FIRST QUARTER 2018 MARKET COMMENTARY
April 2018

STATE OF THE MARKETS

Equities started the year with a continuation of the strong rally that closed out 2017. After January ended, however, the equity markets suddenly became much more volatile, with 28 days of greater than 1% moves in the S&P 500 for the quarter. As we highlighted in our client letter in February and discuss below, equities experienced a long overdue correction due to market concerns over inflation, interest rates, and uncertainty surrounding U.S. trade policy. The RDM Composite of value equity stocks was not immune from the correction impacting most of the market and value strategies in particular. For the quarter, the RDM Composite declined about 3%, consistent with the Russell 1000 value index, although our composite remains up over 3% for the prior 12 months.

In the coming months, we feel that earnings quality will be paramount as declining monetary policy stimulus and strong corporate earnings growth cause investors to focus more on earnings out-performers and less on broad equity speculation. As a result, we continue to believe that value equity strategies emphasizing businesses with strong fundamental earnings growth will rebound as the year progresses. While we clearly are in the second half of the economic cycle, we believe that cyclical sectors, such as financials and industrials, will outperform over the short-to-medium term, and have added to these sectors in recent months. We also used the recent pullback in the technology sector to add to tech names in our portfolio that are trading at a reasonable valuation. We have largely avoided the defensive sectors, such as consumer staples and utilities, except for clients who need exposure to these sectors for income or diversification.

We continue to underweight most fixed income investments, especially those with high interest rate sensitivity, considering the likelihood of rising rates. While the traditional 60/40 equity/fixed income allocation may have made sense in prior decades for pre-retirement investors, that allocation is unlikely to outperform a more equity-weighted allocation in the coming years. For our clients who need income, we have favored fixed income alternatives, such as high dividend paying stocks, as well as short duration fixed income, but we are cautious about making a significant asset allocation to interest rate-sensitive investments. We believe that even our clients who need income have benefitted recently from a smaller fixed income allocation and will continue to do so going forward.

Going into the Second Quarter, we do not foresee an end to the recent volatility, but we are optimistic that equities will begin to trend higher as first quarter corporate earnings results are reported. First quarter earnings should generally be strong on a year-over-year basis, as earnings slowly begin to show the impact of corporate tax cuts and worldwide economic growth. As we discuss below, we suspect the fear of imminent trade wars will decline as the administration's recent threats of tariffs fade amid more substantive trade negotiations.

Nevertheless, we are watching for signs that the bull market is ending due to the beginning of a recessionary economic cycle. While there's always a chance an unpredictable financial shock will suddenly end the bull market, bull markets tend to end due to the onset of a recession. Thus, our investment decisions are based on our view of the fundamental economic factors that have predicted most recessions, including declining corporate earnings, excessive stock valuations, rapidly rising inflation, and a flattening of the yield curve. Based on these factors, we believe the inevitable next recessionary period is unlikely to occur over the short term.

Review of the First Quarter

Uptick in Market Volatility Due to Inflation and Trade Fears

Equity markets experienced a sudden return to volatility in February after a historically long period of low volatility. The volatility was largely caused by the following market concerns:

1. Inflation. A slight uptick in inflation data in February suggested to some that the Federal Reserve may need to raise interest rates faster than previously assumed, which could stall economic momentum. In a classic case of good news is bad news for the market, the market perceived modest wage growth and full employment as signs that inflation may rise faster than expected, and the Fed then would need to more quickly to raise interest rates to avoid the economy overheating. However, low inflation has been a concern for years, as sustainably moderate inflation is one of the Fed's mandates, and has been elusive throughout the economic recovery. For reasons we have discussed in prior market letters, we don't see some of the structural impediments to higher inflation changing quickly. Further, as new Fed Chair Jerome Powell noted in his recent remarks before Congress, peripheral employment data, such as productivity, participation, and underemployment, has not been as strong as the headline unemployment number, suggesting that more progress can be made on the employment front without causing inflation to accelerate too quickly. As a consequence, we do not see signs that inflation is rising rapidly and believe the Fed will continue its slow and steady pace of raising rates.

2. Changes in Monetary Policy. In March, the market again focused on the path of interest rates as Fed Chair Powell oversaw his first Fed meeting. The market was wary of any signs that Powell would take a more hawkish tone on the path of interest rates than his predecessor Janet Yellen. Ultimately, as expected, the Fed raised the benchmark Fed Funds rate by 0.25% while maintaining the 2018 projection of three total interest rate hikes. The Fed governors did increase the projected number of rate increases for 2019 and 2020 by one additional hike each year, which was viewed by the markets as somewhat hawkish. However, there were no indications that a rapid increase in rates is imminent, notwithstanding the chance that the Fed may raise rates an additional 0.25% more than expected in 2018.

3. Trade Uncertainty. After recovering from the inflation and interest rate scare in February and early March, the market again weakened on the heels of President Trump's announcement of tariffs on imported steel and aluminum along with approximately $60 billion in trade tariffs directed at China. The consensus Wall Street view is that protectionist trade policy is a net negative for U.S. businesses and equities, despite the benefits that certain protected industries might realize. As a result, equities performed poorly in response to each tariff-related headline.

   By the end of the first quarter, the threatened trade measures had not been enacted in an extreme fashion – many key trade partners, such as Canada and the EU, were exempted from the steel and aluminum tariff and the China trade tariffs have not been finalized. We suspect that the administration is using the threat of tariffs as an opening parry to open trade negotiations with China and others. If that is not the case, no one can predict the full effect of a series of retaliatory trade actions until they are proposed with specificity, and even then, it is unclear the extent to which the trade war could evolve over time.

However, history demonstrates that overly protectionist trade policies generally stifle economic growth, with artificial price increases helping small segments of the domestic economy at the expense of the overall economy. The cost of a tariff typically gets passed on to consumers and, simultaneously, our trade partners will reciprocate with protectionist policies of their own. The combination of these actions ultimately raises the cost of goods for American consumers while also making exported American goods more expensive to foreign consumers as well. As a result, protectionist trade policies have not been vigorously pursued by most presidential administrations since the 1930s under Herbert Hoover, largely because the 1930 Smoot-Harley Act tariff of 50% on imported goods accompanied, and may have exacerbated, the Great Depression. Since then, global free trade has proliferated, changing our economy from a producer of certain basic goods to an importer of those goods from nations with a comparative advantage in manufacturing production.

The most recent example of similar trade tariffs occurred in 2002, when the Bush administration pursued steel tariffs to punish China for unfair trade practices. This is most directly instructive to the current tariff proposals because it highlights that the U.S. economy today is much more dependent on steel as a consumer than a producer. One study showed that the 2002 tariffs led to approximately 200,000 lost American jobs due to higher steel prices, largely in machinery and equipment manufacturing businesses that rely on steel for production, whereas the entire steel industry at the time *employed* less than 200,000 Americans (it is approximately 150,000 workers today). Additionally, other countries instituted their own retaliatory tariffs on steel and aluminum in response.

To summarize, trade uncertainty is coming at a bad time for the equity markets because tariffs could raise prices and undermine economic growth at the same time that inflation is accelerating due to tax reform and government spending. To the extent that the tariff threats are diluted prior to enactment or serve as an opening for further trade negotiations and better trade deals, equities will recover lost ground. In the meantime, we expect that the uncertainty will contribute to ongoing volatility in equities.

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