FIRST QUARTER REVIEW

The first quarter was marked by a rise in equity and bond market volatility and the first equity market correction since 2016 (a correction is defined as a 10% decline from the peak). The market faced its first inflation scare in many years and we ended the quarter with investors worried about the potential for a trade war with China. These uncertainties weighed on the equity market throughout the quarter. The S&P 500 ended the quarter down -0.8% with the largest declines seen in the more defensive and interest rate sensitive sectors of the market. Technology and the consumer discretionary sector were the only market sectors to show positive returns for the quarter. International equity markets were also down for the quarter. The bond market experienced more volatility as long-term interest rates responded to rising inflation fears. The yield of the 10-year Treasury ended the quarter up 0.33% to 2.74%. Short-term interest rates continued to move higher as the Federal Reserve (Fed), under the direction of new Fed Chairman Jerome Powell, continues to normalize interest rates and reduce the size of its balance sheet. At the March meeting, the committee raised the federal funds rate by 0.25% and forecasted an additional two to three rate increases for the remainder of the year.

THE FUNDAMENTALS OF THE ECONOMY REMAIN SOLID BUT MARKET VOLATILITY HAS RETURNED

The U.S. economy continues to show signs of strength. Growth continues to be aided by a healthy consumer, and an increase in business spending should provide an additional boost. The Fed continues to normalize monetary policy and on the current path it should not be disruptive to the economy or financial markets. While the fundamentals of the economy are solid, there are many risks across the globe which can impact investor sentiment and markets over the near-term. We expect the increase in market volatility will persist for the remainder of the year given the uncertainty of the upcoming mid-term elections and concerns over trade and tariffs. Geopolitical risk remains high outside the U.S. as well, with uncertainty regarding North Korea and a potential escalation of involvement in Syria. Rising inflation expectations may lead to increased volatility for long-term interest rates. However, despite these concerns, the positive outlook for global economic growth and increasing corporate profitability remains intact.

The Consumer is Still Key to Economic Growth.

In recent years, the U.S. economy has exhibited some seasonality in economic growth, with the first quarter's activity slower than the rest of the year. This is likely to occur again this year. Whether it was weather related delays in activity or just a pause after holiday spending, consumer activity was a bit weaker to start the year, but began to pick up as the quarter progressed and is expected to remain solid throughout the year. We continue to see gains in the labor market, with 605,000 jobs added in the first quarter. The unemployment rate declined to 4.1% and wages have risen 2.6% over the last 12 months. The first quarter saw a considerable number of companies increase wages, benefits, or pay bonuses to employees. In addition, the newly passed tax cuts began to impact employee paychecks in mid-February. The combination of these factors bodes well for increased consumer spending and the consumer remains the key foundation of the ongoing economic expansion.

Business Investment is Supported by Tax Reform and Reduced Regulation.

Sustained business spending has the potential to drive growth above the more recent moderate trend. Business confidence remains near record levels at both large and small companies. The lowering of the corporate tax rate has had some immediate impacts including the announcement of increases in wages and benefits for employees, increases in future dividend payments, and increases to share buyback programs. The ability of multi-national corporations to bring foreign-earned profits back to the U.S. at a favorable tax rate (repatriation), will provide the opportunity for investment in the U.S. and increase the financial flexibility for companies. The money from repatriation along with the provision to immediately expense capital investments, has led some companies to announce new investments in plant and equipment, or to accelerate the start of previously announced projects. The ongoing focus on reducing the regulatory burden for U.S. corporations continues and has been particularly impactful for small and mid-sized businesses that often struggle to keep up with the cost of compliance with heavy regulation.

Increased Volatility Impacted All Areas of the Financial Market.

For the last couple of years, market volatility has been very low and it was inevitable that we would see it increase at some point. Periods of higher volatility often cause investors to lose sight of the fundamentals and to make decisions based on fear. At the beginning of January, it looked like the equity markets were going to continue moving higher. The S&P 500 was up 7.5% through January 26th reaching a level of 2,875. By February 8th the S&P 500 had declined 10.1% from the January 26th peak. For the rest of the quarter, we saw the markets bounce around, reacting to the news of the day. Not only did the markets experience greater movement from day-to-day, but the magnitude of intra-day prices changes increased. Through March 31st, there were ten days where the price of the S&P 500 moved more than 2% during the day. By contrast, in 2017, where volatility was historically low, the market did not have any days with a 2% intraday range. The bond market was not immune to rising volatility. February's brief inflation scare led to a rise in interest rates across all maturities. While shorter-term interest rates are largely controlled by the Fed, long-term rates tend to be impacted by the outlook for inflation and economic growth. The yield on the 10-year Treasury bond started the year at 2.41% and reached a high of 2.95% on February 16th. Rates came down from that peak but still ended the quarter higher at 2.74%. The historically low volatility experienced over the last few years is unusual and we should expect to see more volatility going forward. It is important to remember that even as the market reacts to negative headlines, the fundamental economic data continue to support solid economic growth.

Inflation Expectations are Rising, but Actual Inflation Remains Low.

Throughout this recovery, inflation risks have been balanced, meaning the risk of deflation was as much a concern as the risk of inflation. Currently, there are several factors that could lead to higher prices. With the economy near full-employment, employers may have to offer higher wages and benefits to attract qualified candidates. In addition, both tax cuts and increased government spending, could lead to increased inflationary pressures. Tariffs are another potential source of inflation. Many of the deflationary factors that have been present throughout this recovery remain and that along with the Fed's normalization of policy rates and the balance sheet, can help offset some of those pressures. Higher inflation is not unusual in an environment of faster growth and some inflation is good for economic activity and for corporate earnings. It would take a more sustained rise in inflation to significantly higher levels before it would necessitate stronger action from the Fed. However, rising inflation expectations will lead to higher interest rates, particularly in long maturity bonds (10-years and longer).

Equity Markets are Supported by Improving Economic Growth and Rising Corporate Profits.

Equity markets tend to be more volatile during mid-term election years and given the increasing polarization of the electorate, we would not expect this year to be different. But as generally happens, once the outcome of the election becomes more certain, the equity market tends to rally as investor focus returns to the fundamentals. The environment for corporate earnings improved last year and that momentum is expected to continue throughout this year. Earnings for S&P 500 companies rose 10.8% in 2017 and are forecasted to increase at a double-digit pace again this year. The impact of corporate tax cuts explains some of the increase, but increased investment and strong global demand are a big reason for the increased earnings. The rhetoric around trade and tariffs adds to investor angst, but short of a full-blown trade war, the announced tariffs on both sides, if implemented, are not expected to have a major impact on global economic activity. The stimulative effect of tax cuts and increased government spending far outweigh the currently announced tariffs.

IMPACT ON YOUR INVESTMENTS

Given the combination of improving global growth and an improving corporate operating environment in the U.S. we believe that equity markets remain attractive. We continue to focus on companies that are well-positioned to benefit from increased consumer and business spending both in the U.S. and globally. Since the end of the recession, historically low interest rates have made individual bond investments unattractive. To combat that, in balanced portfolios, we utilized large, high dividend paying stocks to help generate the income that bonds would normally provide. As the Fed has raised the funds rate, short-term interest rates have become more attractive, allowing us to begin to shift funds that should be allocated to fixed income back into corporate bonds at attractive yields. We expect to keep the maturities of those bonds short in anticipation of higher interest rates. In addition, our concerns about rising long-term interest rates and the impact that might have on interest rate sensitive equity sectors, led us to make changes to some of the names in the Income Equity strategy to make sure that we own companies with a high and growing dividend, that are less sensitive to changes in interest rates and can benefit from accelerating economic growth. We believe that our Growth and Income Equity allocations are even better positioned to benefit from the positive global economic environment and that the fixed income allocation can provide stability to the portfolio while generating attractive income. Our investment strategy remains to focus on the long-term fundamentals of the global economy rather than the short-term uncertainty in positioning your portfolio.

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