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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Stock market volatility is a reliable indicator of investor uncertainty concerning the future direction of the economy. There is nothing unusual about volatility. Markets are simply clearing mechanisms; for each purchase, there is a seller and for each sale, there is a buyer. **Prices are set by discovery between buyers and sellers, and sometimes this leads to volatility, until equilibrium is attained.**

In past articles, we have described how Federal Reserve practices have dampened volatility over the past several years, whether by maintaining artificially low short term interest rates or by managing the term structure of the bond market through quantitative easing. We have also noted how volatility was further suppressed by restrictive regulatory policies such as Dodd-Frank. After a long period of low volatility, and due to a behavioral phenomenon known as adaptive behavior, investors began to believe that stock market volatility was a relic of the past. Before this February, the last time the stock market experienced a 5% correction was in June 2016, in reaction to the Brexit referendum; this has been the second longest streak of low volatility since 1957-1959. A generally accepted measure of stock market volatility, the five year standard deviation of market returns, is now below 10%, about half its long term average. During all of 2017, there were only eight days when the market closed up or down more than 1%. In just the first quarter of 2018, there have been 23 days of greater than 1% volatility. We got used to low volatility and accepted it as normal; it isn't. As the Federal Reserve raises short term rates to neutral, and reverses quantitative easing, markets will once again determine the price of financial assets. **This return to market based price discovery will be accompanied by greater volatility. Fortunately, there is little correlation between volatility and stock returns.**

Certainly, the price movement of early February was amplified by the unwinding of derivative strategies by hedge funds which had bet on volatility declining forever. As often happens when a trend is in place for an extended period, speculators tend to employ leverage; when the trend reverses, they lose. The benchmark measure of risk is called VIX and rises with volatility. Several different strategies employed a derivative based on a reverse VIX, which profits from a decline in volatility. Many of these strategies were highly leveraged and were forced to liquidate when the market reversed in early February, further amplifying volatility in the short term.

However, this just describes the technical symptoms of recent market volatility. What should be more important to you, as an investor, are the fundamental issues reflected in this recent market volatility. We note two offsetting fundamentals which converged in 2018. The U.S. economic recovery has become the second longest in the post-World War II era, but one of the least robust with regard to cumulative growth. With the passage of tax reform at the end of 2017, and its impact on corporate profits, analysts have been busy revising earnings estimates higher for 2018. Instead of expected deceleration in a mature economic environment, fourth quarter 2017 earnings grew at 15%, the best growth since 2011. **So, on top of an already robust earnings growth trend, estimates for 2018 earnings growth have been revised an additional 8% since the beginning of the year; tax reform, a positive global macro environment, and a weaker dollar are all contributing factors.**

This prospective prosperity comes with a contradiction, however. **Years of monetary stimulus, combined with the fiscal stimulus of tax reform, and additional commitments to greater infrastructure spending cause concern over long term deficits and higher inflation.**

An often cited catalyst for the February correction was the surprisingly high increase in wage inflation. As we approach full employment, higher wage inflation was seen as an omen of higher core inflation to be followed by more aggressive Federal Reserve rate hikes. **But labor statistics have always been imprecise and subject to revision, as was the case the following month.** Also, markets tend to behave like swarms, often overreacting before quickly correcting.

This is not to diminish our concern over inflation and higher interest rates. The price an investor is willing to pay for a stock approximates the present value of a company's future earnings, which in turn is a function of a discount rate. The discount rate is comprised of inflation expectations as reflected in the term structure of interest rates over the life of a company's future stream of earnings; the higher the discount rate, the lower the price of the stock.

While we believe that interest rates and inflation will rise from current levels, we also believe that this will likely occur in an orderly fashion and not disrupt economic growth. **More importantly, we believe that higher stock prices are a function of higher expected earnings, and the data supports our belief that earnings will continue on a positive trajectory for the next couple of years.** Under this scenario, price to earnings ratios are likely to decline, but stock prices should continue to move higher.

In March, an additional factor contributed to market volatility when the U.S. proposed tariffs on steel and aluminum, and later on a basket of Chinese goods in retaliation for intellectual property violations. We have all thrived in a post General Agreement on Tariffs and Trade/ World Trade Organization (GATT/WTO) global trade environment. We have all been schooled on the positives of "competitive advantage," but try to explain this to one of the 200 million workers from the developed world who has permanently lost their job. Since 1994 when the last round of GATT created the WTO, the world has evolved but trade agreements have lagged the reality of the new world order. **While we see the current trade proposals as a less-than-subtle attempt at negotiating new treaties, we do not yet see current events growing into a full blown trade war.**

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Fixed Income

The Federal Reserve's (Fed) decision to raise the federal funds policy rate by another 25 bps to a 1.50% - 1.75% target rate during its March meeting was widely expected. The measured rate hike increases, since late 2015, continue the "normalization" process to bring short-term rates from historically low levels to a neutral target rate. The pace at which the Fed will continue to increase rates has dominated market attention. **However, a discussion of what influences the Fed's decision, particularly the determination of the neutral interest rate, may demand greater investor attention.**

The neutral rate is a fed funds target rate at which the economy is in equilibrium or balance. In theory, if the policy rate was at a neutral level, monetary policy would be neither too loose nor too tight. The economy would be growing at an optimal rate. The underlying theory regards loose monetary policy —where the Fed's policy rate is set below the neutral rate— as a tool to temporarily stimulate the economy with the caveat of causing potential price inflation. On the other hand, if the Fed's policy is too tight and the target rate is set above the neutral rate, then unemployment may start to edge higher and economic activity will slow. **The neutral rate is not directly observable, but is something the Fed attempts to achieve by relying on projected inflation and unemployment data.**

In a market economy, interest rates are determined by a competitive discovery process. Since 2009, the Fed has largely bypassed this discovery process by managing interest rates to attain their desired inflation and unemployment rate targets, in an attempt to stimulate the slower pace of the economic recovery. The determination to raise interest rates at a measured pace is ultimately tied to the Fed's desire to anticipate future inflation while keeping price increases at a modest rate. The Fed's target inflation rate uses data based on the Personal Consumption Expenditures (PCE) rate which excludes the effects of food and energy prices. An increase in the PCE rate from its current level of 1.6% to the Fed's 2.1% target may not seem like much of a move, yet it is still a significant gap. **Even with a modestly higher move in inflation, the Fed is expected to maintain short-term rate increases at a measured, well-communicated pace.**

Despite the outlook for the normalization of short-term rates, this does not change the role of the short-term, laddered bond investment approach in your portfolio. **A short-term bond's lower duration (less price sensitivity to interest rate risk) coupled with a laddered bond approach (matured debt is reinvested at higher interest rates) mitigates the impact of rising interest rate risk.** Further, bonds held to maturity will continue to receive the face value of the bond even though the price of the bond may fluctuate lower when interest rates increase.

International Market

Propelled by synchronized global expansion, international markets had a good year in 2017. For the first time in five years, international markets, both developed and emerging, outperformed the US market. An accommodative environment emerged not only due to monetary policy, but thanks to long-awaited fiscal policy from even deeply entrenched nations such as Germany. **The result is an economic state known as a "Goldilocks" economy; despite above-trend growth and historically low unemployment rates, inflation has miraculously stabilized near target levels.**

We believe this "Goldilocks" economy will continue as long as subdued inflation and accommodative monetary policy remain intact. Underlying inflation, most recently at 1.9%, has remained low and stable for most of the last two decades. Such prolonged stability suggests that it would take a huge economic or structural shock to significantly dislodge inflation from the typical 2% target; so far, we see no evidence of that happening. Also, despite the US Fed raising its benchmark rate, other central banks are still in stimulus mode. For example, the European Central Bank (ECB) probably won't raise its benchmark rate until late 2019, and it may even delay to early 2020, as suggested by ECB President Draghi. The Bank of Japan signaled in a written statement that it will probably keep its rate at current levels indefinitely. **In summary, central banks in aggregate remain in expansion mode into late 2019 or early 2020.**

Even though we are optimistic on global growth, we are not free of worry. One of our concerns is the growth of China. Even the International Monetary Fund (IMF) has recently given warning about China's rising debt levels. To keep debt under control, policymakers have taken an increasingly tighter stance to rein in excess leverage. There is evidence suggesting that, with the scaling back of fiscal, monetary, and regulatory stimulus, industrial activity and credit growth have materially decelerated in recent months. **But, this might not be bad news; in order for China to grow stronger, China has to grow slower.**

In addition to slowing in China, fears of the so-called "trade war" were resurrected as President Trump announced tariffs on steel, aluminum, and other products imported from China. The true economic impact of the tariffs seems relatively trivial and early signs indicate that any retaliation will likely be muted. Nonetheless, protectionist announcements such as these introduce uncertainties into the marketplace and weigh on investor sentiment. **The reaction from global equity markets underlines this psychological vulnerability, and in the short-term, the market may react to uncertainty, regardless of economic significance.**

Markets eventually revert to fundamentals, so it is essential to view the recent volatility from an economic perspective. The impact of the announced tariffs would be immaterial as the $50 billion of imports from China to US make up just 0.3% of world trade and less than 3% of US's total imports. Before the recent events, imports of steel and aluminum accounted for only about 2% of overall US imports. In addition, retaliation from China is likely to be measured, based on early signals. China's announcement that it will impose tariffs on US imports worth a mere $3 billion suggests that its priority is to avoid exacerbating the conflict. On a bilateral basis, the US is not particularly vulnerable to retaliation as US exports to China account for only 8% of total US exports and less than 1% of US GDP.

There is also a high likelihood that tariffs on China may be drastically watered down, similarly to those on steel. Initially announced to cover all imports, the steel tariffs now include exemptions for countries that account for 70% of US steel imports. Trump's track record suggests a negotiation style in which he announces headline-grabbing policies, then subsequently scales them back.

As mentioned earlier in this newsletter, we have concluded that "we do not yet see current events growing into a full blown trade war." For the start of 2018, three-month year-on-year data published by the CPB Netherlands Bureau show that world trade has grown at its fastest rate since 2011. More encouraging is that business surveys and leading indicators suggest world trade volumes will continue to experience strong growth in the coming months. **Therefore, looking beyond short-term volatility, and with the continuation of subdued inflation, market-friendly monetary conditions, and robust international trade, we believe international markets should continue to perform and warrant exposure within a global equity portfolio, based on the investor's risk profile.**