LINSCOMB WILLIAMS

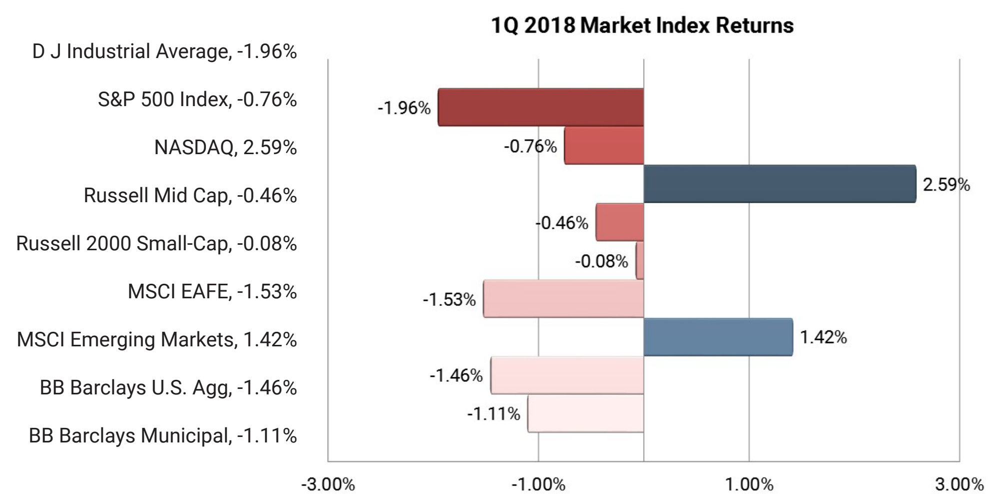
WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *First Quarter 2018*

the ECONOMY

John Pierpont Morgan, best known today from the bank that bears his name, was one of the most important financiers of the late nineteenth and early twentieth centuries. Due to his influence, he was regularly asked for his opinion on what was in store for the stock market. Short-term market movements are notoriously difficult to predict, so Mr. Morgan resorted to a pithy yet proper response – "It will fluctuate." True indeed, especially for the 1st quarter of this year, which has been characterized by quite a bit of fluctuation. Already there have been 23 days in which the S&P 500 moved greater than one percent, compared to just eight such days in all of 2017. Also, stocks experienced their first 10 percent correction since February 2016. On average, declines of that magnitude happen nearly once a year. It has been an uncomfortable start to be sure, but given that 2017 set records for its lack of volatility, 2018's market action may be better described as a return to normalcy, rather than an omen of something more sinister to come. Volatile markets typically don't turn into prolonged bear markets absent material economic weakness, which we don't believe is currently the case.

In fact, even as it enters its 10th year of expansion, the United States' economy appears stable as ever. GDP growth actually picked up in the second half of 2017, coming in at 3.2 percent and 2.9 percent for the 3rd and 4th quarters, respectively, well above trend. Consensus for the freshly concluded 1st quarter is lower at closer to 2 percent, however a little give back could be expected after the stout finish last year. The benefits of sustained growth can be readily identified by the present state of the labor market. While the headline unemployment rate remained unchanged over the past 3 months, albeit at a very low level of 4.1 percent, there were some more promising signs beneath the surface. The



labor force participation rate for prime age individuals – those between 25 and 54 years old – rose to 82.2 percent, up from 81.8 percent at the beginning of the year. So this is an instance of the unemployment rate holding steady for "good" reasons, namely that more people are actively participating in the economy. Wage growth is looking better also. Compared to one year ago, average hourly earnings are up 2.7 percent, one of the best readings since the recession ended in 2009. And while this number isn't exactly soaring, neither is inflation. The core consumer price index rose just 1.8 percent over the same time period.

A meaningful portion of recent job gains have been concentrated in manufacturing and related industries, which experienced recession-like conditions through much of 2016 and into early 2017. The sector has now dug itself out of that hole and come back stronger than before. Data on new orders, production, and employment have all improved significantly over the past year. Just take a look at domestic crude oil production, which hit an all-time high at the end of March. This is despite the number of active U.S. oil rigs, 808, at roughly half the level of its peak in 2014. Talk about efficiency!

Solid growth in the U.S. was matched overseas, as Eurozone GDP grew 2.7 percent in the 4th quarter, capping off the best year for the region since 2010. And it isn't just old stalwarts like Germany doing the heavy lifting. The recovery has spread to the periphery of Europe, with countries like Spain and Portugal seeing healthier levels of activity. Similar to the U.S., the labor market is reflective of better growth, with unemployment down to 8.5 percent. Although high by American standards, it's actually the lowest level in the Eurozone since December 2008. More clarity has emerged surrounding the United Kingdom's split from the European Union. The two parties have agreed in principle to a 21-month transition period beginning in March 2019. But there are still many details to be ironed out before the break is official.
Japan continues to surprise to the upside, as GDP growth for 2017 came in at 2 percent, compared to the 20-year average of just 0.8 percent. Improving consumer demand combined with strength from its export markets created a favorable environment. Also, Japan is experiencing declining unemployment much like the rest of the developed world. The country's jobless rate is at a 24-year low, and job openings are still plentiful.

2017 was a breakout year for emerging markets. Commodity oriented countries like Brazil and Russia rebounded, and a flourishing technology sector powered burgeoning Asian markets including China, South Korea, and Taiwan, among others. Overall, there was little to suggest this trend abated in the 1st quarter. The biggest news was out of China, where President Xi Jinping is now President-for-Life. Constitutional changes allow him to remain in charge as long as he sees fit, yet it remains to be seen how exactly Mr. Xi will use this newfound authority.

CENTRAL BANKS

Out with the old and in with the new. Sort of. In February, Jerome Powell began his tenure as chair of the Federal Reserve (Fed), replacing the outgoing Janet Yellen. And while there are some fresh faces and personalities to get used to, the path of monetary policy isn't likely to veer much off the course Ms. Yellen previously set. That is, one of slow, telegraphed interest rate hikes, coupled with a gradual unwind of the Fed's balance sheet. And speaking of those telegraphed rate increases, Mr. Powell and the Fed did just that in March, raising the federal funds rate one quarter percentage point to its present range of 1.50 percent - 1.75 percent. Mr. Powell's communication style is more direct than his predecessor's, which can give the impression that he is more "hawkish," but for the time being, we will take him at his word. Current projections call for two, possibly three, more interest rate moves by year-end, similar to what Ms. Yellen had advised prior to her departure.

Although the European Central Bank (ECB) hopped on the quantitative easing bandwagon later than its contemporaries at the Fed, the process is playing out in a similar fashion. It is projected to end its bond buying program later this year, but any action on interest rates isn't likely until 2019. Current ECB president Mario Draghi's term ends in September, so investors will be on the lookout for whomever replaces him. Economic data out of Japan suggests the Bank of Japan (BoJ) could scale back a bit on its current monetary policy, but there is little indication from BoJ officials it will happen in the near future.

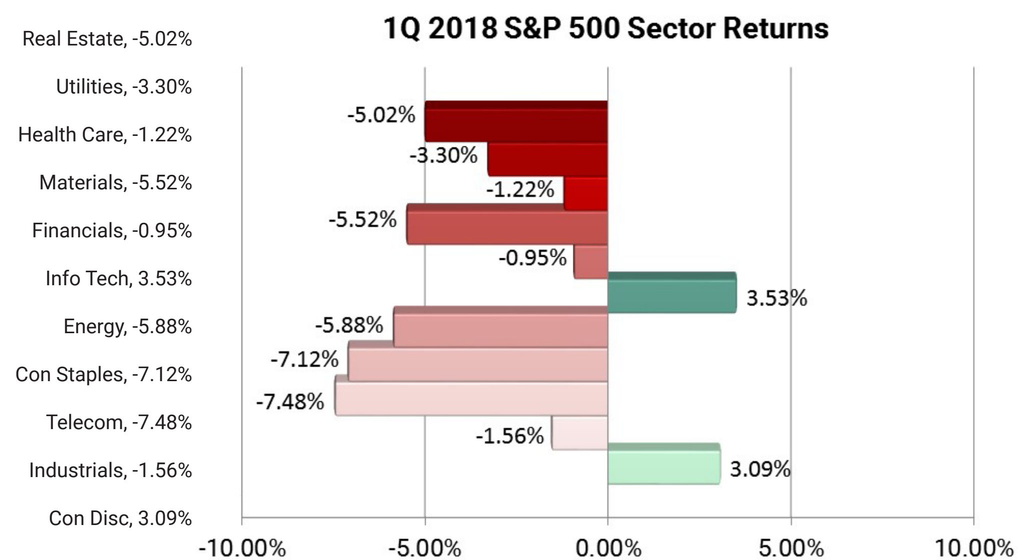
FIXED INCOME

It was a tough quarter for fixed income investors, as most types of bonds declined in value. Prices move inversely to interest rates, so a rising interest rate environment can be a headwind for performance. Over the 1st quarter, the benchmark 10-Year U.S. Treasury yield at one point hit 2.95 percent, before settling back down to 2.74 percent by the end of March. That's up from 2.41 percent to start the year though. And while short-term losses in bond investments aren't pleasant, they are relatively muted compared to possible drawdowns in other asset classes. For example, despite the challenges of higher rates, the Bloomberg Barclays U.S. Aggregate Bond Index, which is composed of investment grade securities, was down only 1.46 percent. A similar index of municipal bonds fell 1.11 percent. Stocks and commodities, just to give two examples, often move more than that over the course of a single day.

High-yield bonds actually fared slightly better, down 0.91 percent. These bonds usually have shorter maturities and higher coupons, which make them less sensitive to rising interest rates. The relative outperformance of high-yield securities compared to investment grade was noteworthy given the large swings in the stock market. Typically, the opposite is true, as high-yield bonds and stocks are both more levered to the underlying economy. So even with the capriciousness of stocks lately, it appears investors are still confident in corporate fundamentals.

EQUITY

Since the last 10 percent decline in the stock market which ended in February 2016, the S&P 500 returned just shy of 64 percent cumulatively over the next 23 months, with only a few hiccups approaching anything more than a brief, 5 percent pullback. The market even managed 15 straight months of positive performance through January! A truly historic level of stability for stocks. Of course, all streaks eventually come to an end. A combination of full valuations,



higher bond yields, and potential new government policy for trade and regulation of large technology companies, sparked the rapid return of volatility. But waiting for the return of that volatility, ostensibly for a better opportunity to invest, would prove hazardous to one's financial health. Even with the latest correction, that 64 percent gain turned into a still very impressive 52 percent increase. As famed portfolio manager Peter Lynch once said, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."

Despite the market's gyrations though, returns over the 1st quarter were pretty tame. The large cap S&P 500 was down a mere 0.76 percent. And those much maligned technology stocks? Well they were actually the quarter's top industry group, gaining 3.53 percent. Rising interest rates took a toll on the traditionally defensive, dividend paying sectors including consumer staples and telecom, which declined 7.12 percent and 7.48 percent, respectively. In a somewhat surprising turn of events, small cap stocks held up better than their large cap peers. The Russell 2000 Index was off just 0.08 percent. Due to their greater ties to the domestic economy compared to large multinationals with global exposure, small caps are arguably bigger beneficiaries of the lower corporate tax rate and less likely to be adversely affected by trade policy.

International equities weren't immune to volatility, but like the U.S., the overall performance was mostly flat for the quarter. The MSCI EAFE Index of International Stocks dropped 1.53 percent and the MSCI Emerging Markets posted decent gains of 1.42 percent. Emerging market equities have had a nice stretch of above-average performance, but with reasonable valuations and improving profitability, the asset class may still have further room to run.

OUTLOOK

The synchronized global expansion shifted into a higher gear last year, and we feel it is poised to continue going forward. Pacific Investment Management Company (PIMCO for short) presents four broad themes that ought to support growth for the duration of 2018, which we will expand on. First, near term recession risks look low. Private sector imbalances, like distortions in the housing market leading up to the 2008 crisis, are hard to find. Similarly, few, if any, historically dependable leading economic indicators are flashing red. Whether it is initial jobless claims, new building permits, or consumer and business expectations, the weight of the data points away from a slowdown. Also, a number of financial market conditions that tend to be associated with economic weakness, including widening credit spreads and an inverted yield curve (where short maturity interest rates are higher than long maturity ones), are not yet present. Second, unlike much of the post-financial crisis recovery, economic progress is broadening around the world. It is not just a developed country story anymore. Global purchasing manager indices, timely indicators that correlate well with future growth, are almost uniformly in expansionary territory. Some regions, like the Euro Area, are at their highest levels in a decade. Next is the upcoming fiscal stimulus in the U.S. Individual tax cuts started flowing through to paychecks in February, which ought to provide a boost to consumer spending, the largest component of GDP. And perhaps an underappreciated facet of tax reform on the corporate side is the immediate expensing of capital expenditures, incentivizing companies to pull forward investment spending. Recent business and consumer confidence surveys are near expansion highs, providing some confirmation of the stimulus' effects. Finally, financial conditions remain favorable. Monetary policy is still, on balance, accommodative, though it is becoming less so. Borrowing costs are low, and both consumers and corporations have access to credit. Profits are rising globally, giving firms the flexibility to invest, pay workers more, or improve their financial health by paying down debt.

While the outlook is generally benign, there are a number of risks to our forecast. One that has grabbed the headlines on a seemingly daily basis, and is a possible culprit for much of the recent market volatility, is the potential for changing trade policy. It started with the Trump administration's announcement of 25 percent tariffs on steel and aluminum imports, and has since moved on to a more direct war of words, with China specifically. Steel and aluminum represent a mere 1.2 percent of total U.S. imports, and after exemptions are granted to certain countries, really only a fraction of that already small percentage will face higher costs. Not near enough to change the direction of the U.S. economy. The bigger issue though may be the ongoing tariff tit-for-tat with China. President Trump announces import tariffs, so China retaliates with the same, compelling Mr. Trump to call for even higher tariffs. Reminds us of that scene from The Breakfast Club where Assistant Principal Richard Vernon is chastising a certain troublemaker in a Saturday detention session. Any response from said troublemaker results in…more detentions. "That's another one pal!" But while an escalation in this sort of protectionism has negative implications for markets, should the China trade negotiations proceed in a similar fashion to the steel and aluminum policies, as well as the ongoing NAFTA talks, the Trump administration's bark is probably going to be worse than its bite. Every proposal regarding China at this point is just that, a proposal. This will, of course, bear close scrutiny going forward, but nothing has gone into effect yet. In fact, world export volume was at a record high at the end of January. Admittedly, this is backward-looking data, but the evidence says that global trade is alive and well. Another policy-related risk is how central banks around the world transition from a highly accommodative stance, to a more neutral posture. While central bank leaders take great pains to communicate their intentions, a misread on inflation or growth projections could force them to alter their plans in unexpected ways. In emerging markets, China's size means the ebbs and flows of its economy have larger second order affects around the world. Xi Jinping aims to simultaneously balance hitting economic growth targets while constraining credit expansion and even reducing debt levels within some firms and industries. There is an obvious tension between those two goals.

These risks in mind, we still believe that both the U.S. and global economy remain on solid footing, and coupled with accommodative monetary policy, should provide a supportive environment for financial asset prices. Equity market valuations have become somewhat more attractive, thanks to the mix of rising earnings and declining prices. We wouldn't rule out further volatility though. Should interest rates continue to trend higher, bond prices will be challenged, but investors will be rewarded with higher yields in the future. As always, we stand ready to adjust portfolios as needed.

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