The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets April 2018

From: *Philadelphia* Investment Management Group

OVERVIEW

- *Overall, We Retain a Moderate but Constructive View Towards the Domestic and Global Economies*
- *Geopolitical Concerns Will Continue to Create Volatility for the Financial Markets*
- *Positive Corporate Fundamentals and the Economy Should Provide Tailwinds for Equities*
- *Headwinds From a Tighter Monetary Policy, i.e,, Rising Interest Rates, Will Remain a Negative for the Fixed Income Markets*

THE ECONOMY

In broad terms, investors have spent much of the past decade wondering when the economy would recover from the crippling Great Recession. Now they are considering another question: when and how will the recovery end?

In April, the current recovery will become the second-longest economic expansion on record. There is no sign, as of now, that the rebound will end anytime soon. Unemployment is low, job creation is strong and the overall economy seems to be gaining momentum, not losing it. Most economists expect the expansion to continue well into 2019, which would make it the longest ever. Even the Federal Reserve's intention to impose three interest rate increases this year, with the first made on March 21, has done little to cloud the outlook.

On March 21, Fed policymakers raised their range on the Fed Funds Rate by a quarter point to 1.5%-1.75% and acknowledged that the outlook for the economy "has strengthened in recent months." New economic projections showed their median expectation was for Gross Domestic Product to expand by 2.7% this year and for the unemployment rate to slip by the end of the year to 3.8%.

Many economists, however, also argue that the seeds of the next crisis are being sown today, even if it is several years before they poke above the surface. Good times are meant to give governments an opportunity to get their "fiscal" house in order and address long-term challenges. Instead, the U.S. is piling on debt and adopting policies, immigration restrictions, increased trade barriers, and looser financial regulations that many view as counterproductive.

In February, markets tumbled after positive economic reports showing unexpectedly strong wage growth revived long-dormant fears of inflation. The markets rebounded but have remained volatile, dropping again in March, related to a degree to the long effects on plans for import tariffs on steel and aluminum and the possibility of increasing trade-war fears.

Yes, concerns have surfaced, and it is possible that the tightening labor market and the unemployment rate, which at 4.1% is the lowest since 2000, may force companies to pay higher wages. That could lead to inflation and prompt the Fed to raise rates more quickly than planned, and the tighter credit for businesses and consumers could cause a recession. On the other hand, the tax bill's passage and the adoption of a big spending package in Congress together could pour hundreds of billions in fiscal stimulus into the economy, causing what is called overheating.

So far, the threats remain hypothetical but have overhung the markets. Inflation has crept up but remains below the Fed's 2% target, and wage growth remains anemic. Even the surprising figure for January was later revised down. If inflation does pick up, it will not result in a recession overnight.

The U.S. economy may be leveling out but does not appear to be slowing. Relatively weak retail sales figures have led to a slight slowdown in first quarter growth, a trend that has occurred in prior first-quarter periods. In one sign that expectations have shifted, the climb in Treasury yields has stalled, with the yield on the benchmark 10-year Treasury note still below 3%, a level it last reached at the end of 2013.

Current trade issues appear to be more about appearance than actual policy shifts. At least for now, it seems that most of the trade discussion is about political posturing rather than economic reality. While steel and aluminum tariffs with China went into effect, key global trading regions were granted waivers. More trade restrictions still require policy specifics. An actual trade war could be wildly unpredictable, and the outcome could spin out of anyone's control, thus presenting more serious concerns for financial markets; but, as of now, we peg the odds of that occurring as relatively low.

Beyond the issues of trade, many see few threats likely to derail the recovery in the short term. That is partly because it would take a fairly substantial shock to knock the economy off course. Tax cuts and spending increases may raise the level of inflation, but they also provide extra insulation against such a shock. Economists surveyed by the Wall Street Journal put the odds of a recession in the next year at 14%.

The financial markets that allowed negative news to just roll off their backs in the past are now more sensitive to ongoing political turmoil: White House personnel shake-ups, tariff announcements, data breaches, etc. But the last few years were the exception. This year is closer to the norm. Sticking with a long-term plan is typically harder to do when the market is not going straight up. Ironically, this is probably a healthier investment environment and could help keep the bull market alive. Valuations, which were quite extended as we entered 2018, have had the chance to retreat somewhat, courtesy of both the correction in prices and the strength in earnings.

Political uncertainty is unlikely to act as a sustained drag on the markets, as the President surrounds himself with loyalists who may not provide unbiased advice. While these events add to political uncertainty, they should not affect basic market fundamentals.

Although the current expansion has been durable, it has not been particularly strong. Quarterly annualized growth in Gross Domestic Product has averaged just 2.2% since the recession ended, compared with 5% for the typical recovery in earlier years. In any case, research has found that economic expansions do not die of old age. Rather, they end because something, a policy mistake, an asset bubble, an outside shock, causes them to end.

We are mainly focusing on the issues of near-term changes. Until more clarity emerges, we are approaching the financial markets cautiously. We would not be surprised to see relatively high levels of volatility continue. Longer term, however, we retain an optimistic view towards the equity markets but somewhat of a defensive view towards the fixed income markets. We do not believe we are close to an economic recession or an imminent bear market. We expect that, over time, equity prices will again be able to climb the "wall of worry" and that the rise in interest rates may be moderate.

FINANCIAL MARKETS

EQUITIES

As the year began, the stock market was marching higher in a virtually straight line on a seemingly preordained path to every-increasing peaks. Likewise, three months into a year in which stocks started with such overwhelming confidence, the major market averages broke their nine-quarter winning streak. Ironically, that stumble took place as the bull market celebrated the ninth anniversary of its liftoff from the financial crisis lows of March 2009.

In early March, newly appointed Federal Reserve Chairman Jerome Powell conveyed an upbeat picture of the U.S. economy. However, as indicated, investors began to worry that the economy may be growing too fast and that it may fuel inflation further, potentially forcing the Fed to hasten its pace of interest rate increases, a negative for the financial markets, both equities and fixed income.

This theme really began to expand during January and February, even as the stock market rally gained more momentum in January, reaching record highs for most major market indices worldwide. But the calm in the financial markets came to a screeching halt in late January and early February, when rising bond yields and a spike in market volatility sent stock prices lower. After a remarkable 80 weeks without a 5% correction, equity markets finally experienced an overdue drawdown.

Notably, the market drop was very broad-based, showing little sector or factor dispersion and no material flight to defensive sectors, dividends or quality. In other words, investors were just selling equities, not remixing their equity positions more defensively.

Although stocks have recovered some of their losses that sent the S&P 500 and Dow into correction territory on February 8, February was the worst month by percentage declines since January 2006 for the indexes. After a record-setting start to the year, a raft of misfired bets on market calm and interest rate concerns helped spark volatility. The S&P 500 had 12 trading days with moves of at least 1% in either direction in February.

Late in the quarter, market anxiety shifted toward worries about geopolitics. A growing public backlash against technology companies has increased the chances that lawmakers and regulators in the U.S. and elsewhere will intensify their scrutiny of them. Shares of those companies helped propel markets to record highs, and their recent declines have led markets lower.

The prospects of a trade war between China and the United States, the two largest economies, has added to the gloomy sentiment. Among the concerns is that protectionism poses a risk to the health of the world economy and global growth. Stock markets around the world have currently reflected these worries.

The damage from two months of uncertainty over how rising interest rates and inflation will affect stock prices and the ramifications of trade tariffs, along with doubts whether shares of technology companies can continue to lead major indexes higher, proved to be too severe to overcome. The S&P 500 fell 0.76% for the quarter, the first time in ten quarters, as indicated in the following table. The Dow Jones declined 1.96%, the first time that either of them posted a loss for a three-month period. The NASDAQ Composite, meanwhile, rose 2.32%, its weakest gain since the last quarter of 2016. The Russell 2000 index, a measurement of smaller companies, returned -0.08% for the period.

	Equity Returns*			
Index	**Jan**	**Feb**	**Mar**	**1st Qtr**
S&P 500	5.73%	-3.69%	-2.54%	-0.76%
Dow	5.88%	-3.96%	-3.59%	-1.96%
NASDAQ	7.36%	-1.87%	-2.88%	2.32%
Russell 2000	2.61%	-3.87%	1.29%	-0.08%

*Total: price change + reinvested dividends

With all the volatility during the quarter, only January was the period when the four major indexes showed positive returns. The turmoil in February and March is reflected in the negative returns for the full market during those months. All in all, nominal negative returns for the full quarter, with only the NASDAQ, the most volatile, closing out with a positive return. Privacy-driven regulatory concerns contributed to technology weakness, even though the group still outperformed for the period, and because of the sector's substantial weight, put pressure on the other broad indexes.

What was interesting was that the Russell 2000, a measure of small capitalization companies, after lagging throughout 2017, began to be recognized as their domestic focus is sheltering them from prevailing trade faction worries. This enables them to benefit from tax reduction. Overall, a potential escalation into trade wars would be the most disruptive geopolitical risk to the global expansion and markets in 2018.

The cyclical or growth style has been the major contributor to performance during the market's positive trend. As reflected in the following table, Technology and Consumer Discretionary, the better performing sectors, are both categorized as growth areas, while value sectors, including Energy, Utilities and, to a degree, Financials, all lagged during the period.

S&P 500

Sector	**Weight***	**Returns* 1st Qtr**
• Materials	2.9%	-5.52%
• Industrials	10.2%	-1.56%
• Telecommunications	1.9%	-7.48%
• Cons. Discretionary	12.7%	3.09%
• Consumer Staples	7.7%	-7.12%
• Energy	5.7%	-5.88%
• Health Care	13.7%	-1.22%
• Info Technology	24.9%	3.53%
• Utilities	2.9%	-3.30%
• Financials	14.7%	-0.95%
• Real Estate	2.8%	-5.02%

03/31/18
*Price + income
Source: S&P Dow Jones

Corporate profitability will be reported as growing again during the first three months of the year. Boosted by a recent corporate tax overhaul and a strengthening global economy, S&P 500 firms are forecast to report profit growth of 17% in the first quarter of 2018 from a year earlier, according to FactSet, a positive move.

A strong earnings season could reinforce the underpinnings of the nine-year bull market, even given the market selloff. A solid economic backdrop has helped. Some sectors, where share prices have trailed recently, should have some of the strongest profit growth. The recent tax code overhaul may be a tailwind to profits across the markets as a whole.

One difference between the coming earnings season and those in the recent past is that stocks now trade at lower valuations. That means they may gain more if earnings turn out better than expected. With the S&P 500 off its record, the Index trades at just above 16 times forward earnings over the next 12 months, the lowest since June 2016, and down from a peak of 18.6x in late January.

Even so, some investors worry that good earnings will not be enough. U.S. stocks stumbled in the first quarter for the first time since 2015. That was even as companies posted fourth quarter results growing at the fastest pace since the second half of 2011.

It is our belief that the U.S. economic cycle is in its later stages. However, because we think the chance of a recession in the next 12-24 months is still low, we continue to maintain a risk-on stance in our portfolios. Equities should be well-supported over the balance of 2018 by the surge in earnings, fueled by the drop in corporate tax rates, although late-cycle challenges and lingering policy concerns, e.g., Fed hikes, tariffs and diplomatic challenges, may forestall an increase in market valuation, limiting further gains to the level of earnings growth.

FIXED INCOME

The long-awaited repricing of the U.S. bond market, i.e., higher yields, stalled once again during the first quarter. The 10-year Treasury benchmark yield has been stuck between 2.8% and 2.9% for most of the period, after an early 2018 debt selloff took the yield within a hair of 3.0% for the first time in four years. The rise in yields since 2016 signals investors no longer fear the global economy will fall apart, but the leveling off suggests investors doubt growth is truly picking up in a substantial way.

The Federal Reserve raised its Fed Funds short-term interest rate 0.25% in March with possibly three more increases this year, depending on how the economy performs and whether inflation rises further. Fed interest rate increases translate almost mechanically into higher short-term Treasury rates, as reflected in the table titled Base Interest Rates. A bigger question for investors is whether those increases will curb growth along with increased inflation, moving up longer rates as well, which, at quarter end, have moved only slightly, resulting in a flattening of the yield curve (short-to-long rates).

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2017	1.38%	1.88%	2.21%	2.41%	2.74%
Mar 31, 2018	1.70%	2.27%	2.56%	2.74%	2.97%
Change:					
12/31-3/31/18	0.32%	0.39%	0.35%	0.33%	0.23%

The 10-year yield reached a four-year peak of 2.94% on February 21 and fell to 2.74% at the end of March, the largest move for a quarter since December 2016. Yields across the full yield curve were basically range-bound in March, despite concerns that increasing tariffs may start a trade war. For the moment, the bond market is sending a message that it wants to see more signs of an accelerating economy.

At the same time, the rising new supply of short-term debt being sold to fund the deficit is helping to push up two-year yields in relationship to the 10-year yield, leading to a smaller gap between 2- and 10-year yields. That gap, known as the yield curve, is sometimes seen by investors as a measure of economic health, with steeper or more positively sloped curves signaling a stronger growth outlook.

A surge in demand for U.S. Government debt from foreign investors has been providing a bulwark against a rise in interest rates. A number of other factors could also be involved. One is the weak dollar, which has led to a comparative strengthening of many emerging market currencies. The central banks of those countries have bought U.S. Treasuries to help slow appreciation in their currencies, which could hurt their exports. Also, comparable maturing U.S. bonds are higher yielding than those of many major countries.

Investors ended the quarter asking whether the Treasury market, the base for the overall bond market's selloff has abated. Data showed wages and consumer prices rose in January, encouraging more investors to sell government bonds and driving the yield on the 10-year Treasury more than half a percentage point higher in less than two months. Yields rise as bond prices fall.

Despite a late-quarter rally, investment grade fixed income had a difficult start to 2018, but the ride over the remainder of the year could be smoother. Rising yields and, thus, falling bond prices have been the main cause of pain for fixed income investors year to date as rates rose meaningfully across the maturity spectrum, resulting in negative returns for all areas of the investment grade market, as reflected in the following table:

Fixed Income Returns

Index	1st Qtr
Corp/Govt	-1.56%
Int. Corp/Govt	-0.96%
Long Corp/Govt	-3.46%
U.S. Government	-1.21%
- Intermediate	-0.70%
- Long	-3.18%
Corporate	-2.20%
- Intermediate	-1.46%
- Long	-3.89%
- **Quality**	
- AAA	-2.85%
- AA	-1.88%
- A	-2.37%
- BBB	-2.08%
Municipal	-1.15%
- Intermediate	-0.57%
- Long	-1.54%

Source: BofA Merrill Lynch

Within shorter maturities, a deluge of Treasury supply pressed rates higher, as did increasing expectations for Federal Reserve rate hikes. Throughout the quarter, rising growth and inflation expectations pushed longer-maturity yields to their highest levels since January 2014. Long-term rates have subsided somewhat from recent highs as funds have moved into the area amid equity market weakness.

The strong global demand for risk-free debt resulted in the government area outperforming the higher-yielding corporate sector. In the credit, or corporate sector, after delivering robust returns throughout 2017, the performance faltered the most, stemming from interest rate risk rather than from a shift in credit fundamentals.

Much of the reason was related to an elevated supply of corporate debt. Just as short Treasury yields were recently pressured higher due to the elevated supply from the Treasury, pent-up investment grade supply that had been on hold because of the uncertainty surrounding the new tax plan was released into the market. Since the passage of the tax plan, the issuance of new corporate debt has increased and credit spreads (yields versus comparable maturing Treasuries) have widened as the supply, at times, is greater than the demand.

Municipals have outperformed similarly rated taxable bonds year to date and continue to trade at attractive valuations compared to U.S. Treasuries and corporates.

Tax reform has also created opportunities in the municipal market. While the new law limited the deductibility of mortgage interest payments, state and local taxes, and other write-offs, it preserved the tax treatment of interest on most types of municipal issues. This, coupled with an expected drop in new issuance and a relatively strong economy, should support the municipal market even in a rising rate environment.

While the first quarter of 2018 was tumultuous for many fixed income investors, some of the headwinds that we had this quarter may be behind us. We believe that the 10-year Treasury yield may end the year in the 3-3.5% range, with volatility along the way as growth and inflation continue to move higher and the Fed continues its gradual pace of rate hikes. We remain cautious but feel that quality fixed income is a potential risk mitigation tool within a portfolio and is a ballast for equity market risk in diversified portfolios.

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