FINANCIAL & ECONOMIC REVIEW

For the first time in over two years, major U.S. market indices closed the quarter in the red. The decline from recent highs was accentuated in early February with the Dow Jones, S&P 500 and NASDAQ each dropping between 11.7% and 12.2% from recent highs. This decline has been predicted ad nauseam for over a year by economists and market prognosticators alike. While the cyclicity of financial markets are of no surprise, the ending of easy money policies of the past decade precipitated this drop. With equity valuations approaching historically elevated levels, while at the same time multi-decade low interest rates rising to counter inflation, the drop was almost an inevitability. The Fed continued to put the brakes on the easy money by raising the Fed Funds Rate another 0.25% on March 21st, resulting in a rate of 1.50-1.75%. They also intimated another three increases in 2018. While these actions slow equity market growth, it continues the process of normalizing interest rates and allowing savers to benefit from higher fixed income yields, both of which we welcome. Several consequences from the rate increase could be seen during the quarter. Bonds continued to produce losses for investors, as they decline when rates increase. We continue to advise managing duration risk (interest rate risk) in the current environment. Secondly, we saw a flattening of the yield curve with short-term rates increasing at a greater pace than long-term rates. Lastly, credit spreads (the rate on corporate debt over Treasuries) widened, exacerbating fixed income losses. These results collectively give pause to the broader markets and damper returns for the foreseeable future. Oil prices continued to rise during the quarter, as OPEC curtailed supply and Venezuela's output continues to be limited due to civil unrest in the country. We view this increase as temporary due to the lower cost of production of U.S. shale oil and the vast potential supply it could bring to the market.

The best performing equity sectors in Q1 2018 were Technology, Healthcare and Financials, returning 5.0%, 1.4% and 0.2%. Energy Limited Partnership, Equity Precious Metals and Real Estate, were the worst performing, losing -11.6%, -6.7% and -6.9% respectively. The S&P 500, Dow Jones Industrial Average and NASDAQ Composite Index returned -0.8%, -1.9% and 2.6% in the fourth quarter. Basic Materials continued to be the most overvalued sector, trading at a 34% premium of Morningstar's coverage universe. Communication Services continued to trade at the greatest discount to fair value at 0.86 respectively, followed by Energy at 0.94 and Utilities at 0.97. The overall price/fair value of stocks covered in the Morningstar universe was 1.03[1] or 3% overvalued to end Q1. As we have stated in the past several quarters, we remain cautious as we navigate the higher interest rate environment. We are currently favoring stocks that offer 4-6% dividend yield that is securely covered by earnings.

We sincerely thank you for allowing us to manage your investable assets and look forward to continually earning your business and your referrals in 2018.

Jack A. Kennedy
Chief Investment Officer

[1] Results referenced from Morningstar.com

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