility change, we will anticipate and respond through appropriate portfolio positioning, using well-researched strategies and investment vehicles.

We welcome your comments, insights and concerns. Please contact your Webster Private Bank Portfolio Manager at any time for a discussion about your personal investment portfolio.

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