DANN ASSET ADVISORS, LLC

Market Volatility

February 8, 2018

As of today's close, the market, as measured by the large company S&P 500 index, is down 3.5% year to date and roughly 10% from its all-time high reached less than two weeks ago. For many with stock investments, euphoria has been replaced by fear or, at the least, confusion. What changed in the last few days? The answer: we don't know.

What we do know:

- From the November 2016 election through January 26, 2018, the S&P 500 rose roughly 33%.
- Through January 2018, the S&P 500 registered 15 straight months of gains, the longest such streak on record according to the Wall Street Journal.
- Downside volatility as measured by the VIX index was at or near record low levels throughout 2017 and into 2018.
- The market entered 2018 relatively highly valued compared to historical multiples of earnings – in our opinion, and as noted by Janet Yellen in a February 2 interview.
- Although beginning from historically low levels, interest rates have moved up meaningfully in 2018 (from 2.41% to a high of 2.87% on the 10 year treasury and from 1.89% to a high of 2.17% on the two year note).
- The employment report released Friday showed the largest year over year increase in wages since June 2009.

Although we don't know what precipitated the market decline that began in earnest on February 2, we believe at least some of the above factors played a role.

Context:

According to a 2015 paper published by Capital Research and Management Company (parent of American Funds), from 1900-2014 the Dow Jones Industrial Average experienced declines as follows:

- 5% or more: about three times per year with the average length of decline 46 days
- 10% or more: about once per year; 115 days average length
- 15% or more: about once every two years; 216 days
- 20% or more: about every 3 ½ years; 338 days

From the foregoing it's clear that the current bout of volatility is completely normal in the context of longer-term stock market returns. What was truly unusual was the length of time of the uninterrupted appreciation over the 15 months through this January.

Outlook:

In our recent 4Q17 update, we wrote, "our guess is that the market is up at most mid single digits in 2018 [which it was at the end of January!]. We wouldn't be surprised to see it down for the year, and would be most surprised to see it up another 10% or more. In other words, looking out for the next year only, we see more downside than upside potential." The volatility of the past several days hasn't changed our outlook.

Our lack of excitement over near term market prospects stems from our belief that the economy and employment are at about the best levels they can reach. If the economy strengthens further from here (possible with recent corporate tax cuts) initially it may be positive for earnings. However, with the unemployment rate at an already low 4.1% and wages showing signs of

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accelerating, we believe inflation will pick up, causing interest rates to rise. The rise in interest rates we believe would put a cap on stock prices that already are at relatively high valuations. Further, increasing wages could crimp corporate profit margins.

If by chance the economy were to decelerate from current growth rates near 3%, corporate earnings comparisons likely would become more difficult and this, too, in our opinion, would temporarily cap the market around current levels. We believe that much of the stock market's advance in 4Q17 into January was driven by the expectation for, and then realization of, corporate tax cuts – and that additional stimulus beyond the tax cuts is needed to accelerate earnings growth above current expectations.

Acknowledging as always that we're not an economist and are no better at forecasting than others … that's the way we see things currently. However, much more important than our forecast is how we're investing for our clients. And in that regard, we believe we're well positioned.

Speaking very generally, across most client accounts (specifics vary, in some cases significantly, by client), in fixed income we're more than 2/3 in short duration (under three years) funds and 85%-plus in investment grade. On equities, we own for most clients a combination of low-cost indexed exchange traded funds and actively managed mutual funds – the goal with the actively managed funds being to reduce downside potential and generate good full market cycle returns.

In our experience, volatility of the type seen this week doesn't evaporate overnight, although typically there are days or periods with strong rebounds. "Buy the dip" has been the correct approach in recent years (even though 2017 didn't have a real dip) but our inclination at this point is to be patient in terms of putting additional money into stocks. As at the beginning of 2018, we continue to believe that international markets offer more near-term upside potential than the U.S.

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