2018 Q1 REVIEW Q2 PREVIEW

OVERVIEW:

Despite a wild Q1 (Jan up +5.71%, Feb down -3.69% and Mar -2.55%), the equity market (as per S&P 500) ended the quarter roughly unchanged from the end of 2017 at -0.78% YTD. For comparison, bonds (as measured by the AGG) fell -1.49% and 10-year Treasury yields rose from 2.41% to 2.74%. Large cap stocks continued their trend of outperforming mid-caps on continued USD weakness. Gold worked well as a USD hedge, gaining 2.01% for the quarter.

Q1 REVIEW:

January's rally was driven by strong Q4 corporate earnings reports as well as analyst upgrades on the back of the corporate tax cut announced in late 2017. However, in early February, the market was spooked by wage inflation data suggesting an accelerated pick-up in inflation, which sent bond yields higher, pressuring equities and triggering a combination of derivative-related, Commodities Trading Advisor and risk-parity fund selling, which exacerbated losses. The market recovered roughly half the initial swoon as derivative stresses eased, but shell-shocked investors awaited further economic releases to confirm the inflation trend. Investors spent most of March attempting to figure out near-term direction, but the announcement of added trade tariffs took a toll on industrial heavyweights such as Boeing and Caterpillar, while Facebook's data breach prompted traders to take profits in the broader Tech sector.

Q2 AND 2018 PREVIEW:

We entered 2018 with an S&P 500 forward P/E of 18.2x. According to FactSet, 2018 earnings estimates have risen to $157.77 (from $146.19 at the beginning of the year). Combined with lower equities prices, the S&P 500 forward P/E ratio is currently 16.68x – roughly in line with its 25-year average of 16.1x. Using our methodology for comparing equity valuations versus the current interest rate environment, a forward P/E of 16.68x equates to an Earnings Yield (EY) of 6%. With 1-Year Treasuries yielding 2.1%, adding a 4.5% equity premium, we arrive at an expected EY of 6.6%. Though the EY is slightly lower than expected EY, we continue to believe equities offer better value than bonds on a relative basis, especially considering expectations of gradual increases in growth, inflation and Fed rate hikes. Additionally, the 10-Year Treasury yield at 2.74% seems expensive compared to its 25-year average of approximately 4.6%. Conservative investors, seeking fixed income exposure, should look at the short-end of the yield curve, in the 1 to 2-year range as this offers the best relative value on the yield curve, with much less duration / interest rate risk.

US VS. OVERSEAS MARKETS:

The US market P/E of 16.68x is higher than Europe (under 15x), but the S&P has higher exposure to high P/E technology names, skewing the US P/E higher. Additionally, US companies are more profitable than European companies as measured by ROE, which would also justify a higher rating. Furthermore, recent economic data out of Europe has softened, and combined with a strong Euro, corporate profits from the region should not be as robust as US counterparts. For offshore exposure, we would overweight emerging markets and underweight Europe.

CONCLUSION:

We expect inflation and interest rates to continue to move higher gradually, and continue to prefer Financials, Industrials, Technology and Consumer Discretionary over other equity sectors. In the same higher rate theme, we are concerned with interest rate risk on longer duration bonds and prefer short-dated 1 to 2-year issues. Equities remain our preferred asset class with US equities preferred over European names. Our fair value on the S&P 500 sits at around 2,500, and this level should act as a near-term buying area. Geopolitical developments may cause short-term headline risks, but we see these pullbacks as buying opportunities for now.

Our Tactical model remains in neutral mode this week:

GAUGE OF THE GRADE

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SECTOR RETURNS					
	5 DAYS	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
Basic Materials	-0.1	-3.7	-5.4	1.0	10.5
Communication Services	-0.7	-2.9	-7.4	-7.4	-8.0
Consumer Cyclical	-0.7	-2.3	1.9	11.3	16.4
Consumer Defensive	2.2	-0.6	-6.4	-0.7	-1.4
Energy	0.3	2.0	-6.0	0.0	-1.3
Financial Services	-0.3	-3.2	-0.5	7.2	17.8
Healthcare	-0.2	-2.4	-0.2	1.4	12.7
Industrials	0.4	-2.0	-2.0	4.4	14.7
Real Estate	2.1	3.9	-8.2	-6.9	-3.7
Technology	-1.3	-3.4	4.0	13.0	27.5
Utilities	1.6	4.0	-3.4	-2.8	2.1