MANAGED ASSET PORTFOLIOS

MAP VIEWS

First Quarter Review

What a difference a quarter makes! Stocks breezed through 2017 with historically low volatility; though, volatility returned with vengeance during the first quarter of 2018, sending most of the major stock averages to their first quarterly losses in over a year. U.S. equities began the year on a strong note, as investors cheered the signing of the tax reform bill at the end of 2017. However, as the quarter progressed, rising interest rates began to pressure stock prices, which were further battered by rising concerns over a possible trade war with China.

Globally, stocks followed a similar pattern, opening the year on a positive note but weakening later in the period. For the quarter, the S&P 500 lost 1.2%, although the index ended off about 8% from its January 26th peak. Globally, the MSCI ACWI fared about the same, losing 1.5% for the quarter, and approximately 8% from its January highs. Intra-quarter, the major averages declined by more than 10% (entering into “correction” territory); however, a sharp quarter-end rally enabled stock prices to finish the quarter off their lows for the period.

Fourth quarter earnings mostly were ahead of expectations and analysts were quick to raise their 2018 forecasts as a result of tax reform. It is estimated that lower taxes will add about 8 – 9% to U.S. corporate earnings for 2018. That is welcome news, as the S&P 500 has rallied about 80% since 2012, while corporate earnings have climbed only approximately 30% during the same time frame. In short, stock market gains have been driven by increased valuations rather than earnings growth. While increased valuations can be justified, perhaps, during periods of low interest rates, they are harder to justify when interest rates are beginning to move northward.

Interest rates on both the short and long end of the curve moved higher during the quarter, with the yield on the 10-year rising 33 basis points. Noteworthy is the fact that the spread between the two-year and the 10-year Treasury has shrunk to its narrowest gap since 2007. Historically, a narrowing of the yield curve can be an indicator of potential economic weakness down the road. Despite this, most Wall Street economists are calling for 3 to 4 rate hikes for 2018; while we are more in the 2 to 3 camp. Also, during the quarter, investors began to fret a bit about inflation. It is worth noting that just a couple of years ago, investors were fretting about deflation. The Fed has fought valiantly to manipulate inflation to the 2% level. Now that that goal has been achieved, there are growing concerns that the Fed may over shoot on their target. While we do believe that inflation is likely to increase modestly from current levels, we do not believe it will get out of control in the foreseeable future, particularly as many sectors have not been fully able to pass those higher prices on to consumers. In order to protect client assets in an environment where we see modest increases in interest rates and inflation, we continue to hold on to our core strategy of focusing on stocks with attractive valuations, while keeping maturities short with fixed income holdings. To that point, our weighted average maturity is approximately 1.05 years, and we are limiting our purchases to those issues less than three years.

As mentioned previously, investors appear fixated on the possibility of a trade war with China. We discount the likelihood of a full blown trade war, and believe recent comments from Washington are nothing more than negotiating tactics and fulfillment of campaign promises. While much rhetoric was made on the campaign trail about U.S. manufacturing jobs going abroad, the fact is that since the beginning of this century, the majority of manufacturing job losses in the U.S. have stemmed from automation and technology rather than firms moving abroad to take advantage of lower wages. In fact in a 2013 study by Ball State University, it is estimated that 87% of U.S. manufacturing job losses since 2000 have stemmed from advancements in automation and technology.

Since the first volley in the verbal trade war centered on steel, let's take a look at how the dynamics of this industry have changed over the years. Carpe Diem American Enterprise Institute estimated that in 1980 it took American steelmakers 10.1 man-hours to produce a ton of steel; now they need just 1.5 man-hours to produce a ton of steel. Voestalpine AG's steel plant in Donawitz, Austria, produces 500,000 tons a steel per year in order to supply customers such as Mercedes Benz, Audi and BMW. ***There are only 14 people involved in the actual manufacturing process.*** While another 300 people are involved in other aspects of the business, ***the fact remains that it took nearly 2,000 workers to make a similar amount of steel in the 1960's***. Even assuming dramatic tariffs being imposed on foreign steel, we estimate Pittsburgh would only see a very modest bump in new jobs as manufacturers would rely more on technology and automation to reduce the need for a material increase in labor.

We view stock market actions in the first quarter as a beginning of the "new norm" rather than a one-time event. For over a year, investors enjoyed stock market appreciation without any volatility. Now that interest rates are moving higher and inflationary fears are beginning to emerge, we believe a shift is taking place within the investment landscape. Further, the times of just buying an Index Fund or overweighting a portfolio with FANG (the acronym for Facebook, Amazon, Netflix, and Google (now Alphabet, Inc.)) stocks to achieve solid returns have ended in our opinion and should translate into an environment stock selection will be a key input to producing benchmark beating returns.

In closing, we sincerely appreciate the opportunity to serve as your investment advisor. It is a responsibility we do not take lightly -- or for granted. We continue to work diligently every day, seeking out the best risk adjusted opportunities for our clients.

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