



600 South Adams Road, Suite 100
Birmingham, MI 48009
(248) 556-2900
www.bernard-wealth.com

First Quarter 2018



Fig. 1 – S&P 500



Fig. 2 – U.S. 10-Year Treasury Yield

Stocks began 2018 with modest losses in most major indices. The large cap S&P 500 index (**Figure 1**) posted a total return of -0.8%. Small cap stocks were close to unchanged, with the Russell 2000 Small Cap index losing -0.1%. International markets were mixed. MSCI's emerging market index rose 1.1% but developed country stocks outside the U.S. fell -1.4%.

S&P 500 fourth quarter earnings jumped 13.5% after rising 6.7% in the third quarter. This was a solid gain over the 10.5% expected at the beginning of the quarter. Earnings growth has been accelerating since corporations emerged from the profit recession of 2015-2016. According to research service Factset, 74% of companies beat analyst earnings projections, and 77% surpassed revenue expectations, a slight improvement over last quarter's strong results. The revenue results in particular indicate a strengthening economy.

First quarter S&P 500 earnings are forecast to rise 15.9%, led by the energy sector's +60.8%. Excluding the energy sector, expected aggregate earnings growth is +14.3%, and almost all major sectors are expected to grow. 2018 earnings are now forecast to rise 18%, which would be the strongest growth since 2011. While earnings growth should generally move stocks higher, it is worth noting that a significant share of the recent revisions is due to the corporate tax cuts enacted at the end of 2017. That tax cut was widely anticipated, and markets had already advanced on that information. The market declines of the last two months indicate that investors will be looking for results beyond the tax cut effects.

Economic reports in the first quarter were generally positive, supportive of continuing economic growth. Both consumer and business confidence surveys showed sustained optimism. Employment has been very stable, with initial claims the lowest since the early 1970s. Both manufacturing and services purchasing manager data were robust, although some cooling was evident late in the quarter.

For equity markets, however, it was a tale of two quarters. In January, stocks continued the strong performance of 2017, with a breathtaking +5.7% gain. At the end of January, strong employment readings, coupled with wage gains, led to worries of accelerating inflation, and fears that the Federal Reserve would raise interest rates further. Bond yields

Index returns taken from Morningstar.com

rose sharply, with the 10-Year U.S. Treasury rate (**Figure 2**) topping 2.9% for the first time since January 2014. Traders took profits across most sectors. Interest rate sensitive stocks including utilities and real estate were among the hardest hit. Most bond sectors also suffered losses, pressured by the rising interest rates. In March, after partial recovery, markets were hit by privacy concerns at technology leader Facebook. Stocks floundered as the technology sector, which has led markets through most of the nine-year expansion, lost ground. Industrials also suffered following the Trump administration’s decision to implement tariffs on imported steel and aluminum. This has the immediate effect of raising input costs for many domestic manufacturers, and has stoked fears of a trade war in which other countries might retaliate against U.S. exports. By the end of the quarter, stocks had surrendered January’s gains, leaving most indices down for the year.

International economies continued to expand. German exports exceeded expectations, and Eurozone unemployment improved, although still high at 8.6%. Emerging markets logged the highest growth. Those economies may have the most room to expand, as they appear to be in earlier stages of the economic cycle. Stock investors there may also have opportunities (**Figure 3**). Valuations are still generally below those of U.S. stocks after lagging performance since 2012.



Fig. 3 – iShares Emerging Markets Index



Fig. 4 –Technology Select Sector ETF

With both stocks and bonds under pressure, investors may be left wondering where to turn. One of the ongoing concerns for stock investors has been the market’s overall valuation, which has climbed steadily through the current economic recovery and expansion. We noted last quarter that the market’s forward price to earnings ratio was 18.3, well above the 5-year average of 15.8. As of this writing, that ratio has declined to about 17, through earnings growth and stock price declines. While stocks may still have further to fall, at some point investors will likely resume purchases as valuations become more attractive, and earnings growth seems likely to continue. The weakness in the technology sector (**Figure 4**) shows the value of a diversified approach with allocations to other sectors and to international stocks.

Bonds have had rough periods before, such as the “taper tantrum” in 2013, when interest rate fears overshoot actual economic growth. Patient investors are likely to benefit from holding their positions as interest rates stabilize and bond payments rise. Fixed income is an important component of long-term asset allocation for many investors as it cushions volatility in times of stock market distress. If you have questions about your asset allocation, we encourage you to contact us at any time.

Sincerely,

Kenneth M. Bernard, CFA