ICR® 1st Quarter Newsletter – April 2018

After a prolonged period of relative calm in the markets, volatility returned in a big way in the first quarter of 2018. After starting the year up over 7%, the S&P 500 index then fell about 10% over the next nine trading days. The ups and downs continued from there, but ultimately, the index recorded its first quarterly loss (-1.2%) since 2015. Technology was the best performing sector (+3.5%), while telecom (-7.5%) performed the worst. Foreign markets did not fare much better, as the MSCI EAFE (a foreign developed market index) lost 2.2%, though the MSCI Emerging Markets index managed a small gain of 1.1%.

Interest rates crept up through most of the quarter, with the 10-year Treasury yield rising from 2.41% to as high as 2.95% before ending the quarter at 2.74%. This rise in interest rates depressed returns from fixed income, with the Barclays U.S. Aggregate Bond Index losing almost 1.5%.

Going back to volatility, it's interesting to note that last year there were eight trading days where the S&P 500 either gained or lost at least 1%. Just in the first quarter of 2018, there were 23 such days (twelve up and eleven down). And the Dow Jones Industrial Average notched its two largest down days ever in terms of points (1,175.21 on 2/5 and 1,032.89 on 2/8) but in percentage terms, neither of those days cracked the top 20 of all time.

This volatility was largely the result of markets reacting to worries about inflation, possible increased regulation on technology companies, and potential trade wars. Wage growth figures for January were the highest since 2009, sparking fears that higher wages could lead to more inflation and that the threat of inflation might lead the Federal Reserve to raise interest rates more quickly than expected. Or, even worse, investors fear that the Federal Reserve may botch its attempt to manage inflation.

Adding to the inflation concerns was news that the U.S. would begin imposing tariffs on steel and aluminum, which could lead to higher prices for goods manufactured with those materials. A few weeks later, the Trump administration outlined over 1,300 Chinese goods on which a 25% tariff would be levied. China responded by announcing a plan of additional tariffs on certain U.S. exports, including soybeans, aircrafts, and automobiles. The back-and-forth between the U.S. and China has led to growing fears of a full-blown trade war between the two countries, which would undoubtedly have spill-over effects on the rest of the world.

In his 1984 State of the Union address, President Reagan said, "A nuclear war cannot be won and must never be fought." The same can be said of a trade war between economic superpowers. Protectionism is broadly understood to be a negative-sum game, where all players lose. For that reason, we believe it is unlikely that a full-scale trade war will erupt. The administration's tough trade rhetoric is ultimately designed to persuade China to address some of its unfair trade practices. This negotiation style, while somewhat risky, is completely consistent with the President's campaign rhetoric and may contribute to continued market volatility as things play out. Already, trade policy sentiment seems to be moderating with suggestions that President Trump may be willing to reconsider the Trans-Pacific Partnership (TPP) agreement.

The Bigger Picture

All of this is taking place against a global economic backdrop that remains strong. Most of the world's economies are in full recovery mode, and the U.S. economy is benefiting from increased federal spending and tax cuts. We are currently enjoying a rare period of globally synchronized growth. The recent stock market volatility and correction (a price decline of 10% or more) are things investors should expect at this stage in the economic cycle, and while it can be disquieting, it is not necessarily an indication of deeper problems. In fact, it should be somewhat reassuring to see investors becoming less complacent as they price in some of the concerns typically associated with a recovery that is entering its tenth year. As long as financial conditions remain positive, this corrective phase in the markets should run its course as economic growth continues.

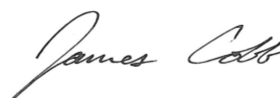
That being said, we do believe we are in the latter stages of this economic expansion. The pro-growth policies of deregulation, increased government spending, and tax cuts should help support asset prices from here, but valuations are full and quite sensitive to negative surprises.

In the longer run, we are mindful that global debt is higher now than it was in 2007, as we entered the global financial crisis. If interest rates continue to rise, it will become more costly for many borrowers to service their debt. Credit risks, currently contained by low borrowing rates and economic growth, may become problematic as interest rates rise further.

As we enter the late-stage portion of this expansion and bull market, we continue to emphasize caution. We expect volatility and economic uncertainty to continue as central bankers try to normalize interest rates and manage inflation in a challenging environment. Our investment strategies will seek to provide wealth preservation in the near term and reasonable growth over the longer term, through diversification and prudent security selection. As always, we appreciate the opportunity to serve as your investment advisors, and we welcome your comments and questions.

Sincerely,

James A. Heine



James L. Cobb

Market Report (as of 3/31/18)

Index	**2018 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	-1.17	8.51	10.98
Dow Jones Industrial Average	-2.49	10.68	10.58
U.S. Aggregate Bond Index	-1.46	1.20	1.83
MSCI EAFE (Foreign Index)	-2.20	2.74	3.68

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