DANN ASSET ADVISORS, LLC

First Quarter 2018 Update

April 12, 2018

1Q18 Highlights

- U.S. stocks post a slight decline after nine straight quarters of gains
- Market volatility returns, seemingly due to concerns over inflation and trade
- First quarter economic growth expected to slow following three relatively strong quarters
- Congress substantially increases spending just months after passing tax cuts

The table below summarizes the performance of some key indices during the first quarter:

Index	Market Performance % Ch. 1Q18
S&P 500	-0.8
MSCI Developed Markets (excl US)	-1.7
MSCI Emerging Markets	1.3
MSCI All Country World	-1.0
US Aggregate Bond (1)	-1.5
Liquid High Yield (1)	-1.0
US Dollar Emerging Markets Bond (1)	-2.0

(1) Barclays indices

Equities. U.S. stocks (as measured by the large company S&P 500 index) returned a negative 0.8% in the first quarter, the first decline since the third quarter of 2015. While the decline was hardly material, it was notable as it came after 15 straight months of gains, mostly with record-low volatility. Illustrating the return of volatility in 2018, the market had been up 7.4% through January 26, fell 10.2% over the next few weeks (the first correction of 10% in two years) and then bounced around in March to finish the quarter down slightly.

While it's not possible to pinpoint what causes short-term market moves, causes of the first quarter's volatility seem to have been the potential for higher inflation (spurred by an early February government report on wages) and increased potential for trade wars due to commentary (so far, more than action) from the Trump administration. We'd add to these two factors that the U.S. market was relatively highly valued by the end of January, making it more vulnerable to perceived bad news.

International markets in aggregate performed roughly in line with the U.S., as indicated in the table. Economic growth had been stronger than expected in China and many European economies in 2017; this growth has moderated thus far in 2018 limiting, we believe, stock market advances this year. In addition, rhetoric around increased trade barriers was not a positive toward quarter's end. International markets generally remain more attractively valued than the U.S.

Fixed income. Similar to stocks, fixed income markets as measured by 10 year Treasury yields also had a volatile quarter. In response to the potential of increasing wage inflation, the 10 year yield rose from 2.41% at the beginning of the year to a high of 2.94% in mid-February before declining to 2.74% at quarter end as near term inflation fears subsided. Two year yields also rose in the quarter, from 1.89% to 2.27%, and have reached levels last seen prior to the 2008 financial crisis. More speculative sectors of the bond market performed roughly in line with the Barclays U.S. Aggregate Bond index.

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<u>Market sectors</u>. The best performing broad U.S. market sectors during the first quarter were technology, consumer discretionary stocks (includes retail, restaurants, entertainment) and financials. Technology substantially outpaced other sectors in 2017 and had been up 10% through early March. The sector backed off late in the quarter as controversy developed around the way Facebook shares data on its users. This followed disputes in 2017 between advertisers and YouTube (owned by Alphabet, formerly Google) over placement of ads alongside controversial content. Finally, although Amazon's stock falls in the consumer discretionary indices, it often is considered a tech stock and its shares were hurt late in the quarter by Trump's negative tweets (among many other businesses, Amazon owns The Washington Post).

In prior reports we've noted that tech has an outsized impact on the market indices. For example, at March 31, the five largest stocks in the S&P 500 were tech companies – together accounting for just over 14% of the index' value. There's no question that these large companies have wonderful financial models and are attractive businesses. However, similar to the drug companies, because of their size, profitability and impact on society, we believe they're likely to continue facing heightened scrutiny and potentially more regulation. Still, these are likely to remain very profitable businesses and some of their valuations are becoming more attractive.

Returning to the other two best-performing groups, consumer discretionary stocks were helped by Amazon and Netflix together accounting for almost 21% of the index (these two were up 15% and 39%, respectively, in the quarter). Without these two stocks, this sector would have been down. Financials as a group were essentially flat on the quarter but likely helped (relative to the market) by rising interest rates (usually positive for earnings).

The first quarter's worst performing sectors were REITs, telecommunications and consumer staples stocks (last group includes Procter & Gamble, Coca Cola and Philip Morris International). The first two groups often lag in a rising rate environment. Consumer staples stocks have been hurt by pricing pressures, rising input costs and less loyalty to big brands, among other issues.

<u>General Comments</u>. The return of stock market volatility is not a surprise. As we highlighted in our fourth quarter 2017 update, what was unusual was the nearly complete lack of volatility from the 2016 election into early 2018. It's also not unusual to have a 10% decline in the market. As mentioned in a 2015 paper published by Capital Research and Management Company, 10%-plus declines occur once per year, on average.

More important than recent volatility is what happens going forward. On the positive side, tax cuts should be freeing up money for consumer and corporate spending and Congress and the President have authorized much higher federal spending. These factors should contribute to good economic and corporate earnings growth in coming quarters (we won't comment on the implication of these actions for long term economic health), usually positive conditions for the stock market.

On the negative side, a narrowing spread between two and ten year treasury yields – an often reliable indicator of a slowing economy – is signaling a potential slowdown (negative for earnings and stocks). Complicating the reliability of this indicator is the Fed tightening monetary policy and the Treasury increasing borrowing – these factors tend to increase rates, currently mostly on the shorter end. Other potential negatives include the possibility of higher wage inflation and significantly more restrictive trade policies.

The S&P 500 is currently trading at 17.1x estimated earnings for 2018, down from more than 18x

at the market high in January and a tad below year-end 2017 levels. With interest rates where they are, stocks are not unreasonably valued in our opinion – assuming earnings come in as expected. For clients where we buy individual stocks we're finding more opportunities than we have over the past six to nine months.

We believe that for the U.S. stock market to move materially higher from present levels most things we judge to be important have to go right; for example, GDP growth around 3%, core inflation in the 2% range, better than expected corporate earnings, no significant trade wars and some semblance of stability in the Administration and its policies. In our opinion, fewer things have to go wrong for the market to move lower. This leaves us where we were at the end of 2017, believing the market's more likely to end 2018 down than up. While making short term predictions can be fun (or humbling!) we're still much more interested where the market is over the long term and in that respect the trend has been and continues favorable.

Portfolio Positioning

Although fixed income markets were difficult during the first quarter, we made no significant changes for most clients. We continue to believe we're conservatively positioned should interest rates continue rising, with two-thirds or more of most clients' fixed income in short duration (which we define as three years or less) funds.

On equities for many clients we initiated a position in a growth focused international mutual fund. For most clients proceeds for the purchase came from the sale of large cap U.S. stock investments. While international stocks fell more than large cap U.S. stocks during the February correction, we believe international stocks are more attractively valued than those in the U.S.

Economy

U.S. GDP grew 2.9% in the fourth quarter, just below the low 3% growth of the prior two quarters. The fourth quarter included the biggest increase in consumer spending in three years, with a 4.0% gain. Business investment spending also continued strong and should remain so deep into 2018 given changes in the tax laws. Inflation remains below the Fed's target of 2%, with the most recent core personal consumer expenditure price index increase only 1.6%.

Expectations for first quarter 2018 GDP (to be reported later this month) have been falling and are now mostly in the 2.0%-2.5% range. Retail and housing sales and orders for durable goods have shown unexpected weakness in recent months. The March jobs report also came in lighter than expected. However, jobs growth over the first three months of 2018 averaged a strong 202,000, up from 182,000 per month in 2017.

Layered on top of current mixed economic signals is the Trump administration's imposition of tariffs on steel and aluminum, and its additional $150 billion in proposed tariffs for Chinese goods. The Chinese have retaliated with $3 billion of tariffs on certain U.S. goods (their response for steel and aluminum); however, beyond that, with all the headlines around tariffs, nearly all of it relates only to proposals – nothing else has been implemented at this time. While we question the Trump administration's tactics, we do know from technology stocks we've owned over the years that the Chinese do not play by American intellectual property rules.

Given recent changes to personal and corporate income taxes, extremely low unemployment and increased government spending, economic growth in 2018 should be strong notwithstanding

some slowing in the first quarter. We expect that growth will pick up in the second quarter. If growth accelerates much above 3%, we anticipate inflation worries (and potentially higher than expected interest rates) will follow. The Trump administration's trade policies add risk to the economic outlook.

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