Stembrook Asset Management

Stembrook Market Review — First Quarter 2018

After a relatively calm, yet prosperous year for equity markets in 2017, volatility returned in the first quarter of 2018. The positive influences of a corporate tax cut in the U.S. and an improving economy around the world were overcome by a number of negative factors. Inflation fears, higher interest rates, concerns over increasing regulations on tech companies, rising federal debt levels and the threat of a trade war, unsettled markets.

It is important to view this recent selloff in equity markets through a historical lens. Though the first quarter was volatile, large cap stocks in the U.S. were down only -0.8% over the period, despite having a maximum peak to trough decline (or drawdown) of -11.8%. The average drawdown since 1980 (see center chart, below) was -14.9% per calendar year, while the average annual return was 13.1% over the course of this period. 2017 was an outlier; with higher returns and lower volatility than normal, U.S. stocks were up 21.8% and only had a drawdown of -3.3%.[1]

We remain in the later stages of a bull market (108 months and counting), one that has only been exceeded in length by that of the 1990s, which lasted 113 months. Since 1926, the average bull market has lasted for 54 months.[2] While our return expectations moved up slightly after the recent pullback, they are significantly lower versus a few years ago.

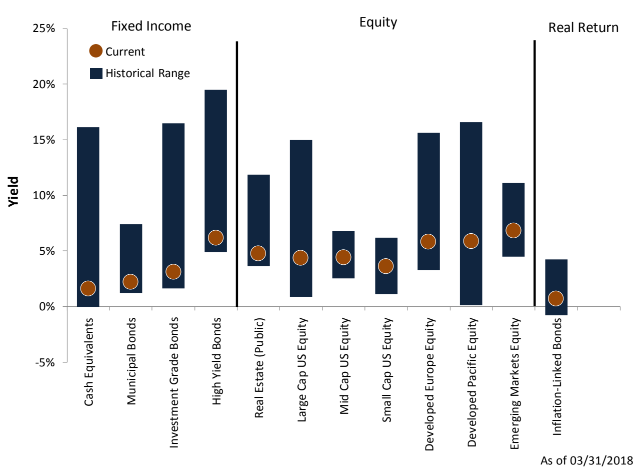
Our proprietary models forecast long-term pre-tax returns ranging from 2% to 3% for fixed income-like asset classes and 5% to 10% for equity-like asset classes (see table to the right). We continue to favor equities over fixed income for long-term investors, despite the recent rise in interest rates and our reduced return expectations for equities. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks 7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
Inflation	2.0%	2.0%	3.1%
Cash Equivalents	1.5%	0.9%	3.5%
Municipal Bonds	2.1%	2.1%	4.4%
Inflation-Linked Bonds	2.6%	1.5%	5.6%
Investment Grade Bonds	2.9%	1.6%	6.7%
High Yield Bonds	3.0%	1.4%	13.2%
Real Estate (Public)	4.7%	2.6%	17.5%
Broad Market US Equity	8.1%	6.4%	16.9%
Developed Non-US Equity	8.0%	6.2%	21.4%
Emerging Markets Equity	10.1%	6.6%	29.6%

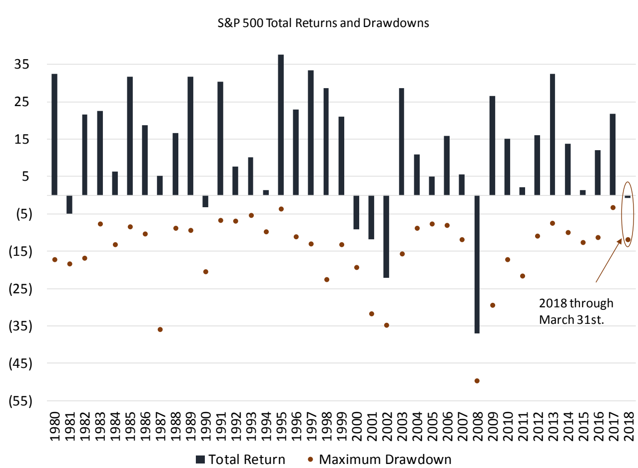
A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



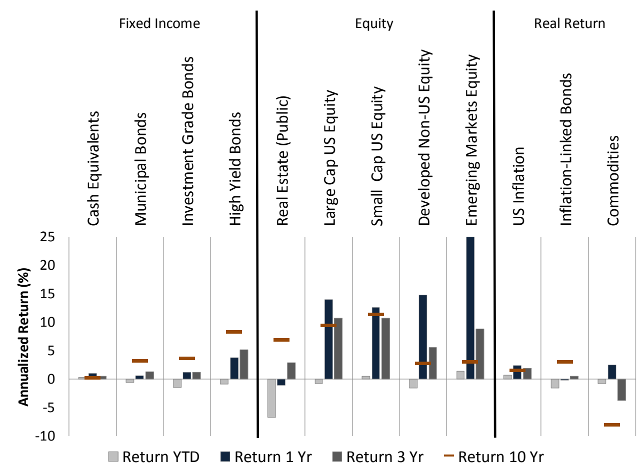
Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Yields are generally low versus their historical range.

History of Market Corrections



Drawdowns measure the price change of the S&P 500 index from its highest point (peak) to its lowest point (trough) over each calendar year beginning in 1980.

Historical Market Returns



Historical market returns as of March 31st, 2018. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Small Cap US Equity	Small Cap 8.6%	Inv Grd Bnd 5.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%
Large Cap US Equity	S&P 500 7.0%	CPI 0.1%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%
High Yield Bonds	HY Bnd 6.5%	Infl-Indx Bnd -1.2%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%
Real Estate (Public)	Real Estate 6.4%	HY Bnd -26.2%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%
Investment Grade Bonds	Inv Grd Bnd 3.3%	Small Cap -31.1%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%
Inflation-Linked Bonds	Infl-Indx Bnd 2.9%	Commod -35.6%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%
Developed Non-US Equity	Intl Eq 1.8%	S&P 500 -37.0%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%
Emerging Markets Equity	EM Eq 1.5%	Real Estate -39.2%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%
Inflation	CPI 1.4%	Intl Eq -43.4%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%
Commodities	Commod -5.8%	EM Eq -53.2%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- Global GDP is expected to grow at a 3.2% annualized pace in G-20 countries for the first quarter.[3] Inflation ticked up slightly to 2.4% for the quarter.[4]
- GDP growth in the U.S. is expected to fall slightly to 2.5% as the labor supply continues to tighten.[3]
- Similar to the U.S., real annualized GDP growth in the Eurozone is expected to decrease by 0.1%, to a 2.6% growth rate in the first quarter.[3]
- GDP growth in Japan is expected to drop by nearly 1% to 0.7%, notably due to weaker exports.[3] Long-term growth in the country will continue to be constrained by an aging workforce, restrictive immigration policies and high debt levels.
- Emerging Markets GDP growth is expected to pick up slightly to 5.1% for the quarter. The breadth of this expansion remains strong within this group of countries.[3]
- The U.S. Federal Open Market Committee raised the federal funds target interest rate by 0.25% to 1.75% in their March meeting, a move that was largely expected by market participants. The majority of economists polled by Bloomberg expect 2-3 additional rate hikes in 2018 and target the rate to be 2.25% by the end of the year.
- Despite increased volatility in equity markets, consumer sentiment in the U.S. reached its highest level since January of 2004.[5]

Currencies

- The U.S. Dollar continued its decline in the first quarter of 2018, down 2.3%.[6] A weaker Dollar results in higher current returns for non-U.S. investments denominated in Dollars. A weaker Dollar can also lead to higher import prices, putting upward pressure on inflation, which increased by 1.2% over the course of the quarter.[7]

Equities

- Emerging Markets equities continued to outperform developed, up 1.4% in the quarter,[8] while non-U.S. developed markets were down -1.5% over the same period.[9]
- Despite the headlines, technology-heavy Nasdaq stocks outperformed the broad U.S. market, up 2.6% for the quarter,[10] versus a return of -0.7% for broad U.S. stocks.[11]

Fixed Income

- Investment grade bonds were down -1.5% in the quarter, as yields rose 0.4%.[12]
- Interest rates increased during the period, but still remain low on a historical basis.

Current Positioning

- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market, over time.
- We maintain our recent shift to marginally **underweight large cap U.S. equity.** After years of holding an overweight position in an outperforming market, valuations have risen to above average levels and our models indicate that a reduced allocation to the U.S. market is prudent.
- We also maintain our recent shift to **overweight developed non-U.S. and emerging market equities**, where valuations and long-term growth potential remain attractive.
- We remain **overweight municipal bonds** for taxable investors.
- Our fixed income portfolio continues to be positioned for a normalization of central bank policy. Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting negative impact on bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries** and investing in **corporate bonds, high yield bonds and floating rate bonds**. This positioning enhanced our fixed income return in the first quarter.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses time-tested return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA　　　Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: S&P 500 Total Return. Drawdowns calculated using price return. As of 3/31/18.
(2) J.P Morgan Asset Management. As of 3/31/18.
(3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 3/31/18.
(4) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 3/31/18.
(5) Bloomberg: University of Michigan Consumer Sentiment Index. Current Level 101.4. Previous peak of 103.8, January 2004. As of 3/31/18.
(6) Bloomberg: Dollar Index. 12/31/17-3/31/18.
(7) Bureau of Labor Statistics: CPI-All Urban Consumers 12/31/17-3/31/18.
(8) Bloomberg: MSCI Emerging Markets, 12/31/17-3/31/18.
(9) Bloomberg: MSCI EAFE, 12/31/17-3/31/18.
(10) Bloomberg: NASDAQ Composite, 12/31/17-3/31/18.
(11) Bloomberg: S&P 1500, 12/31/17-3/31/18.
(12) Bloomberg: Bloomberg Barclays Aggregate Bond Index. 12/31/17-3/31/18.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 3/31/18.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 3/31/18.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

History of Market Corrections: As of 3/31/18.
Sources: J.P Morgan Asset Management , Bloomberg, Standard and Poor's.
S&P 500 Total Return. Drawdowns calculated using price return.

Historical Market Returns: As of 3/31/18.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/17.
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

Disclosures

This material is intended to inform you of products and services offered by Stembrook Asset Management, LLC (“Stembrook”). Stembrook is a New Jersey Registered Investment Advisor.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument.

We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. The opinions, estimates, and investment strategies and views expressed in this document constitute the judgment of Stembrook, based on current market conditions and are subject to change without notice. The investment strategies stated here may differ from those expressed for other purposes or in other context.

Past performance is not indicative of future results.

The obligations and securities sold, offered, or recommended are not deposits and are not insured by the FDIC, the Federal Reserve Bank, or any governmental agency.

The views and strategies described herein may not be suitable for all investors. This material is presented with the understanding that it is not rendering accounting, legal or tax advice. Please consult your legal or tax adviser concerning such matters.

Important note regarding Stembrook’s capital market expectations.

The capital market expectations developed by Stembrook Asset Management are estimates of both a central tendency of asset class behavior and a probable range of asset class behavior over a long-term horizon. These estimates are one of many inputs used in the portfolio construction process, and should not be used independently. These expectations should not be construed as the returns that will be achieved, but merely those that may be achieved if certain assumptions hold true. Also note that each client's portfolio may differ given specific goals and constraints applied to the portfolio construction process.

Additional information is available upon request.