

# Economic and Market Overview

First Quarter 2018



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## The Economy

The global economic environment continues to benefit from a rebound in demand and generally accommodative monetary policies. The US economy continued on its upward trajectory, with overall growth and employment posting solid gains. The Bureau of Economic Analysis reported its third estimate of fourth quarter 2017 gross domestic product (GDP) of 2.9%, up slightly from the prior estimate.

The Eurozone economy grew at a 2.7% annual rate in the fourth quarter, well above trend. Growth in the region has been driven by ultra-accommodative monetary policy, a firming labor market, and robust domestic demand.

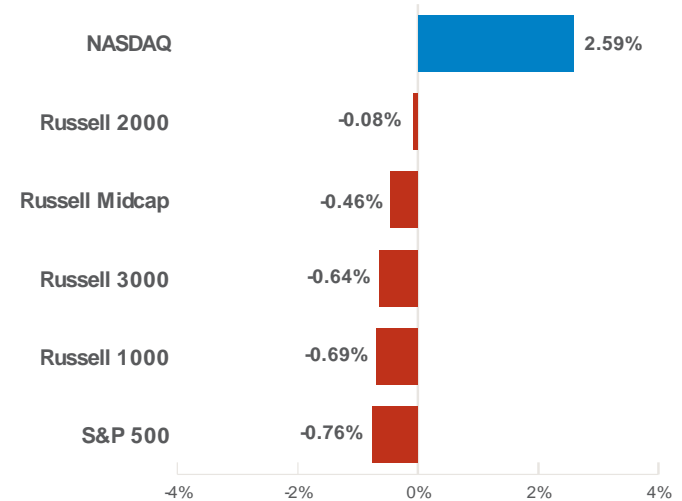
In Asian markets, Japan is expected to maintain its strong momentum into 2018, driven in part by revived external demand. China continued its strong growth from 2017 and experienced its first year-over-year acceleration since 2010. The country's 6.8% fourth quarter annualized GDP growth was higher than the 6.5% target, even as policymakers are implementing deleveraging designed to limit debt-driven growth.

## Highlights and Perspectives

### CONSUMER ACTIVITY

Consumer spending slowed during the quarter but was offset by an increase in inventories. Inflation began to tick higher in the quarter, with the personal consumption expenditures (PCE) index of prices rising 1.5%, following a 0.3% advance in the prior quarter. Corporate profits rose 4.3% (not annualized) during the quarter. Economists are generally of the opinion that with the US economy nearing full employment, wage pressure should begin to pick up.

**Broad Market Index Returns**  
First Quarter 1Q18



Source: Morningstar, Inc.

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## HOUSING

The housing segment remains robust, and analysts continue to have a positive outlook for 2018. Existing home sales for February (the latest monthly data available) grew at an annualized rate of 5.5 million units, an increase of about 3% from January, and up about 11% from 2017 levels. The NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 70, slightly lower than the previous month. Nevertheless, analysts cite strong homebuilder confidence in maintaining a positive outlook for housing over the coming months.

## EMPLOYMENT

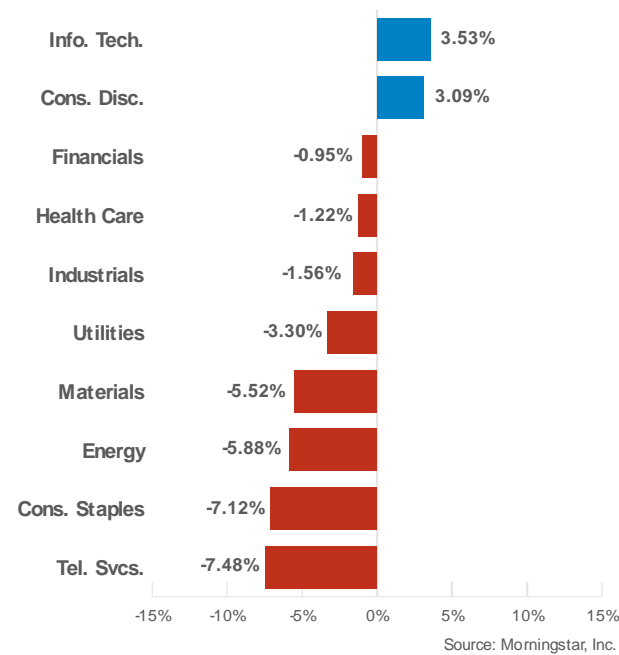
The employment situation continued to be very robust in February. Employers added 313,000 jobs during the month, far exceeding the consensus expectations of 200,000 new jobs, and outpacing the prior month's gain of 239,000. The three-month moving average also jumped, coming in at 242,000. The unemployment rate in February remained at 4.1%, unchanged since October 2017. Average hourly earnings increased by a modest 0.1% in the month, with expectations that wages will rise in coming months.

## FEDERAL RESERVE POLICY

The FOMC ended its recent March meeting by announcing an increase of 25 basis points in the federal funds rate target from 1.50% to 1.75%. While the rate increase was expected, the FOMC also revised upward its economic and interest rate projections. The FOMC increased its GDP growth estimate for 2018 from 2.5% to 2.7%, and also expects growth to be 2.4% in 2019, higher than its previous estimate of 2.1%. Subsequently, the new Federal Reserve (Fed) Chairman Jay Powell expects to raise short-term rates at least three more times in 2018.

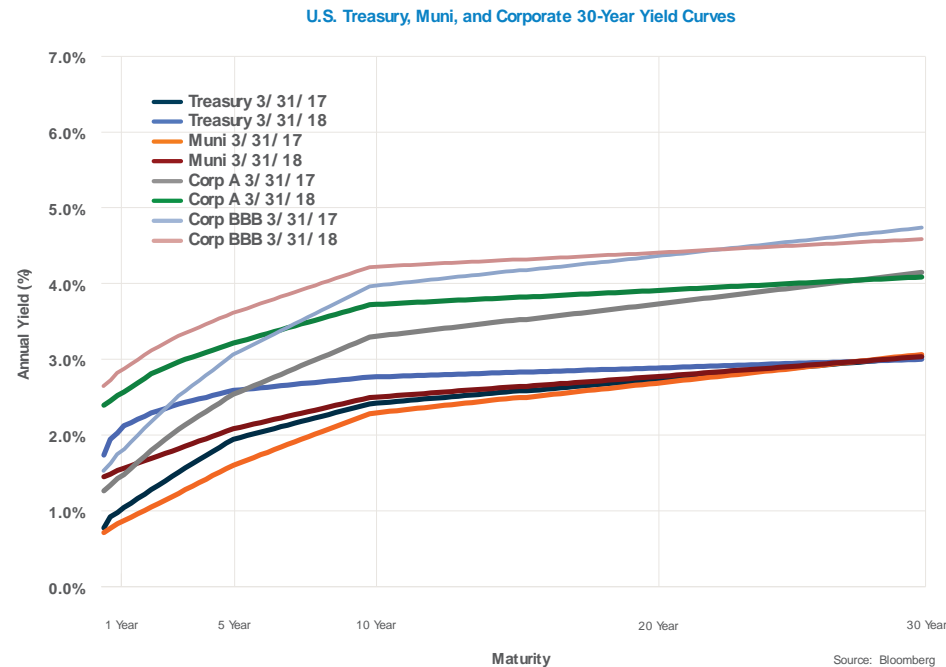
## U.S. Equity Market Returns by Major Sector

(GICS Sectors in S&P 500, First Quarter 1Q18)



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## FIXED INCOME

The trend in yields was higher throughout the quarter, and not very volatile. At the shortest end of the yield curve (up to one year) rates were generally about 30 to 40 basis points higher than in September, while those on the longer end were higher by about 20 basis points. The yield on the 3-month Treasury Bill settled at 1.71% at the end of the quarter, up about 33 basis points from the end of the previous quarter, while the yield on the 5-year Treasury Note ended the quarter at 2.56%. At the same time, the yield on the 30-year Treasury Bond was slightly higher, ending the period at 2.98%, compared to its beginning level of 2.74%. Inflation expectations rose modestly, with the Fed's gauge of five-year forward inflation expectations rising from 1.96% on December 31<sup>st</sup> to 2.18% at the end of the first quarter.

Fixed income securities generated mostly negative total returns across the various market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index declined 1.3% for the quarter. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index fell by 2.4% during the three months. High

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yield securities, which often follow the performance of equities, posted a modest negative return of -0.9%. Municipals were also lower, as the Bloomberg Barclays Municipal Bond Index eased by 1.1% during the quarter. Prices of non-US fixed income securities were higher in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index advanced 3.6%. Emerging markets bonds suffered, with the JPM EMBI Global Index declining by 1.8%.

## DOMESTIC EQUITIES

Equity markets began the year on a strong note, rising 5.7% in January, but encountered volatility in February, from which it never fully recovered. The volatility and pullback were not unexpected, as broad indices had generated consistent gains in a low-volatility environment throughout 2017 and were perhaps overdue for profit-taking. The Chicago Board Options Exchange Volatility Index—better known as VIX—spiked as high as 50 in February before settling at more typical levels of 15-20. Against this backdrop, the S&P 500 Index and Russell 1000 Value indices finished the quarter with a loss of 0.8% and 2.8%, respectively. The negative quarterly return was only the second in the S&P 500 Index's past five years.

The ten primary economic sectors delivered generally negative performance during the quarter. Information Technology, Consumer Discretionary, and Financials were the strongest performers on a relative basis, generating returns of 3.5%, 3.1%, and -1.0%, respectively. The Telecommunications Services, Consumer Staples, and Energy sectors were the poorest relative performers, posting returns of -7.5%, -7.1%, and -5.9%, respectively.

The Russell 1000 Index of large capitalization stocks generated a -0.7% total return. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, slightly outperformed large caps, and finished the quarter with a total return of -0.1%. Small cap growth outperformed small cap value. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of 2.6%. The Dow Jones Industrial Average of 30 large industrial companies declined 2.0%.

## INTERNATIONAL EQUITIES

International stocks performed reasonably well on a relative basis, generally outpacing US equities. As in the prior quarter, European economies continue to accelerate, as domestic demand has picked up and monetary policy has remained extremely accommodative. China continues to deleverage its economy, though has recently posted strong economic growth. With that as a backdrop, international stock indices were mixed. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, declined -1.2%. The MSCI EAFE Index of developed markets stocks fell by 1.5%. Regional performance also was varied for the quarter. Latin America was the strongest

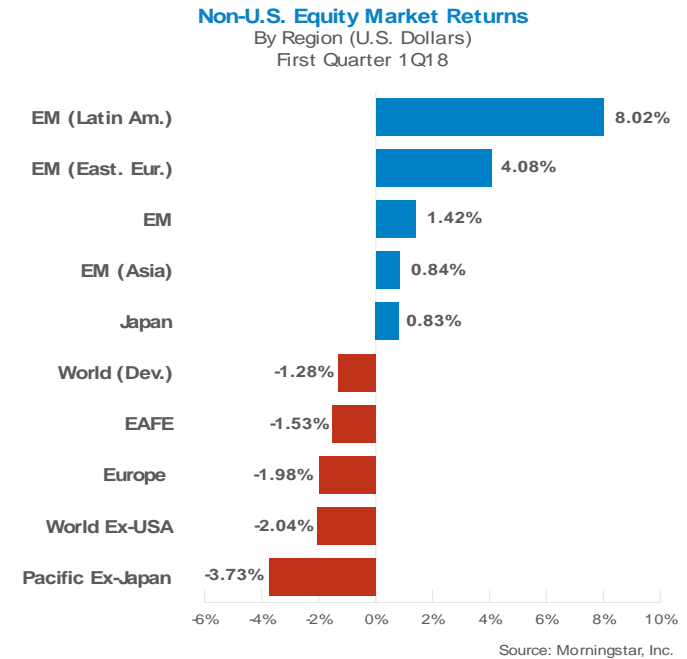
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performer on a relative basis, with a return of 8.0%. China also generated positive returns, with a gain of 1.8%. The Pacific ex-Japan region was the poorest performer, declining 3.7%. Emerging markets performance was modestly higher, as the MSCI Emerging Markets Index gained 1.4%.

## Outlook

The tax cuts enacted in December—which amount to \$1.5 trillion over 10 years—are only now beginning to flow through the economy, and the recent omnibus spending bill will likely add even more stimulus that will be felt over the next few months. Economists expect this stimulus to result in GDP growth of more than 3% this summer, job growth of 200,000 per month, and an unemployment rate declining to near 3%. Although welcomed, such growth historically has not been sustainable for very long. Overall, however, the economy is still growing at an accelerated rate, and is likely to do so for the next several quarters. The risks to the positive economic outlook continue to include the potential for monetary policy missteps by the Fed, specifically, allowing inflation to rise too rapidly. Most analysts also expect the volatility that has defined the market so far this year to continue throughout the year.



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## INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (the Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market, and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization-index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging markets country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across four emerging markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the Index are weighted according to the market size of each bond type. Most US-traded investment-grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The Index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate

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bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between five and ten years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the Index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes Treasury bonds issued by the US with a time to maturity of at least five years, but no more than seven years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1,000 largest US companies in the Russell 3000 Index (which comprises the 3,000 largest U.S. companies). The **Russell 2000 Index** is an unmanaged index considered representative of small cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market, and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities, based on a combination of their market cap and current index membership. The **Housing Market Index (HMI)** is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least \$500 million. The **Chicago Board Options Exchange Volatility Index (VIX)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The **MSCI Japan Index** is designed to measure the performance of the large and mid cap segments of the Japanese market. With 321 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

## DEFINITIONS

The **Federal Open Market Committee (FOMC)** is the monetary policymaking body of the Federal Reserve System. The **Federal Funds Rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank (ECB)** is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics (BLS)** is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis (BEA)** is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measurement of goods and services targeted towards individuals and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor's and MSCI Barra.