



MARKET REPORT FIRST QUARTER 2018

Key Takeaways

- Markets experienced new challenges during the first quarter, and we continue our defensive positioning.
- If you're watching financial news, remember to balance the headlines on market moves with a view of actual percentage changes. Price moves, both positive and negative, may be smaller than they first appear when translated into percentage terms.
- The recent rise in market volatility is a return closer to historical norms, which may offer investors attractive opportunities.
- The price-to-sales ratio (P/S) is an additional valuation measure that suggests the stock market is not cheap.

Economic Overview

U.S. corporate profits and the domestic economy continued to grow in the first quarter as pro-business tax reform was implemented. However, factors such as rising inflation, higher interest rates, and trade disputes seemed to inject volatility and weigh on markets by quarter-end. The Federal Reserve continued increasing short-term interest rates and unwinding its previous massive purchases of debt backed by the U.S. government and government-sponsored enterprises (e.g., Fannie Mae, Freddie Mac). All of this took place in the midst of high debt levels by various market participants and security valuations lacking adequate margin of safety, in our view.

Equities

The S&P 500 returned -0.8% for the quarter (including dividends), ending a nine-quarter streak of gains for the index. No sector generated large positive returns, but Energy and Technology led with returns up several percent.

The Telecommunications and Consumer Staples sectors were the largest underperformers as competition and rising interest rates seemingly reduced demand for their common stocks and dividend yields.

Small caps slightly bested large caps during the quarter, and statistically cheap stocks underperformed their expensive counterparts.

Total Return as of March 31, 2018						
	Annualized					
	QTD	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.
S&P 500	-0.8%	-0.8%	14.0%	10.8%	13.3%	9.5%
NASDAQ	2.6%	2.6%	20.8%	14.4%	18.1%	13.3%
Russell 3000						
Index	-0.6%	-0.6%	13.8%	10.2%	13.0%	9.6%
Value	-2.8%	-2.8%	6.8%	7.9%	10.7%	7.8%
Growth	1.5%	1.5%	21.1%	12.6%	15.3%	11.3%
Russell Mid Cap						
Index	-0.5%	-0.5%	12.2%	8.0%	12.1%	10.2%
Value	-2.5%	-2.5%	6.5%	7.2%	11.1%	9.8%
Growth	2.2%	2.2%	19.7%	9.2%	13.3%	10.6%
Russell 2000 (Small Cap)						
Index	-0.1%	-0.1%	11.8%	8.4%	11.5%	9.8%
Value	-2.6%	-2.6%	5.1%	7.9%	10.0%	8.6%
Growth	2.3%	2.3%	18.6%	8.8%	12.9%	11.0%

Fixed Income

Corporate bonds’ total returns, as measured by the BofAML 1-to-10 Year Index, decreased 1.5% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, decreased 0.7% for the quarter. The 10-Year Treasury bond’s yield of 2.7% finished higher than the previous year end’s yield of 2.4%. In general, we believe bonds became more attractive during the quarter as yields rose, but that bonds in general are still subpar as a low interest rate environment continues.

That being said, we are finding opportunities in bonds. However, they still tend to have very short maturities as some short-term interest rates have recently risen faster than long-term interest rates. An example of the relative attractiveness of bonds maturing in the near term to bonds maturing longer term can be seen in the following example: The yield on a 2-year Treasury bond at quarter-end was 2.3% and the yield on a 10-year Treasury bond at quarter-end was 2.7%. Therefore, purchasing the 2-year Treasury bond, instead of the 10-year Treasury bond, gives an investor over 80% of yield of a 10-year Treasury bond (2.3% divided by 2.7%) while providing the opportunity to reinvest these funds much sooner and ideally at higher interest rates.

Another example of bonds we have found for appropriate account styles are called “floating rate bonds,” which is one of two main categories of bonds, the other being “fixed rate bonds”. We describe and compare them below in plain English and in a table:

- **Fixed rate bonds:** These are the bonds discussed more often by investors and financial media. The holder of these bonds receives the same interest payments from the bond regardless of where interest rates move. Therefore, when interest rates go up, the bond prices of fixed rate bonds go down. And when interest rates go down, their bond prices tend to go up. Because the interest provided by these bonds does not change, the bond prices themselves must change to accommodate new interest rate environments.
- **Floating rate bonds:** These bonds increase interest paid to the bond owner when interest rates rise, and decrease interest paid when interest rates fall. Floating rate bonds tend to see their prices stay relatively stable whether interest rates rise or fall. This is because the interest rates paid by these bonds are able to adjust to the new interest rate environment.

So, to summarize the effect of interest rate changes on these two types of bonds:

<u>Type of Bond</u>	<u>Interest Paid by Bond</u>	<u>Bond Price</u>
Fixed Rate Bonds	Does not change	Adjusts
Floating Rate Bonds	Adjusts	Does not change much

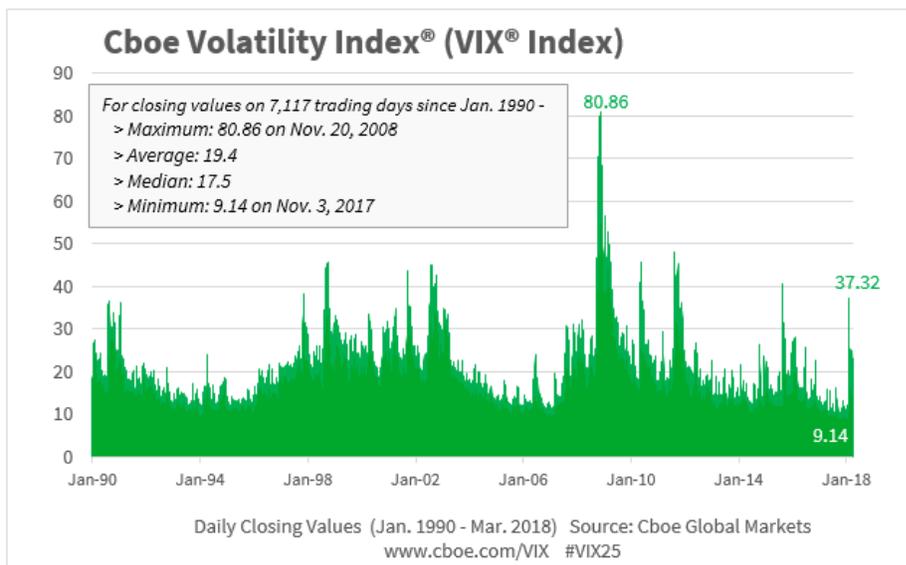
Why is this important? We have recently increased our allocation to floating rate bonds for appropriate account styles because we are in a low interest environment that we think is likely to rise over time. We believe owning floating rate bonds can help us benefit from a higher interest rate environment in the future by receiving higher interest payments on the bonds while their prices do not decline significantly.

Commodities

Commodities, as measured by the Bloomberg Commodity Index, declined slightly during the quarter (-0.4%). West Texas Intermediate crude price rose 7.5% from \$60.42 to \$64.94. Conflicts in the Middle East and the prospect of significant oil producing countries further limiting production though 2018 seemed to support rising oil prices. Further, ongoing trade disputes may result in higher tariffs for many commodities, which could put downward pressure on demand for various producers. Aluminum and pork are just two examples that are caught in the crosshairs.

Comments on market moves and increased volatility

We believe it is important to look at current market fluctuations in the context of history. On Black Monday, October 19, 1987, the market fell 508 points, equivalent to a 22.6% drop in the Dow Jones Industrial Average (DJIA). Today, a drop of 500 points would be only equal to several percentage points. A decline of similar magnitude today to the 1987 market decline would equate to a drop of more than 5,000 points. So, while swings of several hundred points in the DJIA may be eye-catching and reported on with frequency by the financial media, they are not large on a percentage basis.



Having said that, volatility has increased, and we view the extraordinarily low volatility of 2017 as more of an anomaly. Historical data supports this view: On this page is a graphical history of the CBOE Volatility Index (VIX), which is an accepted measure by many market participants for how turbulent markets are at any particular point in time. Without getting into the details of the VIX, you can note several things from this data series going back to the VIX's inception in the 1990s:

- Volatility in 2017 was much lower than the average VIX of 19.4 over time, hitting an all-time low of 9.14 on November 3, 2017.
- Volatility in 2018 has moved up, and with the exception of a short-lived spike above 37, is closer to the longer-term average.

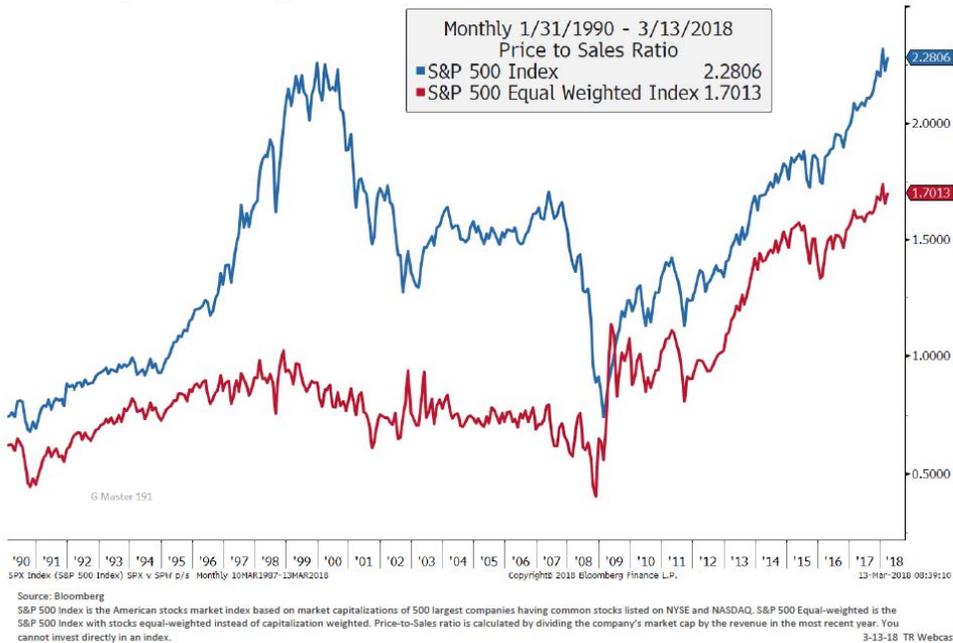
Not easily visible in the graph is the data point showing the VIX ended this quarter at 19.97, approximately equal to the long-term average of the VIX.

As we have stated in the past, we tend to view volatility as something to be taken advantage of rather than fear. It can provide opportunities to reduce positions when securities become more expensive, and produce more profitable opportunities as securities become cheaper with good margin of safety.

The Price-to-Sales (P/S) ratio

We reviewed a variety of price-to-earnings (P/E) ratios with you in a recent letter, and thought we would provide an update on the price-to-sales ratio (P/S), which is a valuation measure that can be calculated by dividing a company’s market capitalization by its sales for the last year. The graph below shows the P/S ratio for the S&P 500 Index (blue line) and the S&P 500 Equal Weighted Index (red line). The S&P 500 Index gives more weight to larger firms, and the S&P 500 Weighted Index gives all firms equal weight in calculations.

Price-to-Sales Ratio: S&P 500 and S&P 500 Equal Weight



As you can see, the P/S ratio for the S&P 500 Index going back to 1990 is as high as it has been since the dot-com boom at the turn of the century. And more striking, the S&P 500 Equal Weighted Index has a P/S ratio far above where it has been, dating back to 1990.

This is just one of many valuation metrics and there can be reasons to partially explain these extremes, such as low interest rates that may have helped make

companies more profitable per dollar of sales and that the S&P 500 may be populated by companies with higher profit margins than in the past. But it is one more valuation metric that suggests the market is not cheap right now. For example: What happens to profit margins if interest rates, wage inflation, and regulation for some massively profitable technology companies rise significantly? Or if a recessionary period arises?

We hope you find this information helpful. Please feel free to contact our team with questions, comments or both at any time.

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