Equity Markets

We started 2018 with expectations for strong earnings and an outlook for a solid year. As January unfolded, returns accelerated as the effect of the Tax Cuts and Jobs Act passed in December clarified. On earnings calls and corporate releases we learned of growing earnings expectations and investment plans to meet increased demand.

By early February, we were in the middle of a correction, the first in two years. Markets began to decline first on the larger than expected wage growth for January and some profit-taking, but they accelerated on technical factors related to speculations on low volatility. This trade worked in 2017, but had become so large and widespread that it only took a small increase in volatility to revert to a loss position, forcing speculators to reverse course and sell.

With trade issues and uncertainties taking over for front page news, we are in a different place now. Starting with tariffs proposed by the U.S. against mostly friendly trading partners, attention quickly pivoted to China. A trade dispute would more accurately describe what we have seen so far rather than war, although the latter is still possible. The initial proposed tariffs on $50b in Chinese imports were met with a similar response on U.S. exports to China. However, actually implementing such tariffs will take time and negotiations between the countries has already begun.

Investors will likely remain on edge until signs emerge that China and the U.S. are checking their worst impulses in favor of long-term, mutually beneficial arrangements. In the meantime, we are focusing on economic fundamentals to guide our decisions.

Earnings results from Q4'17 in our portfolio companies tell us the consumer remains ready and willing to spend. Retailers making the right investments are seeing success and changing the narrative of Amazon as a category killer. This explains the positive returns in Consumer Discretionary being driven by a small, but growing, group of retailers despite subdued consumer activity in January and February.

Consumer Staples fared differently. Dividend-favoring investors left as interest rates rose and offered more competitive options, part of which was offset by the desire for safety amid tough trade talk at quarter end. Staples also face higher input costs without the ability to pass those costs along to consumers. Such sector divergence underscores the narrowing base of equity names driving the market. No longer can investors widely scatter funds in hopes of doing well. It is crucial to know what you own, and more important to know why.

With flat-to-down equity valuations and growing earnings, price/earnings ratios are pushing back towards 16x, a level last seen in 2015. The most appealing companies will be those that grow their earnings by first increasing their revenues. This may seem like a time of tension as the trade clouds circle, but for long-term investors like us, we view it as an opportunity to pick up great companies at attractive prices.

Earnings are expected to grow 8-10% organically and 15- 20% including tax benefits for 2018

Trade conflicts have temporarily commanded the attention of investors, taking the momentum from earnings for now.

Economic fundamentals remain sound

We still look for equity returns of 8-12% in U.S. markets and 10-15% in international markets

Accelerated rate increases from the FOMC are a risk for equity prices

Sector	Weight (S&P 500)	Q1 returns
Technology	23.8	3.5
Financials	14.8	-1.0
Health Care	13.8	-1.2
Cons Disc	12.2	3.1
Industrials	10.3	-1.5
Cons Staples	8.2	-7.1
Energy	6.1	-5.9
Materials	3.0	-5.5
Real Estate	2.9	-5.0
Utilities	2.9	-3.3
Telecom	2.1	-7.5