STERLING
CAPITAL

Investment Review and Outlook
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"Sometimes I pretend to be normal, but it gets boring so I go back to being myself". **Comedian George Carlin (1937 – 2008).**

Although the late George Carlin was not talking about financial markets, his words perfectly describe what occurred in the first quarter. The equity market could not have ended more differently than it began. After nearly two years of uninterrupted appreciation in U.S. and international equity markets, investors confronted the reality of volatility. The year started strong as momentum from last year's tax cuts, reduced regulation, and positive earnings reports pushed the S&P 500 up over 7% in January – marking the strongest start since 1996. The abundance of good economic news led many to believe that volatility was extinct, and that 2018 was tracking along a similar course as last year.

The perception that equity markets could move higher without the discomfort of price fluctuations came to an abrupt halt in the first week of February. A stronger than expected January employment report accompanied by fears of inflation led to concerns that new Fed Chairman, Jerome Powell may raise interest rates more aggressively than anticipated. These concerns were compounded by talk of tariffs on steel and aluminum imports, which gave rise to the fear that a global trade war was brewing. Previously ignored bluster out of Washington soon became reason to flee risk-based assets, such as global equities.

Despite the strong start to the year markets gyrated lower in February and March, pushing first quarter stock returns into negative territory. The market's decline snapped a streak of nine consecutive positive quarters – the longest in over twenty years. For the quarter the S&P 500 dropped 0.80%, and the broad-based Russell 3000 declined 0.65%. After trailing throughout 2017, small cap stocks marginally outperformed large caps with the Russell 2000 Index finishing down 0.05%. There was significant dispersion in sector returns as technology and consumer discretionary stocks rose over 4.0%, while the market was pulled lower by declines of over 7.0% in telecom services, materials, and energy stocks.

The selloff in early February gave investors the 10% market correction they had avoided for nearly two years. In fact, the S&P 500 had accumulated 395 consecutive trading days without as much as a 5% pullback. This market winning streak toppled the previous record of 377 days experienced in the 1966-67 bull market.

International stocks held up fairly well under the pressure of U.S. selling as the developed markets within EAFE dropped 1.5%. Asian markets including Hong Kong and Singapore ended in positive territory while Eurozone markets such as Germany and France fell over 6.0%. Despite the drag from developed markets the MSCI Emerging Markets Index posted positive results for the quarter, rising 1.5%. Although global trade dominated economic news, equity markets in Brazil and Russia were up over 5.0%, while China dropped by 2.0%.

Fixed income markets were pushed around by economic forces that influenced both ends of the yield curve. After three rate hikes in 2017, the Fed boosted the Fed Funds rate by 0.25% in March. Longer duration bond yields were pushed higher on fears of rising inflation brought on by strong economic growth and tightening labor markets. The 10-year Treasury bond yield began the year at 2.40%; however, by late-February the yield topped out at 2.95% - before pulling back to end the quarter at 2.77%.

The selloff in stocks set off a flight to quality, prompting corporate yield spreads to widen from 110 basis points at the start of the year to 130 at quarter end. The yield curve remained relatively flat with the spread between 10-year and 2-year Treasury yields hovering around 50 basis points. Although the curve remains upward sloping, it is much flatter than a year ago when the 10 year/2 year yield spread was 115 basis points.

Fixed income markets felt the brunt of shifting interest rates as all major indices dropped into negative territory. The Bloomberg Barclays Government Corporate Index fell 1.0%, and the Short Term 1-3 Year Index declined 0.24%. Municipal bonds fared just as poorly as the Bloomberg Barclays 1-10 Municipal Index tumbled 1.2%.

Overall, the financial markets experienced a difficult start to the year. The markets' stumble came after a historically long period of rising prices accompanied by extremely low volatility. Our view is that the extended period of tranquility caused most investors to become complacent, leading many to assume upward price gains along with low volatility is the new "normal". However, similar to Mr. Carlin's words, *sometimes the market pretends to be normal, but it gets boring so it goes back to being itself.*

<u>Economic Outlook: The "Tug-of War" Economy</u>

"If you are losing a tug-of-war with a tiger, give him the rope before he gets to your arm". **English Author Max Gunther (1926 – 1998)**

There is an economic tug-of-war underway that risks investors losing their arm (and leg) if matters aren't resolved. The two most powerful influences on a nation's economy are the forces of monetary and fiscal policy. Fiscal policy is the means by which a government adjusts spending levels and tax rates to influence its economy. Monetary policy is the strategy followed by central banks to influence money supply in order to achieve a desired economic outcome.

Historically, over an economic cycle one of these drivers will dominate the attention of market participants, while the other policy strategy fades into the background. For instance, in March, 1980 inflation peaked at an annual rate of 14.8%. To combat soaring inflation the Federal Reserve, led by Paul Volcker, raised the fed funds rate from 11% in early 1980 to 20% in June, 1981. This politically unpopular monetary policy shift sharply constricted money supply growth, and pushed inflation down below 3% in 1983.

In contrast, in 2012 U.S. fiscal policy dominated investor attention as many worried about the "fiscal cliff". Fear of a simultaneous increase in tax rates and cuts in government spending set to occur in January, 2013 would send the economy back into recession. The crisis was avoided by passing the American Taxpayer Relief Act of 2012. Fiscal policy created the risk to the economy, and subsequent fiscal policy actions eliminated the risk of an economic contraction.

The primary and secondary roles played by monetary policy and fiscal policy over economic cycles are very familiar to market participants. However, investors are now confused and concerned. Current economic conditions have become a "tug-of-war" between the Fed's monetary policy strategy and the fiscal policies launched from Washington. In many respects these policies are in direct conflict with each other. This struggle creates enormous uncertainty over the direction of capital spending, global trade, borrowing costs, consumer spending, and national security. The diagram below demonstrates several of the major policy initiatives that investors are grappling with as they formulate their outlook for the economy.

Fiscal Policy

- Impact of recent tax reform
- Relaxed regulation
- Proposed import tariffs
- Mounting federal deficits

Monetary Policy

- Influence of new Fed Chair
- Pace of monetary tightening
- Rising inflationary fears
- Policy options to avert next recession

Fiscal stimulus through reduced regulation and tax reform that features lower household and corporate rates has been greeted with great enthusiasm. However, the push by the Trump administration to apply import tariffs on steel and aluminum from China sparks fears of a trade war that would likely take away many of the benefits of the tax cut. History tells us that tariffs are simply a hidden tax. In addition, the spending bill passed in March pushes the federal budget deficit to its highest level since before the financial crisis of 2008. These contradictory fiscal policies are confusing to investors.

On the other end of the "economic rope" is evolving monetary policy under the new leadership of Jerome Powell, who was confirmed as new Fed Chair in January. In his first testimony to Congress he indicated he would be open to more rate increases this year than previously expected. This surprise statement came at a time when data has begun to suggest that inflationary pressures could be building. In addition, there is a monetary need to push rates sufficiently higher in order to have a policy tool to use to combat the next recession. The ability to drop interest rates from current low levels in the event of an economic contraction is not currently an option, so rates need to be pushed higher in case a future reduction is needed. Despite jitters associated with the pace and magnitude of the Fed's interest rate increases we believe Chairman Powell is taking actions that are consistent with underlying growth of the economy, and a close watch on the threat of inflation.

In every tug-of-war there are winners and losers. In our view investors will ultimately be the primary beneficiary of this battle. Although there are some pieces of the policy debate that would be negative for financial markets, the overall policy bias remains pro-business. Tax reform is expected to be a catalyst for higher capital and consumer spending throughout 2018 and into next year. We believe there is enough gridlock in Washington to keep any tariffs highly focused and concentrated in areas that don't materially impact the broader economy. We are watching closely the future course of the federal deficit. We're disappointed in the acceleration in government spending at a time when tax revenues are likely to fall during the initial stages of tax reform. However, elevated economic growth in the second half of the year should help prevent a budget deficit crisis.

We believe the U.S. economy will grow in the 2.75%- 3.00% range for full year 2018. Final fourth quarter GDP growth came in at 2.9%, pushing 2017 growth to 2.6%. Positive momentum, continued global growth, and the benefits from tax reform should help propel the economy higher this year.

Although our outlook remains positive, the recent economic tug-of-war has ratcheted up our concerns over the near term. Market volatility will remain high as investors struggle with policy uncertainty and escalating protectionism.

First quarter earnings are expected to be very strong relative to analysts' expectation. Consensus estimates suggests S&P 500 profits will jump 17% versus year ago levels, representing more than double the annual increase experienced over the past decade. However, the market has begun to believe first quarter earnings will be the antidote that will calm market volatility. Unfortunately, history tells us that it is not that easy. We expect strong earnings; however, we feel there's little chance of avoiding continued sharp volatility.

As the economic tug-of-war continues to rage we don't believe investors risk losing "an arm and a leg" by staying invested. However, we do believe a period of wide fluctuations in markets lies ahead.

Investment Strategy

***"The hardest part of moving forward is not looking back"*. Novelist George Orwell (1903 – 1950)**

Today's investors would be wise to accept the words of Mr. Orwell. The days of prolonged tranquility and markets consistently plodding higher are over. We believe it is not productive to look back on a market environment that rewarded investors in such a quiet and painless manner. Of the many ways to measure market volatility we are inclined to keep things simple. In 2017 there were only eight days when the S&P 500 swung up or down by 1% or more. In just the first quarter of this year the index has tormented investors with 26 days of similar volatility. Our view is that looking back on the market behavior of 2017 is not an appropriate way to set expectations for the future.

Dramatic swings in stock prices experienced in February and March have spilled over into the second quarter. Investors are justified in feeling apprehensive about what lies ahead. Our expectation is that this jagged pattern in the market will continue as trade tariff rhetoric continues to escalate. In addition, the amplitude of swings in markets will be exaggerated by uncertainty regarding the pace and magnitude of the Fed's moves to raise interest rates. The debate over whether the Fed is ahead or behind the economy in their policy to raise rates will continue for the balance of the year. All of these factors will continue to fuel heightened volatility in the financial markets.

Despite our cautious, our view of the financial markets remains positive. Although we are bracing for higher levels of volatility and modest market returns going forward, our outlook continues to emphasize accelerating global economic growth, rising corporate profits, and manageable inflation.

These positives will become distorted by economic and political influences as the year unfolds. However, economic fundamentals ultimately drive financial markets. We believe investors that maintain a long term focus and emphasize diversification will be rewarded on the other side of this tumultuous period.

U.S. Equities

The benefits of synchronized global growth, steadily rising corporate profits, and a deliberate Fed policy towards interest rates will continue to reward long term equity investors. However, volatility has returned with a vengeance. However, our view is equity market risk is best managed through diversification. Our approach is to have broad exposure to all sub-classes of the equity market. Although we emphasize exposure across the capitalization spectrum, we find small and mid-cap stocks particularly attractive in the current environment.

Small and mid-sized companies should benefit the most from corporate tax reform and reduced regulation. On average small companies pay taxes at a higher rate than large companies that are better positioned to take advantage of tax breaks. In addition, relaxing regulatory hurdles is expected to significantly reduce permitting, R&D, and compliance costs for small companies. In fact, it is estimated that companies in the Russell 2000 could see regulatory-related expenses drop nearly 25% in 2018. Most analysts have not yet factored this into their earnings estimates, making this a source of future positive earnings surprises. However, despite our preference for small and mid-cap stocks we firmly believe diversification across the capitalization spectrum is more important now as market leadership shifts rapidly and volatility intensifies.

International Markets

Over the past year our conviction level of international equity markets has shifted to a more positive stance, and our conviction level continues to rise. We see accelerating global growth, favorable monetary policy enacted by global central banks, and attractive valuations relative to domestic equities. We believe these are the fundamental factors that have driven strong relative performance versus U.S. stocks over the past year. Our belief is that this trend will continue.

We are certain that recent concerns over trade impediments will escalate volatility; however, positive fundamentals are expected to continue as global consumer demand and infrastructure spending grows faster than in the U.S. To manage volatility we maintain diversification across all global regions in order to reduce country-specific risk. We believe exposure to both developed and emerging markets will prove additive to portfolios. Broad-based global growth will benefit emerging markets more directly than many large, more developed economies. Although we are positive on the long term prospects for non-U.S. markets, we are cognizant of the potential risks associated with an escalating trade war between key global partners. We will be watching these developments closely in coming months.

Fixed Income:

Interest rates rose across the maturity spectrum in the first quarter. Rising inflation concerns boosted long term rates, and the Fed's rate hike in March pushed short rates higher. This broad shift up in rates drove bond prices lower across all sectors including corporates, Treasuries, and municipals. We believe upward pressure on rates will persist as the improving U.S. economy, tightening labor markets, modest inflation, and global growth keep the long end of the yield curve elevated. In addition, strong economic fundamentals will give the Fed ample justification to continue escalating short term rates two or three more times this year.

Managing fixed income portfolios in this environment is difficult as the headwind of rising rates erodes underlying bond prices. Therefore, portfolio decisions regarding duration, credit selection, and yield curve positioning become extremely important when considering the total return potential of bond portfolios. Our current strategy emphasizes corporate securities relative to Treasury and agency bonds in taxable portfolios. We remain positive on high quality municipal bonds, and believe current yields relative to taxable bonds are attractive. We are positioning portfolios short of their benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. Ultimately higher yields will result in increased income generation, something investors have not experienced in many years. We believe our current fixed income strategy is positioned well to effectively navigate through the current rising interest rate environment.

Recent market volatility and rising concerns over monetary and fiscal policy initiatives can create anxiety and raise fears over the future direction of financial markets. However, our view is that staying focused on the long term, while managing risk through asset class diversification, will allow investment objectives to be achieved.

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