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Economic & Market Quarterly

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This summary is provided by BMT Wealth Management.

Observations on Economic Growth

The opening months of 2018 were not without their share of negative headlines. Tariffs and deteriorating trade relations between the United States and China, concerns about rising inflation, geopolitical tensions regarding North Korea and Syria, as well as the specter of increased regulatory encumbrances on social media companies – the latter of which may well be overdue – all dominated the news.

Interestingly, global equity markets did not really gain or lose much ground during the first quarter of the year, but volatility levels rose considerably relative to last year.

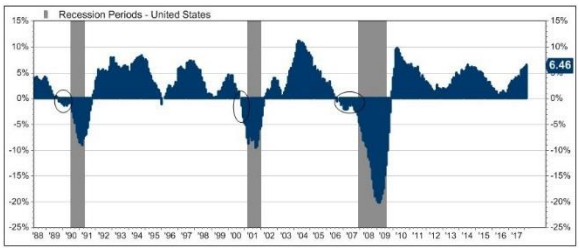
In the era of the 24-hour news cycle, it is sometimes difficult for investors to filter out the "noise" and focus on the critical data points that can influence the direction of the economy. Although it is not always easy, we aim to concentrate on the "big picture" when it comes to surveying the economic landscape and avoid the temptation to be distracted by the daily headlines.

While their long-term effects are still uncertain, we believe the passage of the Tax Cut and Jobs Act of 2017, deregulation in the banking sector, and proposed infrastructure spending will prolong this economic expansion for the foreseeable future and trump (no pun intended) the overwhelmingly negative geopolitical concerns.

One thing to which we pay close attention is the level, and the rate of change, of The Conference Board's Composite Index of Leading Indicators, which predicts the direction of economic movement related to housing, consumer confidence, manufacturing activity, interest rates, and employment.

While no economic statistic can precisely determine significant changes in the business cycle, as the chart below illustrates, the last three recessions in the United States were preceded by consecutive negative readings by the Index of Leading Indicators. Recently, that Index has been accelerating, which is an encouraging sign.

Index of Leading Indicators
In the United States (YoY% Change):
30 Years Ending 3/31/2018



Source: FactSet, Inc.

We also pay attention to whether the economy is on the verge of contracting. ***This is because, since 1990, the majority of the most severe corrections and bear markets (20% or more decline in the price of the S&P 500 Index) have occurred during recessions or in the months immediately preceding them.***

We do note that there has been a recent softening in some of the global economic manufacturing survey measures, or "soft data," which raises some questions about whether global growth has plateaued.

For example, the Euro Area Manufacturing PMI peaked in December 2017 at 60.6, and fell to 56.6 in March 2018. Readings above 50 are indicative of economic expansions, while readings below 50 reflect an economy that is contracting. Global PMI survey data is still overwhelmingly positive, and a slight retracement from the highs seen earlier in the year does not signify an imminent economic contraction.

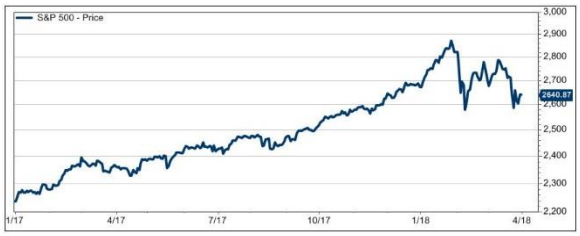
Tranquil No More

Equities started 2018 in much the same mode as they ended 2017, trending higher in a relatively orderly manner.

When the S&P 500 Index advanced by over 1% on Jan. 26, 2018, it marked not only an all-time high, but also the first time the Index ended the day with a move of over 1% in more than four months. At that point in time, the S&P displayed a year-to-date gain of 7.54%.

The lack of volatility and the 2018 gains ended in short order, however. This is detailed in the chart below, which reflects the movement of the S&P 500 Index for the 15 months from the beginning of 2017 through the close of the first quarter of 2018.

S&P 500 Index:
1/1/2017 – 3/31/2018



Source: FactSet, Inc.

The change in volatility was dramatic. For all of 2017, the S&P 500 registered just eight days when the Index closed with a move of at least 1%. In 2018, the month of February alone witnessed 12 such days, and for the first quarter as a whole, the Index tallied 23 trading days with moves exceeding 1%.

Further, 2017 saw no days where the market ended with a change exceeding 2%, while 2018 has already seen six.

With regard to the advance registered in January, a sharp decline was enough to erase the gains and move the S&P 500 into the red by early February. The selloff was seemingly triggered by an employment report that showed a greater-than-expected increase in hourly earnings, which rekindled long-dormant fears of inflation.

The balance of the quarter saw equity prices swing back and forth before they closed out the month of March roughly where they started the year. For the S&P, this translated to a loss of just -0.76%.

Clearly, the modest loss registered by the S&P 500 Index belies the volatile trading action, which appears likely to continue. The Chicago Board Options Exchange Volatility Index, or VIX, a market metric used to gauge volatility, was at 11.04 at the beginning of January 2018, and closed at 19.97 during the final trading session of March 2018.

International developed equities fared a bit worse, with the MSCI EAFE Index ending the quarter lower by -1.53%. From a geographic perspective, the best returns were had in the emerging markets, where the MSCI EM Index finished out the three-month period with a gain of 1.42%.

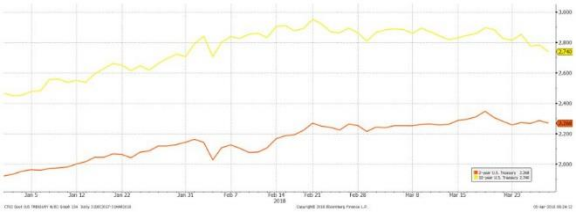
Fixed Income Commentary

U.S. Treasury yields marched higher in the first quarter of 2018, as investors positioned for more

aggressive monetary policy by the Federal Reserve (the Fed), an expected rise in U.S. Government deficits, and increasing inflation expectations.

The two-year U.S. Treasury yield (orange line in the graph below) jumped 38 basis points (0.38%) and the 10-year yield (yellow line) advanced 33 basis points (0.33%), finishing the quarter at 2.27% and 2.74%, respectively.

Two-Year and 10-Year U.S. Treasury Yield: 1/2/2018 – 3/29/2018



Source: Bloomberg Finance L.P.

The Fed raised the target range by 25 basis points (0.25%) to 1.50% - 1.75% in March, while indicating that more rate hikes are likely in the current rate-hiking cycle.

Collectively, members of the Federal Open Market Committee (FOMC) raised their outlook for economic growth, while also anticipating a lower unemployment rate. It is likely that fiscal policy was a key component of the FOMC's more optimistic economic outlook.

The combination of fiscal policy and tax cuts is expected to boost economic growth, but at the expense of higher government deficits. Deficits are funded by more U.S. Treasury debt, which increases U.S. government security issuance and puts upward pressure on government funding costs and bond yields. The jump in yields during this past quarter was partly attributed to investors' expectations of more U.S. government bond issuance to fund the anticipated increasing deficits.

The fiscal policy measures come at a time when the U.S. economy is already operating on solid footing. The economy has experienced multiple years of economic growth, raising concerns that additional fiscal stimulus may lead to a spike in inflation. Currently, inflation remains somewhat subdued, with core inflation increasing 2.11% over the past year.

Overall, the jump in yields during the quarter led to a drop in bond prices and negative performance for fixed income assets. The Bloomberg Barclays U.S. Intermediate Government Credit Index was down -0.98%. Intermediate U.S. credit dropped -1.36%, and intermediate U.S. government securities were down -0.73%. Credit spreads widened during the quarter.

We believe there is little yield benefit to extending out on the yield curve, given its current flat shape and the additional price risk of owning longer-dated securities.

Underlying company fundamentals remain firm, providing some comfort to owning high-grade credit over U.S. government bonds for the additional yield.

The preferred course for portfolio positioning in the current environment remains limiting yield-curve extension, while favoring high-quality corporate issuers.

Where Do We Go from Here?

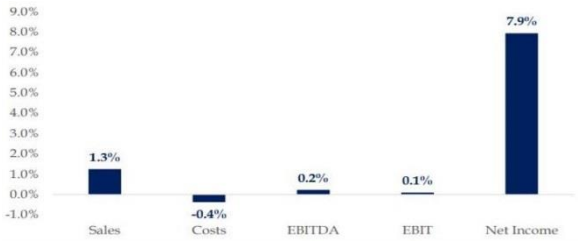
Global economic growth should produce uneven, but positive, results in 2018, driven by employment gains, strong consumer spending, and relatively low levels of inflation and interest rates.

The Tax Cut and Jobs Act passed in December of last year legislated lower tax rates on both individuals and corporations. On the corporate side of the ledger, estimates for 2018 corporate

earnings have accelerated, driven by an improving top line (sales), in addition to lower corporate tax rates.

The graph below highlights the estimated financial impact of the tax bill on S&P 500 companies in 2018, across several metrics. The graph shows that net income (earnings) estimates are expected to rise by almost 8%. Sales (revenues), driven by demand, are also expected to improve.

Change in S&P 500 2018 Estimates Since Signing of Tax Cut and Jobs Act of 2017



Source: Strategas Research

As we noted earlier, over short periods of time, markets often react to headline news, rather than fundamental factors, such as macroeconomic data and corporate earnings growth. Overall, we think company fundamentals are on solid ground.

We do not think there is a significant risk of a severe and prolonged market selloff, but we believe we have entered a period of higher volatility compared to recent years.

Block Out the Noise and Focus on Fundamentals

As we have said before, it is important during times of market volatility to look beyond the noise and focus on the fundamentals.

We continue to urge caution in making long-term portfolio construction decisions based on short-term market issues. Market downturns often present longer-term investment opportunities.

The combination of diversified equity and bond portfolios and client-sensitive asset allocations provides defensive characteristics for our client portfolios.

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