2018 First Quarter Review

Key Takeaways

After a strong start to the quarter, U.S. stock markets collapsed in February with the release of inflationary wage data. With 2017's confidence shattered, stocks started a jittery ride, ending the first quarter slightly below where they began. Table 1 and Chart 1 below illustrate the performance of our main benchmark indices. Domestic stocks set all-time highs in late January but ended the quarter 7.5% off those highs. We are maintaining equity allocations given the strong economy and expected earnings growth.

International developed equities performed poorly in local currency terms but were helped by weakness in the dollar. Emerging market equities continued their outperformance after a huge 2017. We are maintaining our allocations to international equities.

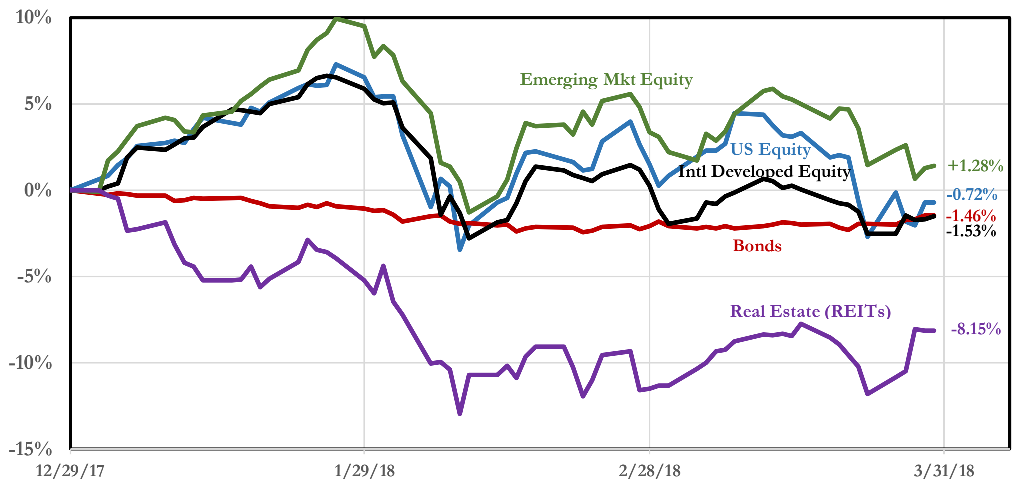
U.S. bonds performed similar to U.S. stocks although bond's underperformance occurred early in the quarter. Three-month Treasury bills went from 1.39% to 1.73% while the ten-year Treasury went from 2.40% to 2.74%. We expect interest rates to climb further in 2018.

Real estate markets, as measured by publicly-traded REITs were sharply lower, due to concerns about rising interest rates. Our US REIT index lost 8.15%, the worst performing market by a wide margin. We are selectively adding real estate exposure to portfolios.

Table 1: Benchmark Index Performance as of March 30, 2018

Benchmark Index	*1 Mo*	*YTD*	*2017*	*5 Year*
Domestic Equities (S&P 1500 Composite)	-2.17%	-0.72%	21.1%	13.2%
International Developed Equities (MSCI EAFE)	-1.80%	-1.53%	25.0%	6.5%
Emerging Market Equities (MSCI EM)	-1.86%	1.42%	37.3%	5.0%
Fixed Income (Bloomberg Barclays US Aggregate)	0.64%	-1.46%	3.5%	1.8%
US Real Estate (S&P US REIT Index)	3.80%	-8.15%	4.3%	5.6%
Global Equities (MSCI ACWI)	-2.14%	-0.96%	24.0%	9.2%

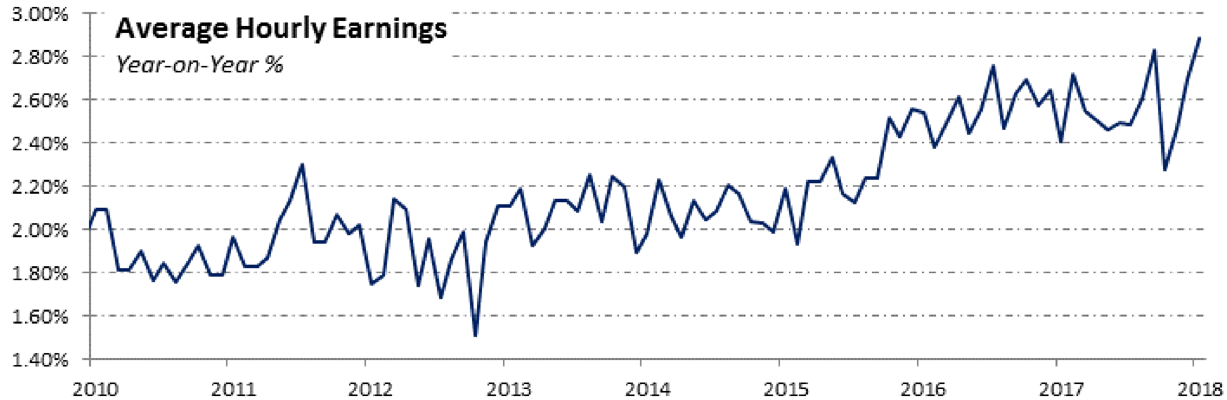
Chart 1: Market Index Performance, First Quarter 2018



U.S. Market Review

On the morning of February 2nd Punxsutawny Phil was roused from his burrow for his annual survey of sunlight. According to his handlers, Phil saw his shadow and predicted another 6 weeks of winter gloom. That same morning the Department of Labor issued its monthly employment report and presented evidence of wage increases in the labor markets with average hourly earnings up 2.9%. (see Chart 1 below). That wage report spooked the market, creating a different kind of gloom for investors who emerged from their own winter doldrums and started selling securities. The DJIA sold off 666 points that Friday and continued the sell-off the following week.

Chart 2: The Inflation Evidence that Provoked February's Correction



Source: FTN Financial

Average hourly earnings growth has abated slightly since the February 2nd data release with more recent growth figures around 2.7%. Nevertheless, markets are still concerned about inflation and now adding worries about tariffs and "trade wars". We think worries about "trade wars" are overblown.

Growth stocks, propelled by tech stocks, continued their outperformance seen in 2017. However, small cap stocks showed renewed life and outperformed large cap stocks across most metrics. Growth stocks are clearly expensive to value stocks on a historical basis but we expect to see that persist with the strong economy. We are patiently waiting for the right time to reduce growth exposure and add value exposure.

US Equity ETF Returns	*2017*	*2018 Q1*
All Stocks (VTI)	21.2%	-0.70%
Tech Stocks (QQQ)	32.7%	2.98%
Large Cap Growth (SPYG)	27.2%	1.87%
Small Cap Growth (SLYG)	15.3%	2.48%
Large Cap Value (SPYV)	15.4%	-3.62%
Small Cap Value (SLYV)	11.7%	-1.45%

International Equity Markets

International developed equity markets as represented by the MSCI EAFE (Europe, Australasia, and Far East) Index were off 1.5% for the quarter, generally due to poor performance in local markets but balanced by the currency effects of a weaker dollar. Table 2 below shows market statistics for the top 5 EAFE countries with our 3 equity asset classes added in for comparison. Note in Table 2 the poor performance of EAFE stocks in local currency terms and the effect of currency translation effects on USD returns. A strong yen had a particularly positive influence on the index, helping Japanese stocks to a positive performance in dollar terms. European stocks, including the UK, have been hurt by evidence of slowing manufacturing growth. While those economies are still expanding, expectations for future growth have been reduced. We are concerned about slowing growth and a potential resurgence in the dollar as US companies repatriate overseas earnings that were set free by the new tax code. However, given the relative cheapness of international markets we are maintaining our asset allocations.

Emerging market equities were the sole asset class with positive returns in the first quarter. With the lowest P/E ratios and the highest expected growth, emerging markets continue to be the asset of choice for investors and we are maintaining our overweight in this asset class.

Table 2: Year-to-Date Performance of the Top 5 EAFE Countries and EAFE, EM, and US According to MSCI, March 30, 2018

Country/Index	*% of Index*	*Local Return*	*USD Return*	*Currency Change*	*Dividend Yield*	*Forward P/E Ratio*
Japan	24.6%	-4.81%	0.83%	6.04%	2.1%	13.4
UK	17.3%	-7.31%	-3.88%	4.26%	4.2%	13.2
France	10.9%	-2.03%	0.34%	2.54%	3.2%	14.2
Germany	9.7%	-5.86%	-3.58%	2.54%	2.8%	12.5
Switzerland	7.8%	-5.98%	-4.32%	2.22%	3.3%	15.7
EAFE	100%	NA	-1.53%	NA	3.2%	13.8
EM	100%	NA	1.42%	NA	2.4%	11.9
US	100%	-0.72%	-0.72%	NA	1.9%	17.1

Bond Market Review and Outlook

Unlike stocks, bond markets started the year under pressure. The 10-year Treasury increased from 2.40% to 2.78% by February 1st and then held near that level for the rest of the quarter. Treasuries found themselves the beneficiary of a flight-to-quality as stocks flagged but then lost that support when stock markets rebounded. High yield bonds came under pressure when the stock market fell in February and investors shed credit risk. Fixed income investors are rightfully concerned about increased issuance in 2018. The U.S. Treasury has alerted the market that issuance will more than double this year to over $1 trillion. We expect higher interest rates will be necessary for investors to absorb the extra bond issuance.

Real Estate Market Review and Outlook

Real estate markets plunged early this year when interest rates rose. Those markets were dropped into further disarray by falling stock markets. REITs then recovered a bit of their losses as investors saw value in the sector and bond yields leveled off. We see value in this sector given the much cheaper valuations currently available and are selectively adding exposure.

Ed Yale, CFA

President and Chief Investment Advisor

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