

CAPITAL MARKET REVIEW

First Quarter 2018



The Economy

“We are bigger than US Steel,” said Hyman Roth to Michael Corleone in the classic film *The Godfather Part II*. That scene was placed in a Cuban hotel shortly before the conclusion to the Cuban Revolution in 1959. The irony being that both the mob and US Steel had begun to decline in importance by the time the movie came out in 1974. Those trends have continued to this day.

Who knows, in 1959 steel production might very well have been an issue of national security, but I’m not sure how important domestic steel is in the world today. This I do know. Protectionism was one of the main causes of the Great Depression and helped to create an international environment that eventually led to World War 2. The lesson we supposedly learned from this is that trade promotes both prosperity and peace.

Those who back such policies tend to see commerce as a zero sum game. In other words, they see day to day transactions as having one winner and one loser. That, however, is not how commerce works. When I go buy a new suit, it is not a zero sum game. The store that I go to wins when they sell me a suit and I win when I have a new suit to wear and enjoy. Commerce is by nature win-win. Good business people understand that they only win over the long term if their customers win. Good customers also understand that if they want to have good service and enjoy quality products then the companies they choose to do business with must want to have their business. It is relational not transactional.

This is one of the many reasons tariffs are so disastrous. It just sends the wrong message, and eventually it does not work as companies find alternatives and workarounds. If tariffs raise the cost of steel for large manufacturers like Ford, or Boeing, they will simply ship the steel to a plant somewhere outside the US and then make whatever they were going to make there. One would think an administration which just reformed the corporate tax system would understand this.



tariff

/ˈtærɪf/
noun

1. a schedule of taxes or duties imposed by a government on imported or in some countries exported goods.

synonyms: tax, duty, toll, excise, levy, charge, rate, fee

Source: Merriam-Webster.com

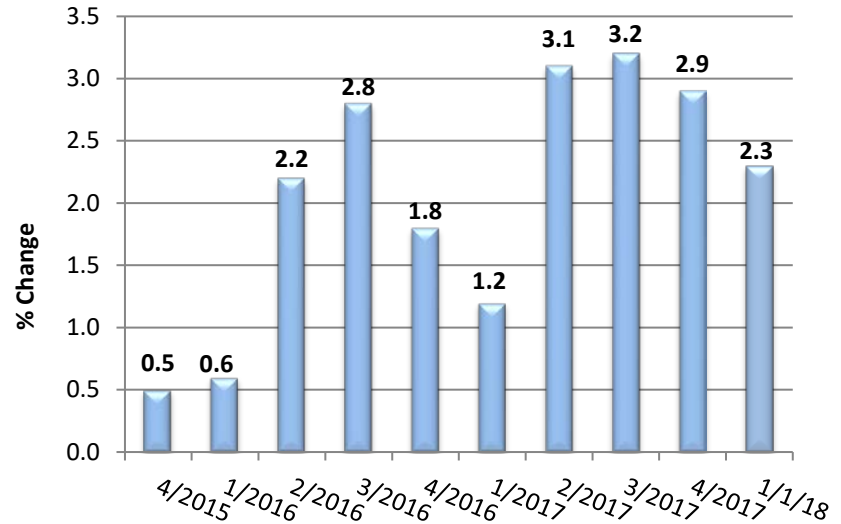
The Economy

The 1st Quarter GDP came in at 2.3 percent, marking four quarters in a row of better economic growth. We may finally be breaking out of the so-called new normal, and the impact of tax reform has not hit yet.

The official unemployment rate remained at 4.1 percent in March. The labor market keeps improving and, perhaps more importantly, we are seeing wage growth of 2.7 percent. That is an encouraging sign.

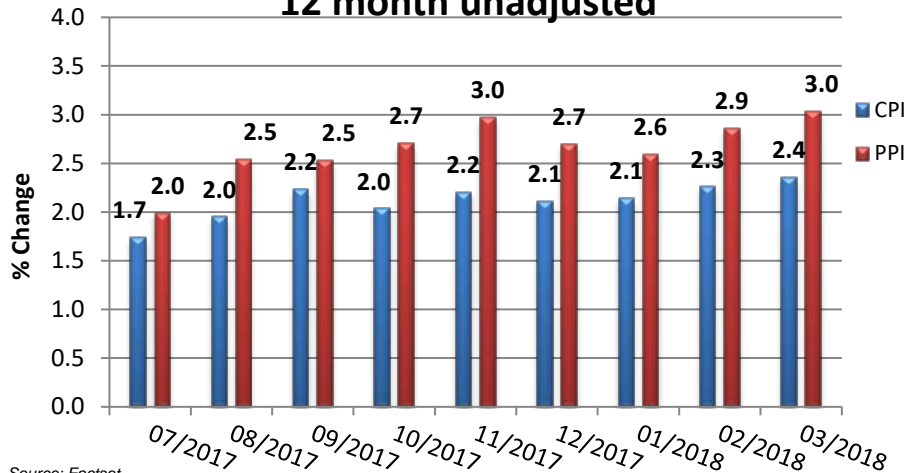
Inflation is at 2.2 percent based on the latest consumer price index report. Core inflation stands below the Fed target at 1.8 percent. The inflation worries have not come true as of yet and we doubt they will.

Domestic GDP



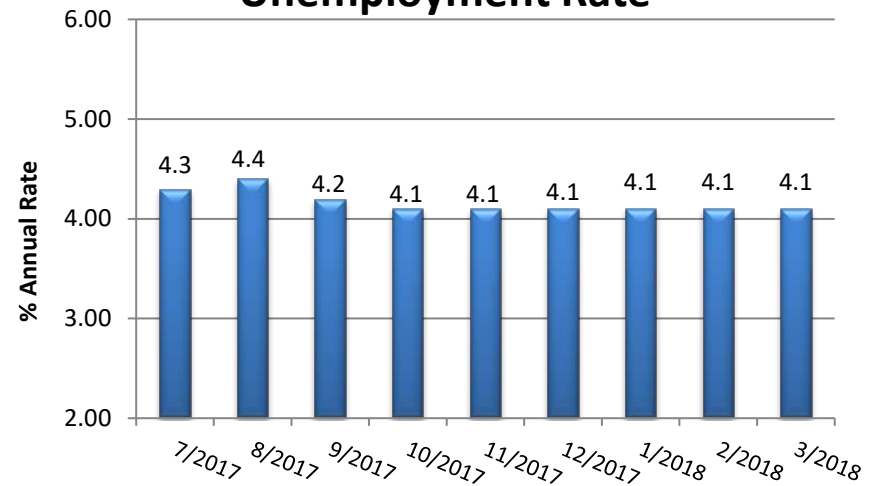
Source: Factset

Inflation Indicator 12 month unadjusted



Source: Factset

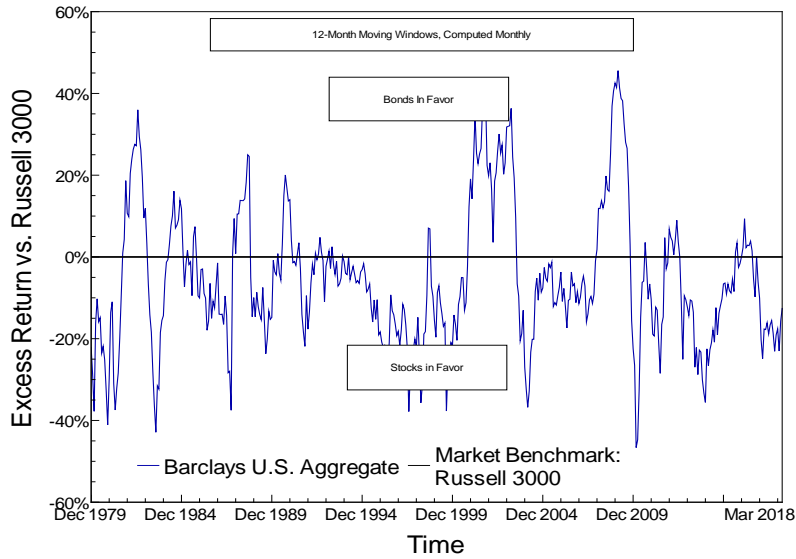
Unemployment Rate



Source: Factset

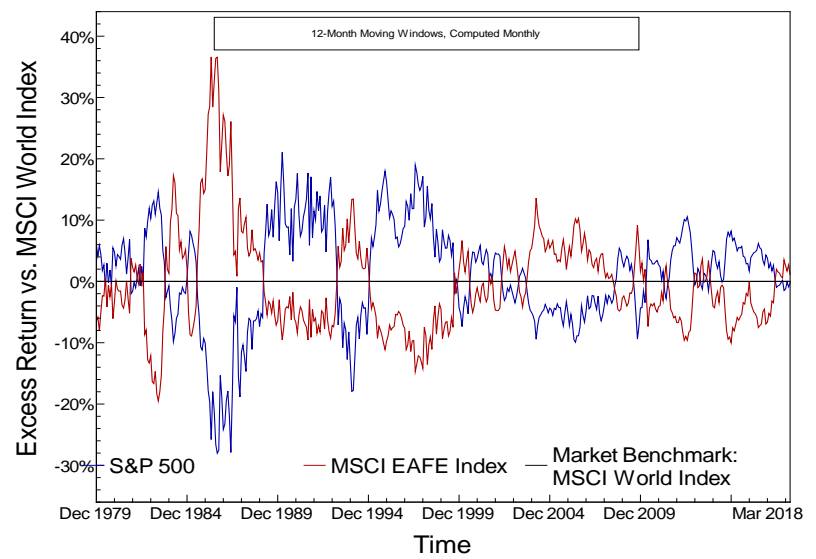
Bonds vs. Stocks

Zephyr StyleADVISOR: Iron Capital Advisors



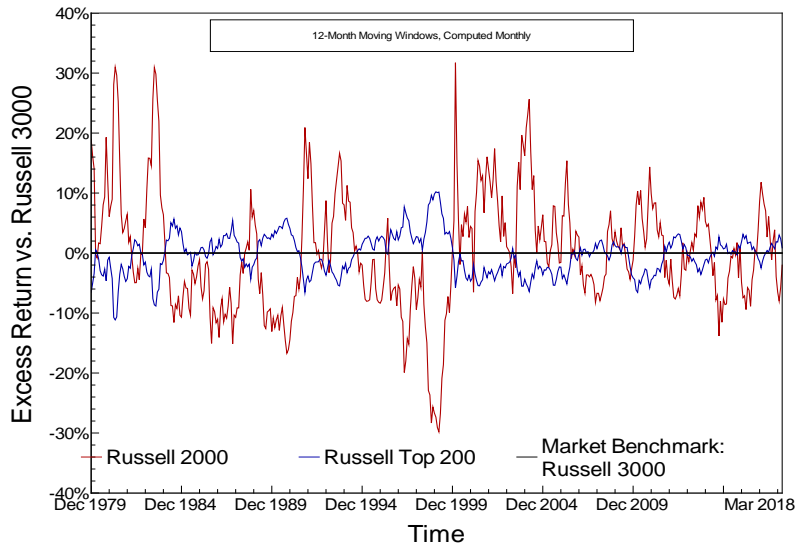
International Vs. Domestic

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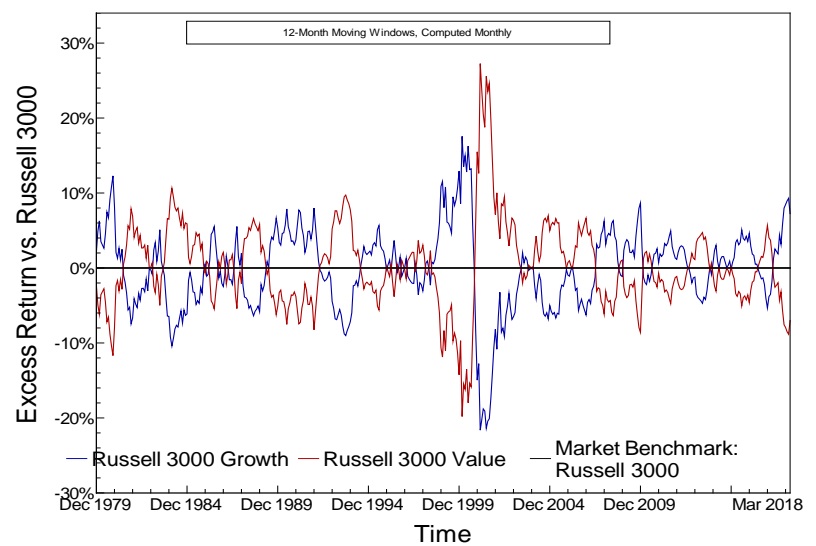


Large vs. Small

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Value vs. Growth



Domestic Equity Markets

What a wild ride. For the quarter, the S&P 500 was down just 0.76 percent, but how we got there was the real story. Volatility is back. Growth outpaced value for the fifth quarter in a row. The Russell 1000 Growth Index finished up 1.42 percent, while its value counterpart was down 2.83 percent.

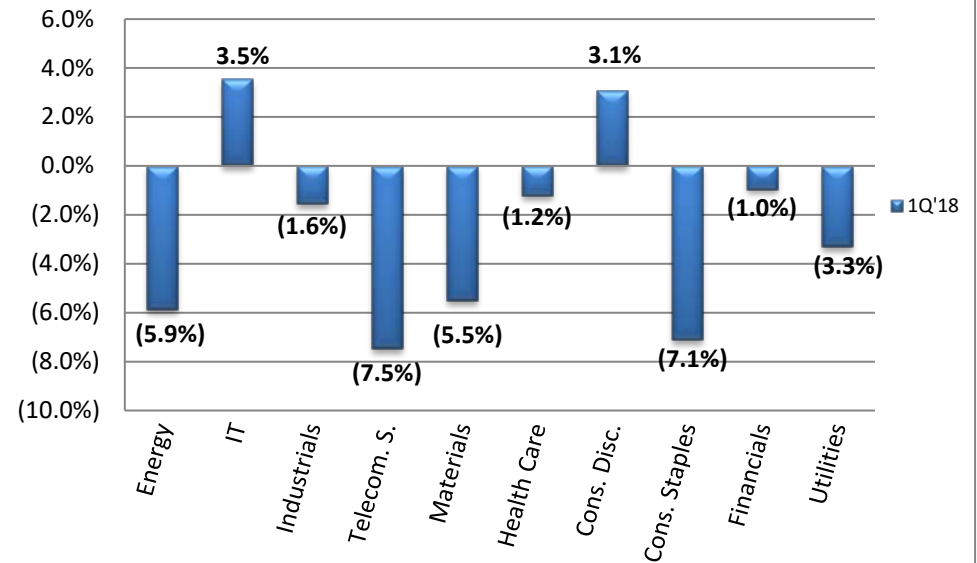
For most of the quarter, the fear in the market was that things are too good. This means a more aggressive Fed and interest rate sensitive areas got hit. Telecom and energy were the worst places to be. Technology and the consumer were the best places to be.

Towards the end of the quarter, attention shifted to tariffs, but that was not enough to change the quarter-end results. It could change things going forward...time will tell.

Domestic Indices Three Months Ending March 31, 2018

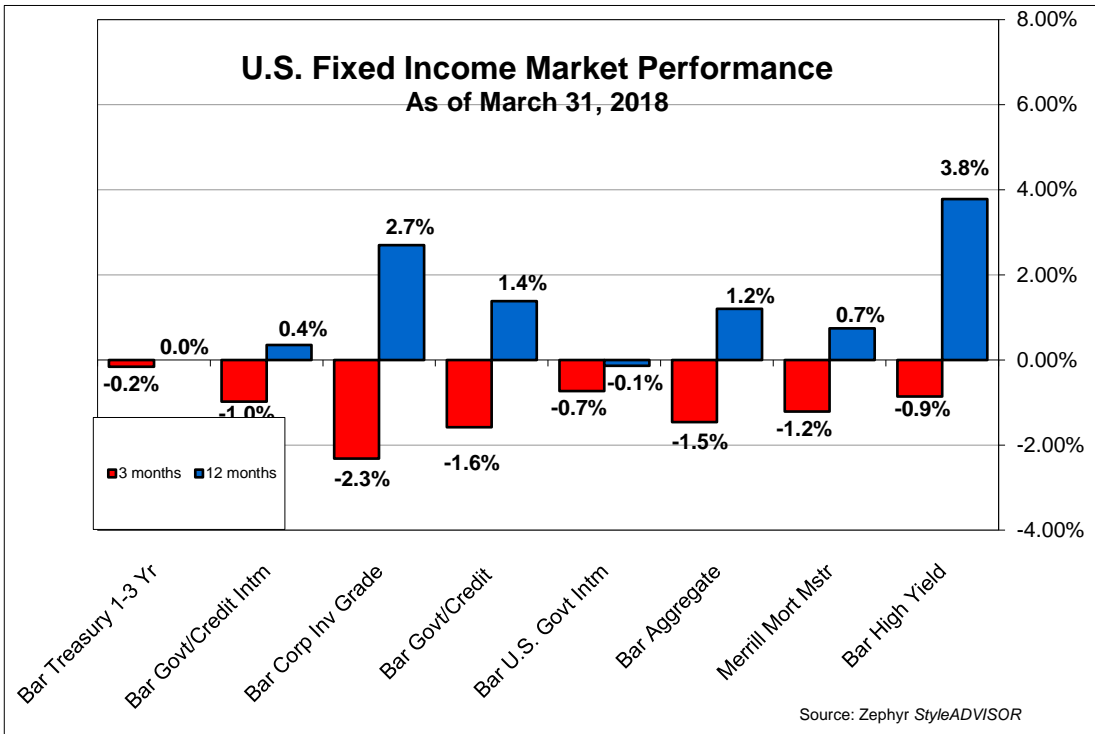
	Yield	Price/Earnings	Price/Book
S&P 500	1.84%	21.7	3.17
Russell 1000 Gr	1.25%	26.5	6.60
Russell 1000 Val	2.39%	18.5	1.97
Russell Midcap	1.62%	22.4	2.74
Russell 2000 Gr	0.60%	53.0	4.30
Russell 2000 Va	1.85%	31.2	1.50

S&P GICS Sector Returns



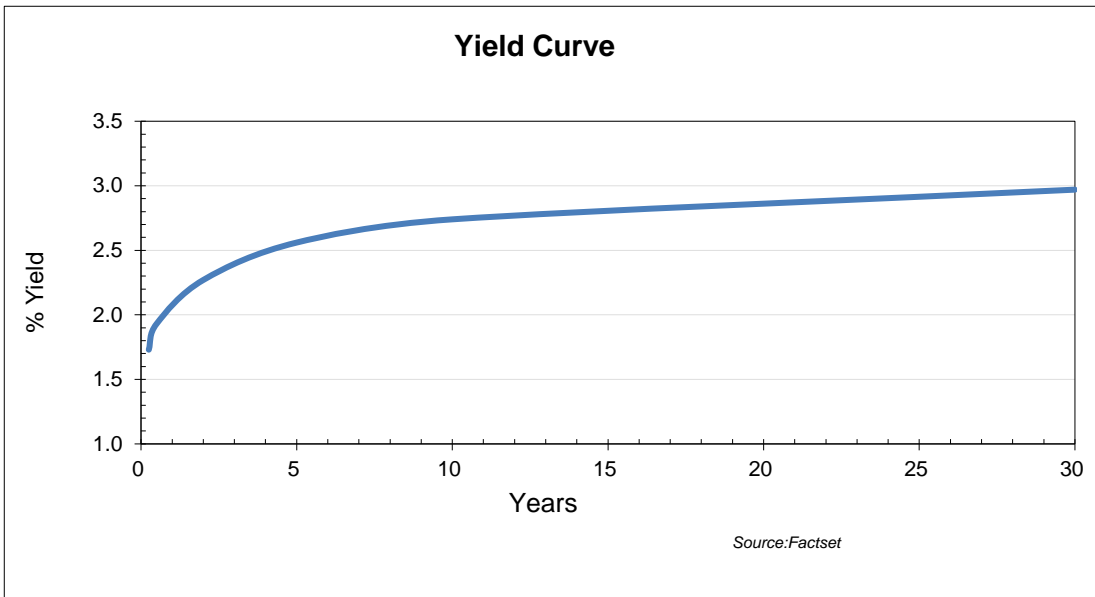
Source: Factset

DOMESTIC FIXED INCOME MARKET



Bonds dropped during the quarter as interest rate crept higher. The Barclays US Aggregate Bond Index ended down 1.46 percent. High yield bonds ended the quarter down 0.94 percent.

Rates are rising and getting closer to the 3 percent target that we have held for some time.



Yield Curve as of March 31, 2018

Time to Maturity	Interest Rate
3 Month	1.73
6 Month	1.93
2 Year	2.27
5 Year	2.56
10 Year	2.74
30 Year	2.97

INTERNATIONAL MARKETS

International stocks suffered as well. The EAFE Index finished down 1.41 percent, while the MSCI Emerging Markets Index ended the quarter up 1.47 percent.

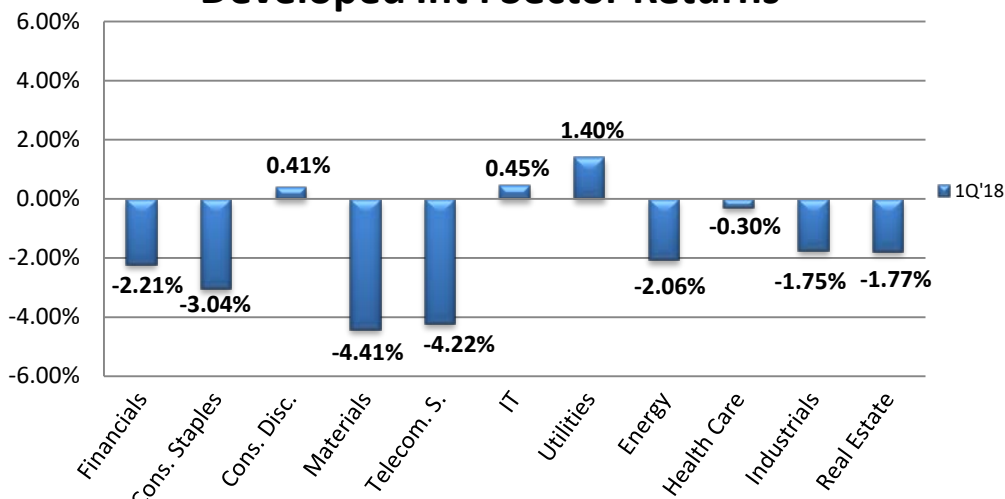
Much of the loss in the quarter was due to the strength of the dollar. The idea that things are too good domestically and that the Fed will continue to tighten had an impact on the currency. The attention then went to tariffs and protectionism.

Emerging markets were the best place to be. Commodity prices have begun to climb as better economic growth and the threat of tariffs combine to raise prices. This is a positive for the emerging world where natural resources represent a larger portion of the overall economy.

MSCI Country Returns Three Months Ending March 31, 2018

	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Austria	2.28%	-0.13%	2.41%
Belgium	0.53%	-1.85%	2.38%
Denmark	-1.07%	-3.29%	2.22%
Finland	8.64%	6.07%	2.57%
France	0.39%	-1.98%	2.37%
Germany	-3.52%	-5.80%	2.28%
Ireland	-5.70%	-7.92%	2.22%
Italy	5.44%	2.95%	2.49%
Netherlands	0.99%	-1.15%	2.14%
Norway	2.36%	-1.75%	4.11%
Portugal	3.09%	0.66%	2.43%
Spain	-1.65%	-3.97%	2.32%
Sweden	-1.86%	0.39%	-2.25%
Switzerland	-3.91%	-5.58%	1.67%
UK	-3.86%	-7.29%	3.43%
Europe Total	-1.86%	-4.23%	2.37%
Australia	-6.13%	-4.28%	-1.85%
Hong Kong	-1.37%	-1.00%	-0.37%
Japan	0.88%	-4.77%	5.65%
New Zealand	-4.89%	-6.23%	1.34%
Singapore	2.76%	0.85%	1.91%
Pacific Total	-0.57%	-4.04%	3.47%
Brazil	12.47%	12.69%	-0.22%
Canada	-7.19%	-4.50%	-2.69%
China	1.82%	2.12%	-0.30%
Greece	-6.73%	-8.93%	2.20%
Hungary	-1.00%	-2.72%	1.72%
India	-6.95%	-4.92%	-2.03%
Indonesia	-7.11%	-5.74%	-1.37%
Korea	-0.37%	-0.81%	0.44%
Mexico	0.94%	-5.83%	6.77%
Poland	-8.18%	-9.48%	1.30%
Russia	9.38%	9.31%	0.07%
Thailand	9.04%	4.63%	4.41%
Emerging Markets	1.47%	0.76%	0.71%

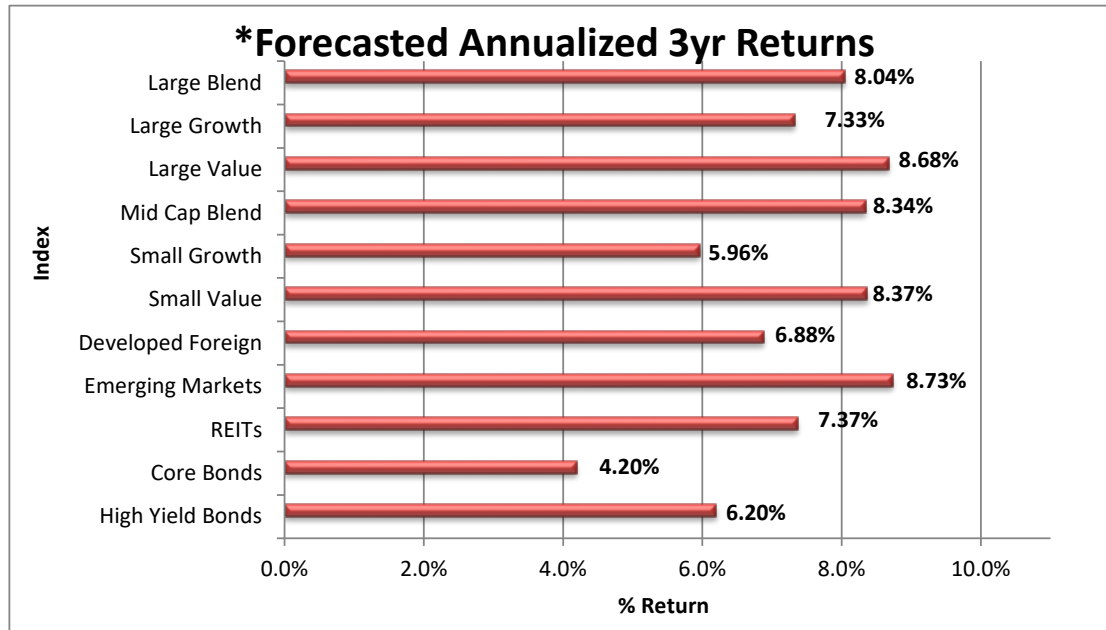
Developed Int'l Sector Returns*



Source: Harbor Capital

* MSCI EAFE Index

Market Forecast



Volatility has returned and is likely to stay. We are still positive on the markets for the year as the economy and corporate earnings are still strong. Those are the things that really matter. In the meantime, any threat of a trade war or other political unrest will continue to cause day to day fluctuations.

Small company stocks should do well. Emerging markets still look attractive as do international stocks.

Bonds remain our biggest concern over the long term and will until the yield on the 10 year treasury exceeds 3 percent. It has gotten closer but is still not there.

Indices Three Months Ending March 31, 2018

	Yield	Frwd Earnings Yield	**Hist. Return	***Hist. Risk Prem. + RF Rate
Large Blend	1.84%	7.93%	9.95%	6.28%
Large Growth	1.25%	6.39%	9.64%	6.28%
Large Value	2.39%	9.43%	10.09%	6.28%
Mid Cap Blend	1.62%	7.63%	11.36%	6.28%
Small Growth	0.60%	3.83%	7.49%	7.28%
Small Value	1.85%	7.75%	10.27%	7.28%
Developed Foreign	2.85%	10.17%	4.97%	4.41%
Emerging Markets	1.93%	10.25%	9.52%	5.91%
REITs	4.24%	6.58%	10.95%	4.85%
Core Bonds	3.15%	3.15%	6.61%	3.18%
High Yield Bonds	6.13%	6.13%	8.13%	4.35%

* Weighted average using 40% earnings yield, 30% historic return and 30% historic risk premium + RF rate

**Annualized 28 Yr return

***Hist. risk premium of domestic and international equity as defined by Zyphyr Style Advisor's GFD Long Term Index database except for REITs and High Yield which are based on average 20 year rolling returns of the NAREIT Equity REIT Index and the Barclays Corporate High Yield Index minus the average 20 year rolling returns of the 3-month T-Bill and scaled using proprietary data. The Current 3-month T-Bill yield (as of 03-31-2018) is added back to each risk premium.

SELECTED INDEX RETURNS - PERIODS ENDING March 31, 2018

	Quarter	Year-to-Date	One Year	Three Years	Five Years	Ten Years
US EQUITIES						
Broad Stock Market - Russell 3000	-0.64%	-0.64%	13.81%	10.22%	13.03%	9.62%
Large Stocks - S&P 500	-0.76%	-0.76%	13.99%	10.78%	13.31%	9.49%
Dow Jones Industrial Average	-1.96%	-1.96%	19.39%	13.48%	13.32%	9.86%
Medium-Size Stocks - Russell Mid-Cap	-0.46%	-0.46%	12.20%	8.01%	12.09%	10.21%
Small Stocks - Russell 2000	-0.08%	-0.08%	11.79%	8.39%	11.47%	9.84%
Small Value Stocks- Russell 2000 Value	-2.64%	-2.64%	5.13%	7.87%	9.96%	8.61%
Small Growth Stocks- Russell 2000 Growth	2.30%	2.30%	18.63%	8.77%	12.90%	10.95%
Large Value Stocks - Russell 1000 Value	-2.83%	-2.83%	6.95%	7.88%	10.78%	7.78%
Large Growth Stocks - Russell 1000 Growth	1.42%	1.42%	21.25%	12.90%	15.53%	11.34%
US FIXED INCOME						
1-3 Yr Treasury (Gov't) Bonds - Barclays Capital	-0.16%	-0.16%	0.00%	0.38%	0.51%	1.13%
US Government Bonds Int - Barclays Capital	-0.73%	-0.73%	-0.14%	0.46%	0.75%	2.21%
US Corporate Inv Grade Bonds - Barclays Capital	-2.32%	-2.32%	2.70%	2.30%	3.02%	5.42%
Government/Credit (Corp) Bonds - Barclays Capital	-1.58%	-1.58%	1.38%	1.22%	1.84%	3.65%
Int Govt/Credit (Corp) Bond - Barclays Capital	-0.98%	-0.98%	0.35%	0.94%	1.25%	2.92%
US Aggregate Bond Market - Barclays Capital	-1.46%	-1.46%	1.20%	1.20%	1.82%	3.63%
Mortgage Master - Merrill Lynch	-1.21%	-1.21%	0.74%	1.11%	1.79%	3.45%
US Corp High Yield Bonds - Barclays Capital	-0.86%	-0.86%	3.78%	5.17%	4.99%	8.27%
INTERNATIONAL (Measured in US Dollars)						
Non-US Stocks - MSCI EAFE	-1.41%	-1.41%	15.32%	6.05%	6.98%	3.23%
World Stocks (includes US) - MSCI World	-1.15%	-1.15%	14.20%	8.58%	10.32%	6.51%
European Stocks - MSCI Europe	-1.86%	-1.86%	15.13%	5.39%	6.97%	2.68%
Japanese Stocks - MSCI Japan	0.98%	0.98%	20.04%	8.72%	9.25%	4.33%
Asian Stocks (Ex-Japan) - MSCI Pacific ex-Japan	-3.71%	-3.71%	8.57%	5.20%	3.39%	4.80%
Chinese Stocks - MSCI China	1.82%	1.82%	39.15%	10.72%	11.59%	6.21%
Indian Stocks - MSCI India	-6.95%	-6.95%	10.23%	4.27%	7.87%	2.96%
Emerging Markets - MSCI EM	1.47%	1.47%	25.37%	9.21%	5.37%	3.36%
Int'l Gov't Bonds -Citi World Gov't Bond (Non USD)	4.42%	4.42%	12.93%	5.02%	1.36%	1.82%
REAL ESTATE						
FTSE NAREIT Equity-Reits Index	-8.20%	-8.20%	-4.51%	1.08%	5.92%	6.37%
SHORT TERM INTEREST RATES						
T-Bills	0.35%	0.35%	1.07%	0.49%	0.31%	0.31%

Note: Returns for periods longer than 12 months are annualized.