Investment Strategy Update March 31, 2018

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That long-lost acquaintance, volatility, returned to financial markets this quarter. We have come through an incredibly unusual period for its lack of volatility. In the first quarter of 2018, we set the record for the least volatile period ever! We had enjoyed the longest period without a 10%, 5%, or even 3% correction. Told differently, the VIX Index (a measure of volatility) is 25 years old. During the first 24 years, the VIX traded below 10 on only 9 trading days. In 2017, its 25th year, the VIX was below 10 on 52 trading days.

Ironically, within days of setting those records, we set new records for the largest point drops ever from the major indices. It is important to remember that the size of the point drop does make for big headlines. However, as a percentage, it did not even register in the top 20. Make no mistake, it was a significant and broad correction as no major equity or bond sector posted positive returns during February.

Will this more volatile market translate into a broader distruption? The global economy continues, for now, to be healthy and strong. For the first time since 2007, all major OECD countries (Organization for Economic Cooperation and Development) are growing. In fact, well over half of those countries are experiencing accelerating growth. While the growth has been positive, it remains anemic relative to past expansions. That lower, slower global growth has not led to excesses seen in the last cycle (e.g. housing) which was the catalyst for overheating the economy then. But, this time, the overheated areas are more mundane and traditional – all-time high corporate debt levels, excessive equity, junk bond, and real estate valuations, coupled with late-cycle, old-fashioned, interest rate hikes. It's almost text-book and somewhat confusing as to why so many investors are surprised.

While we do feel the global economy is relatively stable, it is troubling and surprising to investors (ourselves included) that President Trump seems intent on imposing tariffs and protectionist measures. He has enacted and further proposed a wide range of ideas to restrict trade and commerce. His ideas run the gamut from tariffs on raw materials (aluminum, steel), finished goods (washing machines, solar panels, automobiles), and corporate actions (Broadcom's takeover of Qualcomm). He remains committed to this despite the resignation of his most senior economic advisor and a resounding rejection of these principles by most economists and policy makers. Should a trade war with China ensue, it will be inflationary. These measures bear close watching for their potential to disrupt the world's economic health.

With the economy strengthening, and the stock markets having retraced much of the February losses, this appears to be another time when we should be "buying the dip". During this bull market in U.S. stocks, buying when the markets have fallen has been very profitable. However, it is important to consider if this is yet another brief drop, or if the environment is evolving and giving us notice that a change in profitability is coming.

The yield on the 30-year US Treasury crossed 3% this quarter, signaling the bond market is growing concerned about inflation, a lack of interested buyers at lower yields, a lack of liquidity, and questioning the ability of corporations to pay for higher interest rates on their debt. Furthermore, long absent higher yields on Treasuries give competition to the return received on stock dividend yields. Back when bond yields were much lower, and in many cases, negative; investors had to look elsewhere for income and they turned to stocks. Today, much less risky Treasuries provide a higher yield than the stock market dividend yield resulting in a pull to bonds from stocks.

It seems imprudent not to hear the message of volatility. We have taken this opportunity to further adjust portfolios in response to our perception of the shifting landscape. To that end, we have added two new international funds for both debt and equity reflecting our view that U.S. markets will not be the powerful driver of returns they have been for the last several years. This was our view well in advance of all that happened in recent months – and the market's surprise provided the opportunity to implement.

Thank you for your ongoing trust in our services.