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Market Review
First Quarter 2018

The first quarter of 2018 marked the reemergence of volatility in equity markets.

The year started on the heels of the passage of the Tax Cuts and Jobs Act, which ensured accelerating earnings growth and drove a sharp, broad-based January rally. The surprise, however, was that the strength of the advance first stretched and then snapped a very crowded "short volatility" trade. The result of the unwind was a hard spike in the VIX (implied volatility index) in the first week of February, and an equally sudden swoon in large and small cap stocks. Caution has pervaded since the late January break.

When all was said and done, the S&P 500 index gained 7.5% in the first four weeks of the year, but ended the quarter down -0.8%. The Russell 2000 index followed a similar, but less pronounced path and returned 4.7% and -0.1% over the same time frames. It was the first negative quarter for the large cap benchmark since 2015.

The initial jolt completely unnerved markets in the height of bullish optimism. It also reignited the discussion about well understood, but long ignored risks for stocks and bonds that suddenly felt relevant again.

First of all, there was increased focus on the potential for rising inflation, which in combination with a new Fed Chair, caused a backup in long duration bond yields. This challenged investors to rethink both the duration of the expansion and their valuation assumptions and frameworks.

In addition, there was increasing attention on, and consternation about, the Trump administration's protectionist trade policies and tact. While the initial focus was on NAFTA, it didn't take long for the narrative to pivot squarely on China, which felt more ominous and disruptive to global business and markets. The trade actions escalated quickly from solar panels and washers to a much broader product list that could affect over $50 billion of imports.

The final jolt to the market, however, was the most unexpected as the FANG stocks came under pressure in the last few weeks of the quarter. The sell-off started with Facebook in response to a data privacy scandal, and expanded to Google amid concerns about both platforms' advertising efficacy. In the last week of March, the President criticized Amazon's influence, business practices, and tax policy through a series of tweets that created further dislocation for the group.

At this juncture, the obvious question is whether the heightened risk aversion portends the beginning of the end of the extended bull market, or if this was a dry run for all the different factors that could derail the positive momentum.

Because earnings are strong and the economy conducive to business growth, our take is that it is premature to write-off the bull. We also don't believe that investors are ready to abandon the FANG leadership. It is easy to envision a scenario in which a calming in trade rhetoric and tensions catalyzes an extended market advance. That said, we are in the tenth year of a bull market that has produced high double-digit annualized gains in its first nine years. Valuations are stretched, uncertainty abounds - the catalyst for a significant market decline is most often seen only in hindsight.

The higher conviction call is that it is highly likely that the increase in volatility in equities is here to stay. After successfully implementing tax reform, it is clear that we have moved to a much more contentious phase of the Trump administration's economic agenda. The Federal Reserve, under the guidance of a new Chair, has a more difficult balancing act now than in the past. The risks are exacerbated because it is hard to differentiate between the President's policy and posturing, which can change the outlook for companies and industries abruptly.

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Sources: *FactSet, Credit Suisse, GICS Sector Classification*

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S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

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Index Definition Sources: *Standard & Poor's; Russell Investments*

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