Q1 2018
Investment Perspectives

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- **VOLATILITY REAPPEARS:** The placid market conditions of 2017 gave way to more severe moves across global asset classes as investors reacted to the possibility of tightening monetary conditions, higher interest rates, and increased geopolitical tensions. The S&P 500 and Barclays Aggregate Bond Index both posted quarterly losses for the first time since Q3 2008.
- **BONDS HIT BY HIGHER RATES:** Fixed income investors demanded higher interest rates in Q1 in response to a confluence of factors: accelerating inflation metrics, robust economic growth, a reassessment of the Fed's hawkishness, and the impending issuance of record amounts of U.S. government debt. Higher prevailing rates sent bond prices down, leading to losses across the fixed income landscape.
- **PROTECTIONIST TRADE RHETORIC SPOOKS INVESTORS:** The Trump administration roiled investor confidence by introducing protectionist trade measures during Q1, including tariffs on steel and aluminum, as well as new levies on Chinese products.

Market Recap

After 15 consecutive monthly gains for the S&P 500 and a parabolic rally to start the year, stocks around the globe finally gave way to the correction that many had been predicting. Since the sell-off in early February, market volatility has soared—particularly relative to the benign levels of the past 2 years—and equities have whipsawed between the high and low extremes of their recent range.

Seemingly the catalyst for the spate of equity selling, bond yields spiked higher at the start of the quarter. However, calls for a bond bear market may be premature; bond indices rallied in March thanks to a more dovish Fed outlook, with rates declining during the final two weeks of the quarter.

MARKETS CAN STILL GO DOWN

Months' worth of persistently positive returns from the S&P 500 had analysts and investors alike scratching their heads, wondering if a pullback would

FIXED INCOME

	USD Total Return (%)	
Index	**Q1 2018**	**2017**
Barclays 1-10 Yr Muni	-0.7%	3.5%
Barclays US Agg. Bond	-1.5%	3.5%
BofA/ML HY Master II	-0.9%	7.5%

EQUITIES

	USD Total Return (%)	
Index	**Q1 2018**	**2017**
Russell 3000	-0.6%	21.1%
S&P 500	-0.8%	21.8%
Russell 2000	-0.1%	14.6%
MSCI All Country World	-1.0%	24.0%
MSCI EAFE	-1.5%	25.0%
MSCI Emerging Mkts	1.4%	37.3%

Source: Morningstar (Data as of 3/31/18) ever materialize. Every market dip was bought in 2017 leading some to argue that the growing popularity of "robo-advisors" programmed to automatically rebalance portfolio allocations and trend-following quantitative strategies attempting to ride the wave of market advances would continue to soften any market sell-offs going forward. Alas, financial gravity finally reasserted itself, and the long-awaited correction came in February when stocks tumbled over 10% from their January highs. This was the first decline of over 10% since January 2016 and only the third such decline since mid-2011.

With that said, investors that avoid the financial media and only check their portfolio performance after the close of a quarter will surely be confused by the talk of wild market swings and volatility in Q1. The rather pedestrian quarterly return of -0.8% for the S&P 500 belies the rollercoaster ride that stock prices took to get there.

SMALL CAPS OUTSHINE LARGE CAPS

Bucking the market orthodoxy that smaller companies should underperform large companies during market declines, smaller capitalization U.S. companies modestly outperformed their larger capitalization brethren during Q1 2018. The Russell 2000 Index, a measure of small company performance, returned -0.1% versus -0.8% for the S&P 500, and March actually saw the Russell 2000 outperform the S&P 500 by nearly 4%.

There are a number of theories about what would motivate investors to prefer small stocks over large stocks in the current market environment. Among them: (1) Analysts have noted that smaller companies, on average, paid a higher effective tax rate than large, multinational corporations under the prior tax regime. Therefore, over the coming years smaller cap stocks should actually see a bigger direct benefit from the tax reform bill passed in Q4 2017. (2) Relative to the S&P 500, a larger percentage of the Russell 2000 revenue and earnings comes from U.S.-based sources. In a landscape seemingly littered with geopolitical risks and talks of global trade wars, small companies may be more insulated from those issues. (3) Small caps have underperformed large caps over the past 5 years by nearly 2% annually, and this may simply be a "catch-up" phase to bring the relative performance more in-line with historical norms—i.e., small caps outperforming large caps.

EMERGING MARKETS IN THE LEAD AGAIN

After leading the global stock market rally in 2017 with returns in excess of 37%, emerging market equities continued to outperform their developed market peers in Q1. In fact, the MSCI Emerging Markets Index was the only major index to post a positive total return for the quarter, advancing 1.4%. A combination of a weaker U.S. dollar, cheaper relative valuations, and strong recent performance has attracted inflows from asset allocators since the end of 2016. Akin to the "catch-up" theory regarding recent U.S. small cap outperformance, some analysts posit that this period of relative gains for emerging markets is a response to roughly six years of underperformance relative to U.S. stocks. In effect, they argue that investor sentiment had diverged to such an extreme level that emerging markets had nowhere to go but up.

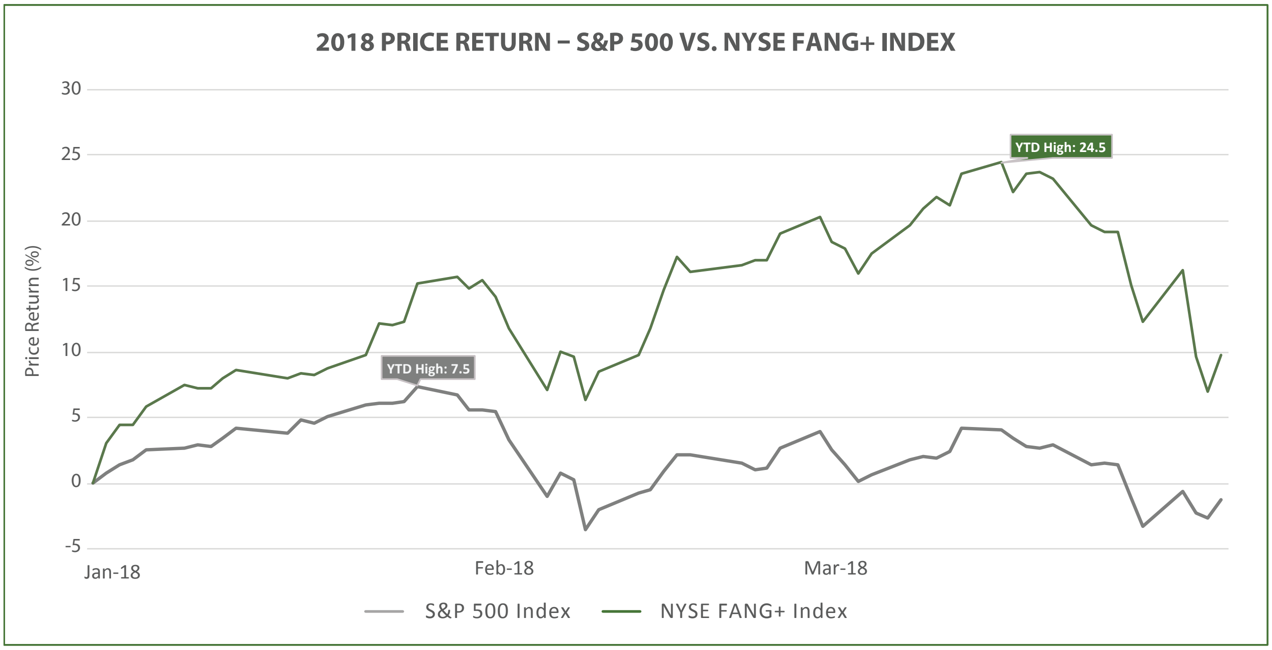
FACEBOOK FACES SCRUTINY; "FANG" STOCKS FIZZLE

High-flying tech and consumer stocks began to face issues in mid-March after news broke that Facebook users' personal data may have been used for unauthorized purposes by the political consulting group Cambridge Analytica. Fears of a regulatory backlash and possible user revolt upended Facebook shares and dragged down tech-oriented indices with it. The company was slow to respond, and the stock price declined nearly 18% before rallying modestly into month-end. Over $73 billion was wiped off of Facebook's market capitalization during the sell-off.

continued on page 3

Facebook was not the only high-profile growth stock facing issues in March, however. The so-called "FANG" stocks, consisting of Facebook, Amazon, Netflix, and Google, suffered as investors fled high-momentum names. President Trump likely exacerbated the tech sell-off by sending tweets targeting Amazon, and fatal accidents involving self-driving cars from Tesla and Uber further damaged investor sentiment.

As seen on the chart below, after rallying nearly 25% through early March, the New York Stock Exchange's FANG+ Index—which tracks six other widely-followed, high-growth tech names in addition to the original FANG stocks—suffered a 14.8% decline from its March high through quarter-end. Given the combined size and market weighting of these names, it is remarkable that the S&P 500 did not experience a larger decline as a result.



Source: Bloomberg (Data as of 3/31/2018)

TRUMP TALKS TRADE WAR

Hardline rhetoric from the White House on tariffs and trade restrictions temporarily roiled markets as the specter of a protectionist, tit-for-tat trade war threatened rosy global growth projections. Only after learning from President Trump's tweet that trade wars were "good, and easy to win" did investors' jitters dissipate.

In all seriousness, many observers have argued that concerns over a full-scale trade war are likely overstated given Trump's willingness to negotiate. Evidence of this could be seen in the evolution of the steel and aluminum tariffs announced during Q1. The administration's initial position was that there would be no exceptions to the new levies. But, after threats of retaliation—including the European Union threatening tariffs on products from Trump-friendly regions, such as Kentucky Bourbon whiskey and Harley Davidson motorcycles—and behind-the-scenes negotiations, Canada, Mexico, the European Union, Argentina, Brazil, South Korea, and Australia were ultimately granted a reprieve for the time being. Similarly, despite proposing tariffs on U.S. products shortly after quarter-end in response to U.S. threats, China demonstrated its willingness to negotiate by declining to announce an implementation date.

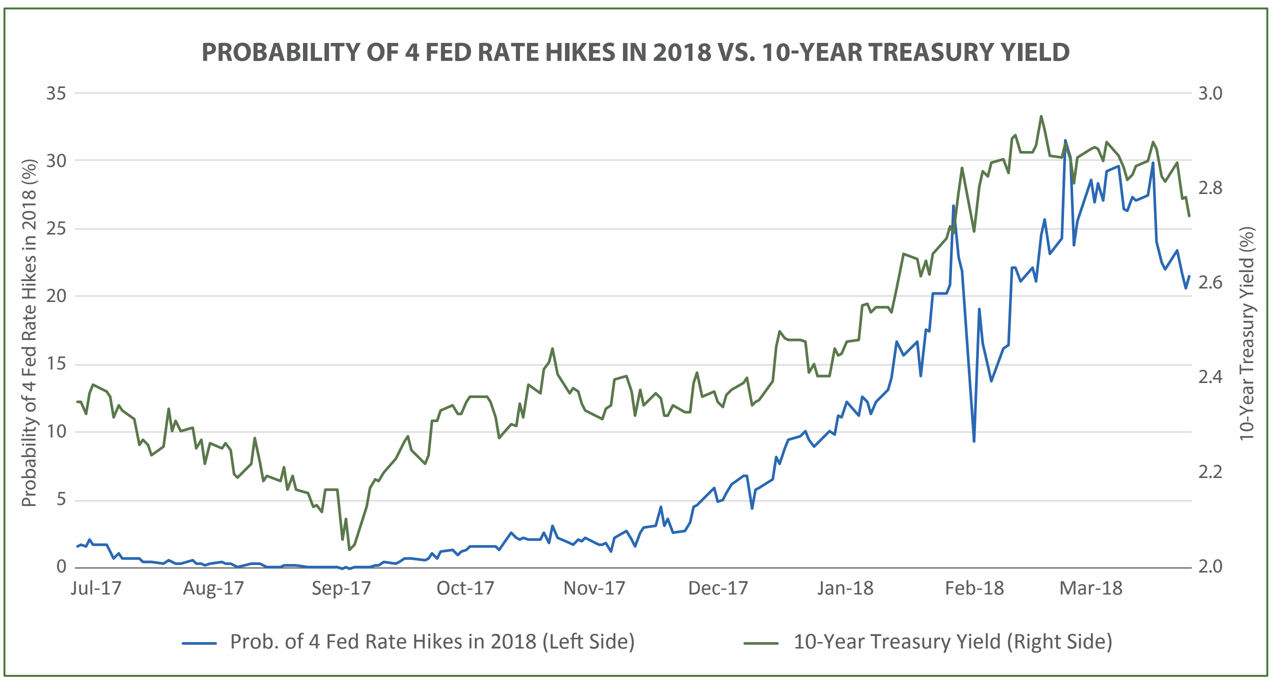
continued on page 4

BONDS FEEL THE PAIN, TOO

Bond investors were far from immune to volatility in Q1. In fact, they may have caused it.

The benchmark 10-year Treasury rate climbed 0.3% in January after a few higher-than-expected inflation reports caused market participants to revise expectations about the Fed rate hike trajectory as well as long-term inflation prospects. This sent the taxable bond market, as measured by the Barclays Aggregate Bond Index, down -1.2% and -0.9% in consecutive months to start the year—the worst two-month stretch since the "taper tantrum" in 2013, when the Fed announced that it would end its bond-buying program, causing yields to spike.

The chart below visually tells the story. Using Fed funds futures to derive the market-implied probability of a certain number of Fed rate hikes in a given year, you can see how investors quickly began to take the Fed seriously when members said they would consider raising rates four times in 2018 (blue line). Before January, the clear consensus was for three rate hikes in 2018, but as investors began to reprice their expectations, yields rose rapidly (green line). That is, until the comments from the March Fed meeting had a decidedly less hawkish tone, sending rates lower and bringing the bond bulls back into the market to close the quarter.



Source: Bloomberg (Data as of 3/31/2018)

THE CRYPTO BUBBLE POPS

After numerous cryptocurrencies and tokens posted gains in excess of 1,000% in 2017, a combination of profit-taking, risk-off sentiment, and heightened regulatory scrutiny sent crypto prices spiraling downward in Q1. Bitcoin, the biggest and best-known cryptocurrency, declined roughly 52% during the quarter as its exchange rate dropped from $14,311 per one bitcoin to $6,729. That, of course, came after bitcoin briefly cracked $19,500 in December 2017. According to the market-tracking website CoinMarketCap, Q1 2018 saw the total cryptocurrency market capitalization drop by a staggering 59% to roughly $250B—or, roughly the market capitalization of Wells Fargo. ●

Breaking Down Your Fixed Income Portfolio

Nearly every investor owns some type of fixed income investment—bonds, CDs, money market funds, private loans to businesses, etc. In most quarters, these investments simply produce income and have minimal price fluctuation—if any. This quarter was different, though; most bonds posted a loss in Q1 as yields rose, and investors may have been surprised to see the magnitude of the price swings.

With that as a backdrop, we thought it would be useful to revisit a few of the key elements that drive fixed income returns:

- **Yield.** Obviously, one of the biggest considerations as a fixed income investor is the cash flow that one expects to receive when buying a bond. In fact, the best predictor of the return on a given bond is the yield at which one buys it. Yields reflect the prevailing interest rate environment as well as the relative riskiness of the issuer. Investors generally command higher yields for lower quality bonds to compensate for the additional risk of default.

- **Duration.** Duration is a measure of a bond's sensitivity to a change in prevailing interest rates that is tied to its maturity and yield. You can use duration to derive the expected percentage change of a bond's price given a 1% move in prevailing yields. For instance, a bond with a duration of 5 years would be expected to lose roughly 5% of its market value if interest rates increased 1%. This concept is critically important when constructing bond portfolios—particularly in a rising interest rate environment like we saw in Q1.

- **Credit Quality.** As the name suggests, this is a measure of the creditworthiness of the issuer. Most commonly, investors will see ratings from firms like S&P, Moody's or Fitch—e.g., "AA+" or "Aa3." As we saw during the global financial crisis, these ratings agencies are not always correct in their assessment of a security's risk. This creates a huge opportunity for active managers in the fixed income space. Good managers will identify bonds that are mispriced relative to their credit rating, generating excess yield due to the market's misperception of a company's riskiness.

- **Spread Duration.** Spread duration is a more advanced concept that is not as widely discussed. It is used to measure a bond's sensitivity to a change in prevailing spreads—or the premium that investors demand over a risk-free bond, such as a Treasury. If a bond has a spread duration of 3 and spreads widen by 1%, you would expect a market value decline of roughly 3%. This is a helpful data point to keep in mind as credit spreads approach inflection points, often at extreme levels. ●

The Long Road to Normal

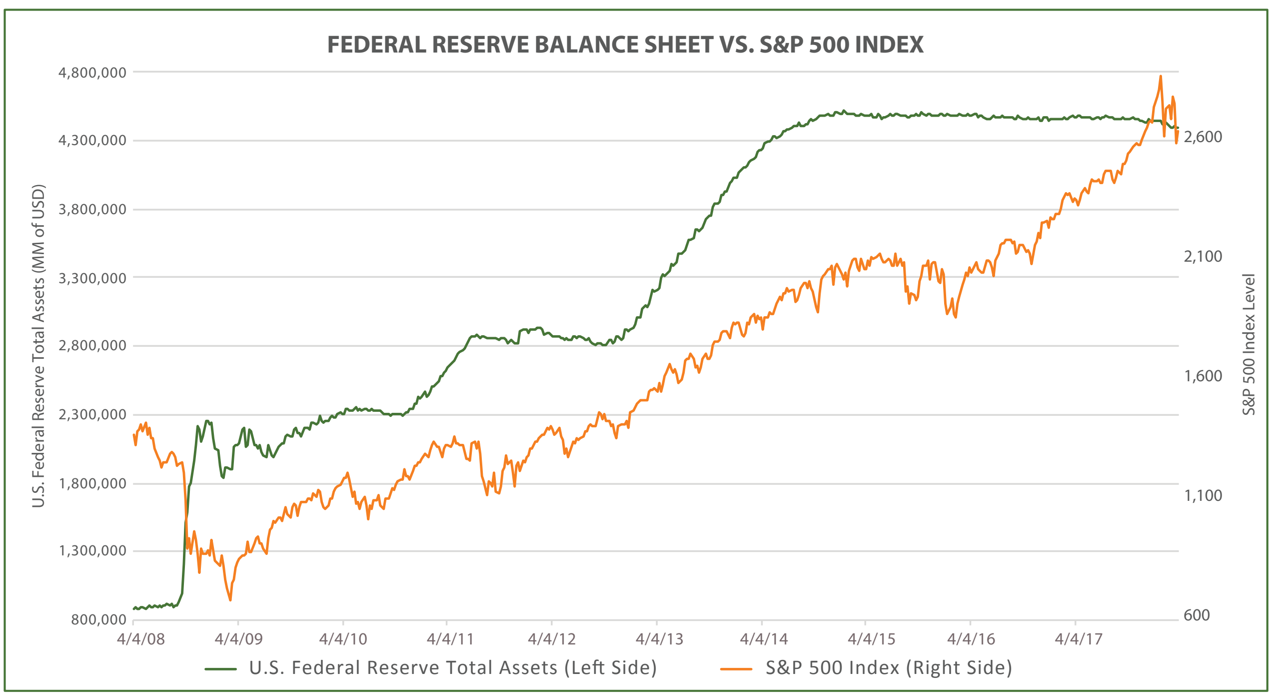
Jerome "Jay" Powell was officially sworn in as the new Fed chairman on February 5, 2018, which happened to be the same day that the S&P 500 plunged by 4.1%—the biggest one-day loss since 2011. While more superstitiously-inclined investors may fixate on what such an ominous first day in office may portend for the rest of Powell's term, we would suggest that the more daunting reality is the size of the Fed balance sheet that Powell is inheriting.

You will recall that, in an attempt to stimulate the economy after the global financial crisis, the Fed engaged in three rounds of so-called "quantitative easing" that involved purchases of Treasury securities and mortgage-backed securities. Since 2008, the Fed's balance sheet has grown to over $4.3 trillion as it purchased these assets in an effort to support its two mandates: (1) stable prices and (2) maximum sustainable employment. Now that the Fed believes that the economy is on firm footing—supportive of healthy inflation levels and labor markets—the process of "normalization" is underway.

What does normalization look like? For now, slow and measured. In Q2 2018, the Fed will unwind $30 billion of assets each month, or less than 1% of its balance sheet. For the next 2 quarters, the Fed will up its monthly pace by $10 billion until it is trimming its balance sheet by $50 billion per month. Importantly, this process is unlikely to occur via outright sales; rather, the Fed will simply let bonds mature without reinvesting the proceeds.

How is this likely to affect your portfolio? Despite being such a remarkable number in absolute terms, most bond strategists agree that unwinding $1 - $2 trillion over a 5 – 7 year period should have a minimal impact on the fixed income markets. The drivers of your bond portfolio yields are more likely to be inflation, economic growth, and the new supply of Treasuries. The bigger question lies on the equity side of the equation. If a rapidly-growing Fed balance sheet is a tailwind for stock prices, should a slowly-shrinking Fed balance sheet necessarily be a headwind?

Consider the chart below that rescales the size of the Fed balance sheet (green) versus the S&P 500 (orange). There is an unmistakable similarity between the two trajectories since quantitative easing began in late-2008. The S&P 500 has even rolled over recently as the Fed started its tapering process in earnest.



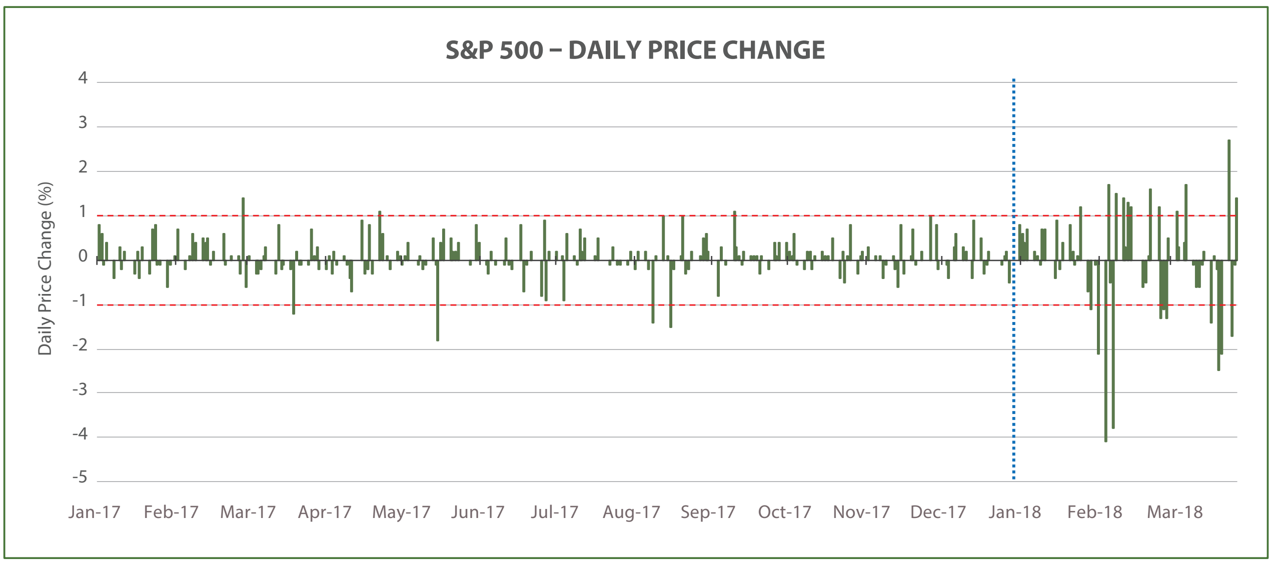
Source: Bloomberg (Data as of 3/31/18)

While we are not making a call on the end of the bull market, these dynamics at least suggest that the days of liquidity-fueled stock market "melt-ups" may be behind us, and that a more cautious approach is warranted in U.S. equities going forward. It also argues for a closer look at Japanese and European equities, where central banks are still expanding their balance sheets and providing liquidity injections into markets.

Chart of the Quarter

Last quarter's "Chart of the Quarter" focused on volatility—or more specifically, the lack of volatility in 2017. At the risk of being repetitive, this quarter's chart also explores volatility—but from the other extreme of the spectrum.

Below you will see a plot of the daily returns for the S&P 500 going back to the beginning of 2017. The red, dotted lines are set at +1% and -1%, so any green bar that extends above or below the lines indicates a day when the market advanced or declined greater than 1%.



Source: Bloomberg (Data as of 3/31/18)

While the takeaways are fairly self-evident, it is worth putting numbers to the stark difference between the bars on the left and right of the blue line that marks the beginning of 2018. Consider that the S&P 500 had 23 days of plus/minus 1% returns in Q1 2018. There were only 7 such days for all of 2017! As we described last quarter, 2017 was an historical anomaly for its lack of volatility, but 2018 has been nearly as extraordinary for its massive price swings.

From a practical perspective, a number of analysts and economists have noted that this transition from a low volatility regime to a higher volatility regime is not uncommon for "late cycle" markets; in other words, economic expansions that are entering their final innings. Typically, these environments are characterized by tight labor markets, limited economic slack, and inflationary pressures. These conditions have historically favored value versus growth within equities, commodities or commodity-related businesses, and bonds with limited interest rate sensitivity. ●

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