Q1 2018

QUARTERLY REVIEW

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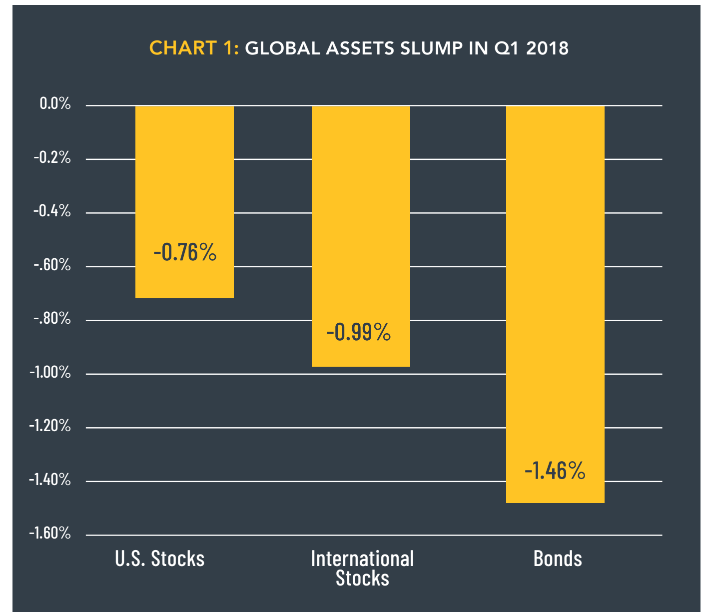
MARKET NOTES

Stock and bond markets around the world suffered losses during the first quarter of 2018 as investors worried about a broad range of issues—including rising interest rates, inflation pressures, and the potential for trade wars between the U.S. and other nations—and how they might impact global economic growth.

For the quarter: (see Chart 1)

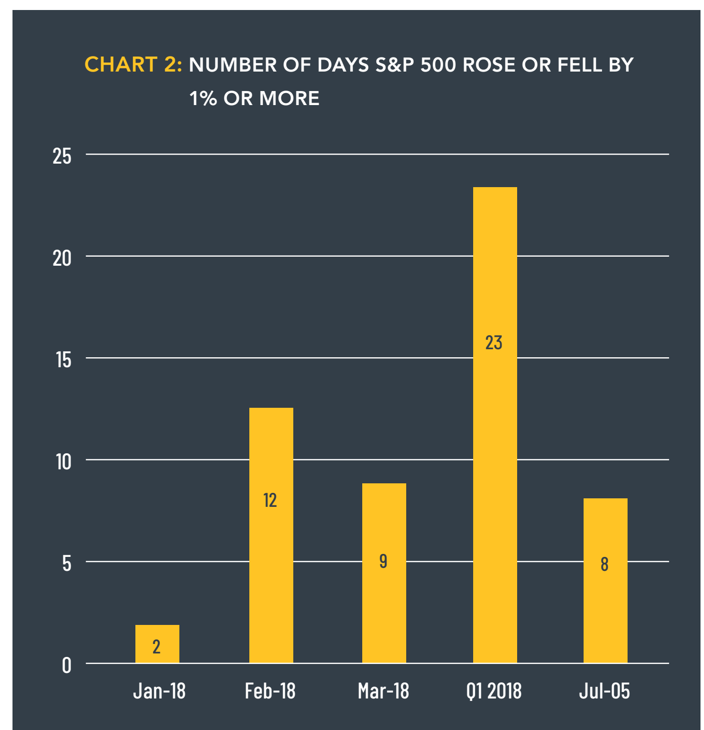
- The S&P 500 index of large-cap U.S. stocks was down 0.76%—its first quarterly loss since 2015.
- Broad-based international stocks (as measured by the S&P Global Ex-US BMI Index) fell 0.99%.
- Bonds (as measured by the Bloomberg Barclays US Aggregate Total Return Index) lost 1.46%.



VOLATILITY MAKES ITS PRESENCE FELT ONCE AGAIN

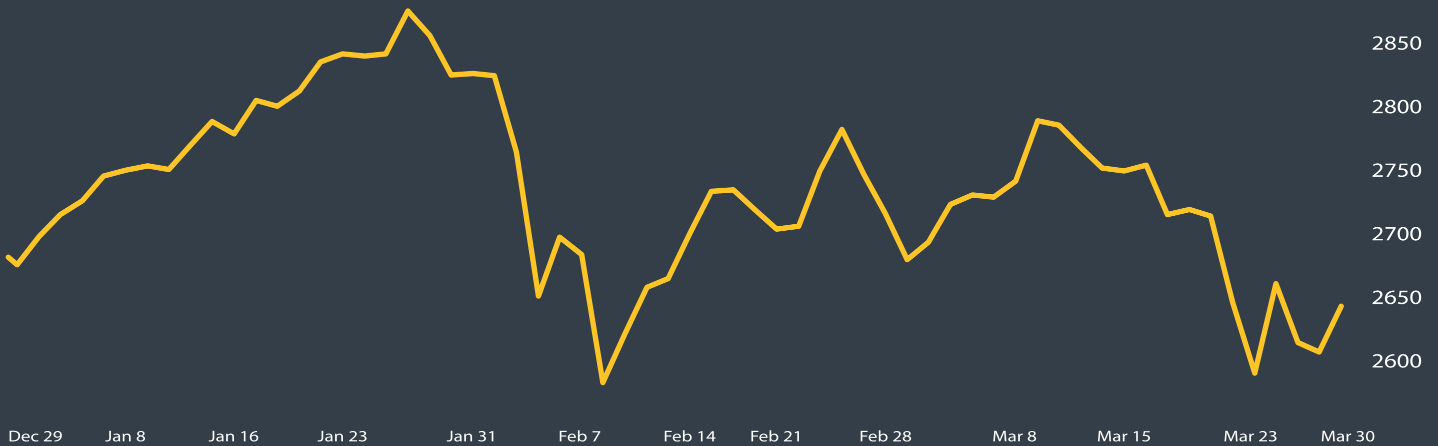
While market volatility was practically nonexistent throughout all of 2017, it came roaring back during the first quarter of 2018.

- The S&P 500 gained or lost at least 1% in a single day 23 times during the first quarter—versus a total of eight such days during all of 2017 (see Chart 2).
- By mid-February, markets had matched the number of 1% swings in 2018 that occurred throughout all of last year.
- The CBOE Volatility Index, or VIX—which measures expected stock market volatility—soared 81% during the quarter. That was its biggest quarterly increase since 2011.
- The VIX jumped by 20% or more during six trading days this quarter—the most ever for a quarter.



The impact of this significant rise in volatility was evidenced by the equity market's month-by-month results during the quarter (see Chart 3):

- S&P 500 total return in January: 5.73% (the index's best January performance since 1997)
- S&P 500 total return in February: -3.69% (the index's first down month since October 2016)
- S&P 500 total return in March: -2.54%



Several factors were responsible for the intense surge in volatility during the quarter, including:

1. **Signs of rising wage inflation.** Data released in early February showed that workers' wages the previous month rose at the fastest pace in eight years. That made investors nervous that overall inflation could spike, and could prompt the Fed to raise interest rates aggressively to put a lid on rising prices. Volatility skyrocketed on the news.

Example: On February 5th alone, the VIX shot from 18 to 39—its largest-ever one-day rise

2. **Technical factors related to short volatility positions taken by investors.** The market losses in early February started a vicious cycle. The sharp rise in the VIX put tremendous selling pressures on so-called "short volatility" strategies—which, in turn, pushed stock prices even lower while pushing volatility levels even higher.
3. **Concerns about tariffs and trade wars.** The Trump administration's announcement in March that it would implement stiff new tariffs on certain imports from other countries fueled fears of a massive global trade war that could hobble the global economy and consumer spending. Although we believe these fears are largely overblown, they spooked the markets enough to generate large swings in asset prices from day to day (and even hour to hour).
4. **Trouble in the tech sector.** Near the end of the quarter, concerns that Facebook may have allowed its users' data to be accessed inappropriately by political campaigns made investors leery of the once-red-hot technology sector. Selling pressure among Facebook and other tech names created additional volatility.

Important: Despite rising volatility and the many headlines about it, it's important to recognize where we are in terms of volatility relative to historical levels. During the quarter, the VIX's average was 17. While that's significantly higher than where the VIX started the year (around 10), it's still below its long-term average level of around 20.

In short, what we experienced during the quarter was a return to a much more historically normal level of market volatility—not an environment of historically high or excessive volatility.

Don't miss: For more on how to view volatility through the correct lens as an investor, see the section below "Is Volatility Irrelevant? Putting Market Volatility in its Proper Place". Taking the right perspective on volatility—what it does and does not mean—can help investors stay on track during those moments when the market is challenging and the headlines are nerve-wracking.

FUNDAMENTALS REMAIN STRONG

With so much attention being paid to market volatility during the quarter, it was easy for investors to overlook an important fact: Many key fundamentals underpinning both the economy and the financial markets remained strong. For example:

- The U.S. economy in the fourth quarter of 2017 grew by 2.9%, driven by robust consumer spending and business investment.
- Consumer confidence hit an 18-year high in February.
- Inflation remained relatively tame, with the Fed's preferred inflation gauge (core PCE) up 1.6% in February, on a year-over-year basis—below the Fed's target rate of 2%.
- Jobless claims sank to their lowest level since 1973.
- Fourth quarter corporate earnings were strong and exceeded expectations, overall.

Ultimately, the noise of the markets during the quarter drowned out the fact that the economy remains healthy going into the second quarter.

STOCKS SINK AFTER STRONG START

Stocks began 2018 extremely strong—with a string of record high closing prices in January—before declining sharply in February and March, and finishing the quarter with a loss.

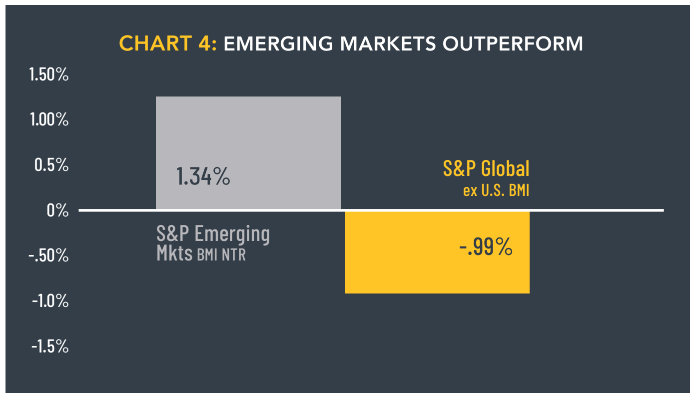
Even with the major indices down, a closer look reveals that there were relative winners and relative losers within the broader market.

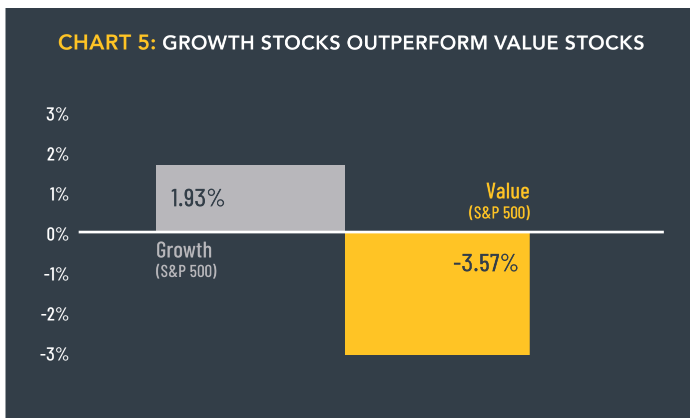
U.S. tops international

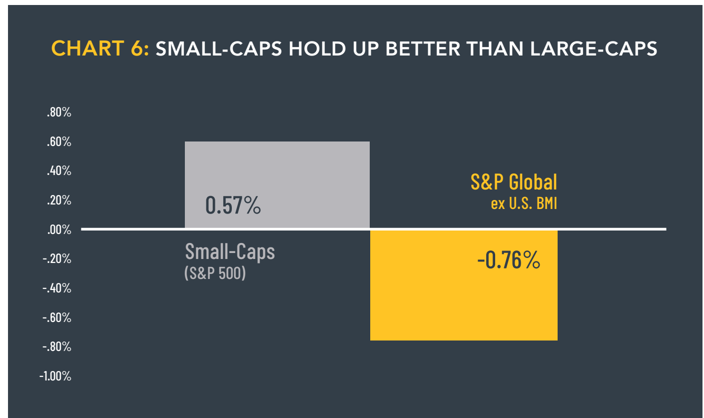
U.S. stocks slightly outperformed broad-based international markets during the quarter. One bright spot internationally was emerging markets, which once again generated strong results on both a relative and absolute basis. As seen in Chart 4, emerging markets beat more established international markets during the quarter—buoyed by attractive growth prospects and valuations, as well as generally stable currencies.

Growth and small-caps lead the way

Growth stocks in the first quarter once again bested value stocks (see Chart 5)—a trend that continued from 2017. Despite suffering heavy losses in March, the technology sector was the primary driver of growth's outperformance—thanks largely to that sector's strong showing earlier in the year. Another growth-oriented sector, consumer discretionary, also contributed to outperformance as strong consumer spending and confidence boosted those stocks in that sector.







Meanwhile, small-company stocks outperformed large-company shares (see Chart 6). One key driver here was investors' fear of a potential trade war, which arose after the Trump administration announced (and later imposed) import tariffs on certain foreign goods. A trade war would likely hurt large, multinational companies much more than it would smaller U.S. firms (which typically don't generate much of their sales from foreign buyers). As a result, small-caps held up relatively well during March when tariff-related concerns pressured large-caps.

SECTOR WINNERS AND LOSERS

Only two equity market sectors posted a positive return during the quarter: technology and consumer discretionary.

SECTOR	Q1 2018 RESULTS
Technology	3.53%
Consumer Discretionary	3.10%
Financials	-0.95%
Energy	-5.88%
Consumer Staples	-7.12%
Telecom	-7.48%

FIXED INCOME FLOUNDERS AS RATES RISE

Bond markets also suffered losses for the quarter—making this the first quarter in which both stocks and bonds declined in value since the third quarter of 2008.

- The Bloomberg Barclays U.S. Aggregate Bond Index was down 1.46%.
- The ICE U.S. Treasury 20+ Year Bond Index fell 3.36%.

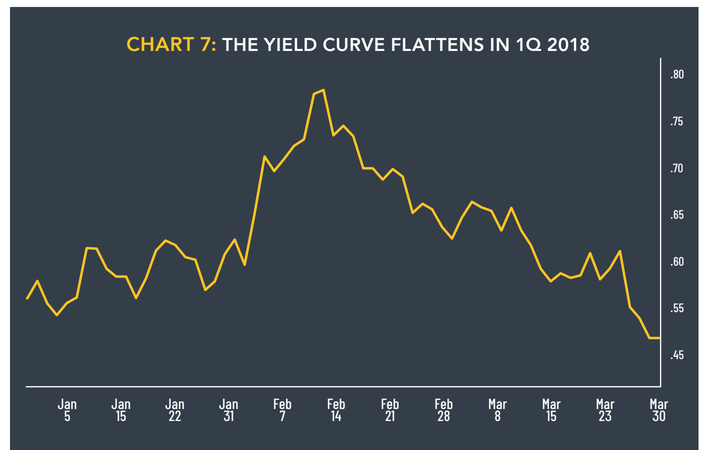
Bonds faced headwinds when signs of strong economic growth created fears that the economy could potentially overheat, sparking unwanted inflation and forcing the Fed to raise interest-rates aggressively—all bad developments for bond investors.

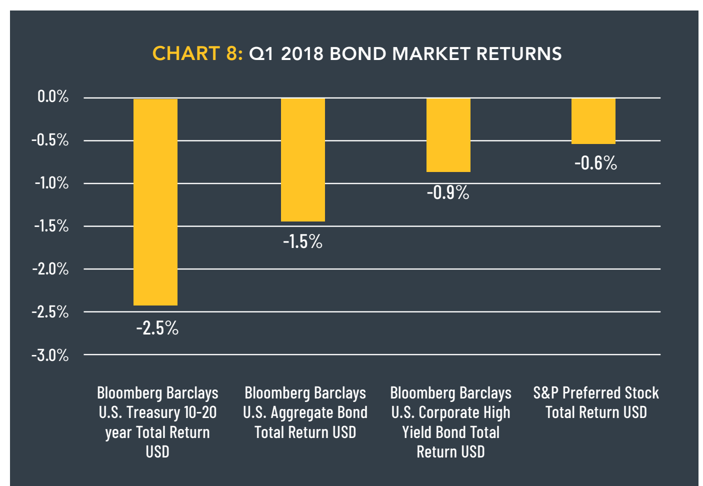
As noted, those concerns ramped up in late January and early February in the wake of strong wage growth data. The result: Bond yields rose—pushing bond prices down. By mid-February, for example, yields on some U.S. government debt hit their highest levels since 2014. Bond markets also had to contend with a new Chairman of the Federal Reserve Board, which determines U.S. monetary policy. And, as expected, the Fed raised a key-short term interest rate at its March meeting—marking the sixth rate hike since December 2015.

As bond yields rose, the yield curve flattened—meaning that the difference in yields between short-term bonds and long-term bonds became smaller and more compressed (see Chart 7).

This happened for two main reasons:

1. Shorter-term bond yields, which are influenced heavily by the Fed's monetary policy decisions, increased steadily during the quarter. Example: The yield on the 2-year Treasury note ended the quarter at 2.27%, up from 1.88% at the start—a difference of 39 basis points.
2. Longer-term bond yields rose more slowly. Rising interest rates and inflation fears would typically cause long-term yields to spike. However, strong demand for these bonds (especially from foreign buyers) in the wake of stock market volatility helped to tamp down their yields somewhat. The yield on the 10-year Treasury bill ended the quarter at 2.74%, up from 2.41% at the start—a difference of 33 basis points (the largest quarterly rise since 2016).

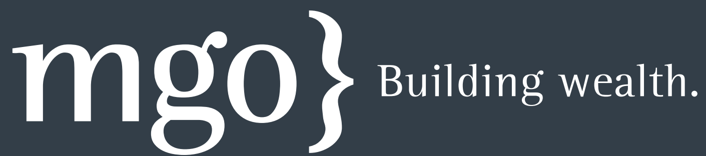




Charts source: Bloomberg

Note: The spread between the yield on a 2-year note and a 10-year bill by the end of the quarter tightened to a level not seen since October, 2007—the peak of the stock market before the 2008 financial crisis. While this doesn't suggest a major recession or market correction is around the corner, it's a development that we will be monitoring in the coming months.

Ultimately, as seen in Chart 8, the key driver of bond market returns during the quarter was duration: The longer a bond's duration, the worse its return; the shorter a bond's duration, the better it did. Indeed, duration is a big reason why both high-yield bonds and preferred stocks, which tend to have relatively short durations, performed relatively well during the quarter.



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