Quarterly Economic Update 1Q 2018

American Trust

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The Quarter in Brief. Following a very strong start in January, stocks eventually declined, volatility soared, interest rates moved higher, and nearly all major asset classes ended Q1 in negative territory.

Economic News. Real gross domestic product (GDP) increased at an annual rate of 2.9 percent in Q4, according to the final estimate released by the Bureau of Economic Analysis. That is slightly less than the 3.2 percent increase in Q3 and the 3.1 percent increase in Q2 – but still very healthy.

The March employment report was weaker than expected (103,000 vs. expectations of 193,000) and the prior two months were revised lower by 50,000 jobs. However, the U.S. still managed to post a monthly average of 201,000 new jobs in Q1, far greater than the roughly 100,000 required to keep up with population growth. The unemployment rate stayed at 4.1 percent for the sixth consecutive month and initial unemployment claims were the lowest since 1973.

The ISM Manufacturing Index level (59.3) is firmly in expansion territory and the Non-Manufacturing Index is near a 13-year high. Tax reform has business confidence near an all-time high and a strong job market has kept consumer confidence at levels not seen in over 17 years.

The economy was clearly strong enough for the Federal Reserve to maintain a tighter monetary strategy – raising the overnight rate .25 percent (to a range of 1.50-1.75 percent) at its March meeting. The Fed expects three more rate-hikes in 2018 and it raised its outlook to three for 2019. This is in addition to the fact that the Fed continues to shrink its balance sheet (another form of tightening) in the wake of stronger economic growth.

On March 8, President Trump sparked fears of a trade war (primarily with China) with the introduction of tariffs on imported steel and aluminum. Later in the month he announced other measures related to intellectual property and technology related products. China retaliated with tariffs of their own – targeting cars, aerospace, and agricultural products – amounting to a similar value of goods and services that the U.S. levied – clearly a tit-for-tat response. While not significant (current tariff proposals would represent less than 5 percent of imports on either side) as it stands now, an escalating trade war could clearly have long-term ramifications.

The Markets. When looking at Q1 returns, one might think that it was a fairly uneventful quarter. In reality, it was anything but.

Stocks hit new highs in January, as investors remained enthusiastic about tax reform and corporate profits reached levels not seen since 2011. The market gained momentum throughout the month, reaching its high point (up 7.45 percent fromthe beginning of the year) on January 26.

The rally came to a screeching halt in early February when the Bureau of Labor Statistic's January employment report showed the highest wage growth (+2.9 percent) in over eight years. Investors worried that a strong economy, growing corporate profits, new tax cuts, and now stronger wage growth could lead to higher inflation and force the Fed to accelerate tightening. In response, the S&P 500 dropped over 10 percent by February 8 (only 10 trading days) – representing the first "correction" the market has seen since 2015.

Stocks abruptly rebounded over the next 30 days, up 8 percent from the February bottom, only to sell off again when the U.S. and China began to fight about trade. When it was all said and done the S&P 500 finished down .76 percent – the first negative quarterly return since Q3 2015 – with volatility levels near double from last year.

Index Performance	Q1 2018	Q4 2017	YTD
Domestic Equity			
S&P 500	-0.76%	6.64%	-0.76%
Russell Mid Cap	-0.46%	6.07%	-0.46%
Russell 2000	-0.08%	3.34%	-0.08%
International Equity			
MSCI EAFE	-1.53%	4.23%	-1.53%
MSCI Emerging Markets	1.47%	7.50%	1.47%
Fixed Income			
Barclays Aggregate	-1.46%	0.39%	-1.46%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Small Cap stocks (Russell 2000) slightly outperformed Large cap stocks (S&P 500) in Q1 – mostly due to the 3.83 percent outperformance in the month of March. Talks of a trade war disproportionately hurt large cap multi-national companies (given their global diversity) more than their domestic-oriented small cap counterparts, allowing small caps to log a slightly better return (-.08 percent) by the end of Q1.

Developed International equities performed the worst (MSCI EAFE -1.53 percent) of the major asset classes, as recent weakness in Europe compounded already widespread trade fears. France, Germany, and Switzerland were all down over 2 percent in Q1. Stronger commodity prices and a weak U.S. dollar helped Emerging Market equities end the quarter as one of the only major asset classes to post a positive return (+1.47 percent).

The 10-year Treasury yield hit its highest level (2.94 percent) in over four years, before settling down to 2.74 percent by the end of the quarter. That is .35 percent higher than the beginning of the year. Fears that the economy was overheating (and rates would move higher, faster) helped push nearly all fixed income asset classes negative. The Barclays Aggregate (-1.46 percent) generally trailed the return of equities, even in the face of weak stock markets and heightened volatility.

S&P 500 Sector Performance	Q1 2018	Q4 2017	YTD
Consumer Discretionary	3.09%	9.86%	3.09%
Consumer Staples	-7.12%	6.49%	-7.12%
Energy	-5.88%	6.02%	-5.88%
Financials	-0.95%	8.63%	-0.95%
Healthcare	-1.22%	1.47%	-1.22%
Industrials	-1.56%	6.05%	-1.56%
Information Technology	3.53%	9.01%	3.53%
Materials	-5.52%	6.93%	-5.52%
Real Estate	-5.02%	3.22%	-5.02%
Telecommunications	-7.48%	3.61%	-7.48%
Utilities	-3.30%	0.21%	-3.30%

Market leadership was relatively narrow in Q1 with only two sectors posting positive returns. A tough month of March wasn't enough to keep Technology (+3.53 percent) from being the top sector in the quarter, as large-cap growth stocks dominated other sectors earlier in the year. The Consumer Discretionary sector (3.09 percent) was helped by the passing of the new tax bill as well as the ongoing outperformance of internet related companies (think Netflix and Amazon). Those sectors most sensitive to rising interest rates (Telecom, Consumer Staples, Real Estate, Utilities) all performed poorly in the quarter as interest rates moved higher by .30%-.40 percent across the entire yield curve. The Materials sector (-5.52 percent) was hurt by the tariffs put on steel and aluminum late in March, and despite a 7.5 percent increase in the price of crude oil, the energy sector was down 5.88 percent in Q1.

Outlook. Unlike 2017, the start of 2018 has been rife with newsworthy headlines and rampant volatility. Last year, the market had only eight trading days that moved 1 percent (+/-). The S&P 500 posted 23 such days in Q1 alone. Despite all of the volatility, has anything changed to justify a negative outlook for the markets? Not really. The market is now just a little cheaper.

Key economic indicators continue to support a stronger global growth outlook. Consumer confidence is high, jobless claims remain low, and job openings are the highest on record. Business confidence is still elevated, particularly in the U.S., where tax reform has added to already lofty expectations. And while the U.S. recovery is almost nine years old, most international economies are relatively early in their growth cycles, helping push global economic forecasts higher, now above 3.5 percent for 2018.

Market weakness (and a corresponding surge in earnings) has also made valuations more attractive. On a forward P/E basis, the S&P 500 Index now trades at 17.5X earnings, a premium not considered extreme (within one standard deviation) compared to its 10-year average. Also, a shift in leadership beyond FAANG (Facebook, Apple, Amazon, Netflix, Google) began to develop toward the end of the quarter. In fact, the Russell 1000 Growth Index (21.25 percent) had outperformed the Russell 1000 Value Index (6.95 percent) by 14.30 percent over the last 12-months ending in Q1. Cheaper valuations and a more global recovery could help broaden market leadership beyond just a few select groups. This would provide a better foundation for future stock market gains.

Federal Reserve policy and global trade negotiations probably represent the biggest concerns in the near-term. However, strong earnings growth in 2018, aided in part by corporate tax reform, should provide support for equity markets should volatility continue.

In the end, Q1's sell-off was not triggered by weak economic data, nor was it triggered by poor corporate earnings. It was caused by the fear that things were getting too good, and the economy was overheating. Emotion (and most-likely computer aided trading programs) played a major role in the recent volatility. Investors who keep the day-to-day news headlines in the proper perspective should prove successful over the long-haul.