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Investment Commentary

1st Quarter 2018

Below you will find our investment commentary for the most recent quarter. We hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call our office to schedule a meeting or conference call.

Economic Review & Outlook

According to the most recent Wall Street Journal economic forecasting survey of 60 economists, the economy appears to be on solid footing as 2018 commences. The average forecast for Q1 GDP growth currently stands at 2.5% and is expected to strengthen to 3.2% in Q2 and 3.1% in Q3. Tax cuts are the most often cited catalyst that will drive this growth rate higher throughout 2018. It is pretty difficult to argue with this forecast given the optimism most publicly traded companies have been guiding analysts towards this year. Further evidence of an improving economy comes in the form of the unemployment rate which has dropped to 4.1% from 4.7% a year ago. Perhaps even more important is the employment to population ratio has risen from 60.0% to 60.4% over the past year. The method which the government uses to calculate different measures of employment have statistical nuances that can make the data confusing. The employment to population ratio is the simplest of these calculations, thus seeing it grow over the past year gives us tremendous confidence the labor market is truly improving, and it isn't simply a government aberration due to adjustments that plague other employment related statistics.

The chart to the right illustrates the amount of interest the U.S. government is paying on its various forms of debt as a percentage of GDP. You will notice it peaked around 1990. At first blush you might think this is what you would expect given the sharp drop in interest rates over the past 30 years. However, when you look at the total government debt outstanding in 1990 of $3.2 trillion compared to the nearly $21 trillion today, it seems unfathomable it could be this much lower. Obviously, GDP has grown sharply since 1990, but what this chart illustrates is the government's ability to stimulate the economy with debt over the past 30 years has come at relatively little cost in terms of interest. This has been a huge tailwind for the economy. With the Federal Reserve having raised interest rates 1.5% over the past two years and expectations for another 1% over the next year or two, the low interest rate nirvana we have been in may become a distant memory in short order. This is not something that should be taken lightly as refinancing the $21 trillion in debt and climbing could become problematic at higher interest rates. The Federal Reserve has their work cut out for them to normalize interest rates over the next year without causing a material drop in economic activity given the obvious dependence the U.S. economy has on low cost debt. Adjusting this cautiously will be of paramount importance, which is why we still expect interest rates to rise at a "glacial" speed. Fortunately, inflationary pressures have not manifested themselves yet, giving the Federal Reserve a long runway to normalize monetary policy.

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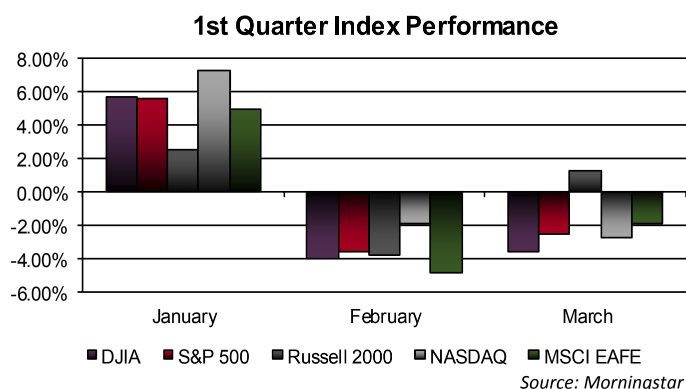
Bond Market Review & Outlook

Bond returns have been lackluster this year as interest rates have continued their upward momentum. The benchmark 10 Year U.S. Treasury Bond began 2018 with a yield of 2.4% and closed the first quarter at 2.7%. This resulted in core bonds, as measured by the Barclays Aggregate Bond Index, losing 1.5% in the first quarter. Although losing money is never the goal of an investment, we want to continue to put this into perspective given all the misinformation in the financial media over how bonds react to interest rates. A rise of 0.4% over a three-month period is a sharp increase in a short period of time given how low interest rates are. We do not expect this to happen often over the next couple of years given our expectation of a "glacial" rise in interest rates. The economy is so heavily leveraged with debt that a quick rise in interest rates will have a negative impact much quicker than it has in the past, which should help keep a lid on interest rates. Nearly every recession throughout history has been at least indirectly triggered by higher interest rates and we don't expect the next recession to be any different. Let that last statement sink in. Yes, we will have another recession at some point in the future and when it occurs there is an extremely high probability that interest rates will fall during that period. This is one of the self-correcting features of capitalism. Hence, the outlook for bonds remains little changed from previous years, suggesting they will underperform stocks during economic expansions and outperform during recessions. This is their function in a well-diversified portfolio and we find no reason to believe this won't hold true again when, not if, the next recession occurs.

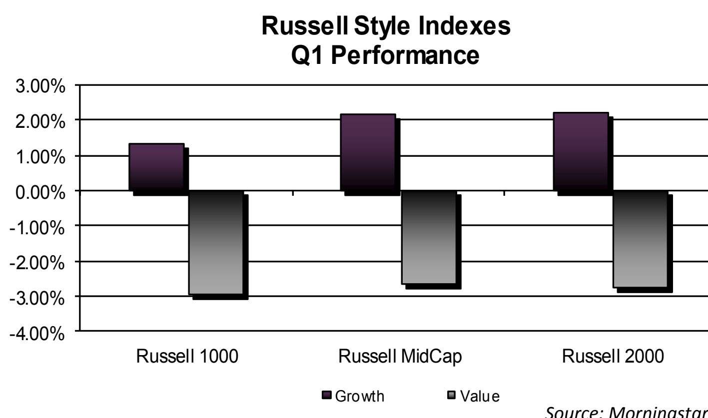
Stock Market Review & Outlook

Just when you thought stocks would never fall again, reality sinks in. After bolting out of the gate in January, stocks did an about face in February and continued their decline in March as you can see from the chart to the right. It has been quite a while since investors have experienced losses lasting more than a couple weeks, but that is exactly what happened in the first quarter of 2018. The major broad market indexes suffered losses in the first quarter of 2018, with the flagship S&P 500 losing 0.8%. There really was nowhere to hide as small caps and international stocks both suffered similar losses.



To suggest this pullback was overdue may be one of the biggest understatements in history. Prior to the drop in February, the S&P 500 had delivered a positive return every month for the last fifteen straight months. This led many investors to become increasingly emboldened to take more and more risk with their investments, assuming the good times would roll on indefinitely. Of course, as we all will be reminded of time and time again, the stock market usually finds a way to humble us all. Fortunately, we have several strategies in place to prevent us from falling victim to these common behavioral mistakes. First, we rebalanced our portfolios twice in the first quarter, a feat that has never occurred in our company's history. This was done after the stock market rose 50% from its January 2016 low and then less than a month later fell 10% from its 2018 high. Second, we reviewed our managed stock accounts to trim positions that had increased well above the initial desired investment we had made. Most of these changes were made in qualified plans, resulting in no adverse tax ramifications, however, some of these adjustments did result in taxable events for those with after tax investment accounts. While paying taxes is never fun, we would like to stress that paying taxes on long term capital gains is a good thing, assuming of course you like to make money. With so many portfolio managers and investment advisors entering this business within the last ten years, many investment professionals today never experienced the pain investors went through during the 2008 financial crisis, or the 2000-2002 dot.com crash. Fortunately, your confidence in us has provided you with a team of investment professionals who experienced both periods firsthand and remember them vividly. The primary lesson that should have been learned is to always focus on risk management. Accordingly, a disciplined rebalancing approach as we outlined above is crucial to a successful long-term investment strategy during periods like these.

Growth stocks continued to dominate value stocks in all market capitalizations as you can see from the Russell Style Index chart. Value sectors tend to be more interest rate sensitive, thus the rise in yields was detrimental to their performance. Despite elevated valuations, investors clearly remain willing to pay significantly higher multiples for faster growing companies. This has created one of the largest valuation discrepancies in history when comparing growth and value stocks. Accordingly, we remain comfortable maintaining a slight bias towards value stocks, which appear to offer more attractive risk adjusted investment opportunities.



Source: Morningstar

Over the last couple of years, low cost passive investments have become all the rage. The flagship for this movement has been the broad-based S&P 500 which tracks 500 of the largest U.S. based companies. The catalyst for its rise in popularity is the fact most portfolio managers have had a very difficult time outperforming it. The evidence of this underperformance is indisputable, causing many investors to focus their entire portfolio solely on passive investments. While we certainly wouldn't condemn this approach as history does suggest it has led to better long-term results than a fully actively managed portfolio, we are concerned investors who have embarked on this path may not be prepared for what lies ahead. By allocating your entire portfolio to passive investments you are guaranteed to capture 100% of both the upside and downside of the index. Although the past couple of years may have made this decision easy to tolerate, if we are moving into a new era of increased volatility and lower returns, a higher level of risk tolerance may become necessary to stick with this strategy during the next downturn. Our fear is the last couple of years may have lulled investors into a false sense of security, assuming the S&P 500 was a low risk investment. This couldn't be further from the truth.

Since the postwar era, there have been 27 corrections of between 10% and 20%, with the average recovery time taking four months. There have been eight bear markets, defined as a 20% or greater decline, over the same period of time. The average recovery has taken fourteen months. Investors must accept the fact the fifteen consecutive positive months the S&P 500 delivered from November of 2016 through January of 2018 was **not** normal. As difficult as it may be to hear, the performance thus far in 2018 **is** normal. During times like these we are all reminded why investing in the stock market involves risk and past performance is no guarantee of future results. Bull markets can make us fail to heed these warnings from time to time. Recognizing that these negative return environments are part of investing is what long term investors must be willing to tolerate if they wish to achieve higher returns.

Another common warning investors should be reminded of is, ***you can't time the market***. What this really means is if you want to benefit from the long term upward trend stocks have historically demonstrated, you must be willing to watch your portfolio decline when the inevitable corrections and bear markets occur. The evidence is overwhelming that those who try to outsmart the market by assuming they can avoid the downturns end up worse off than if they had simply made no changes at all. Therefore, our advice is to maintain your current investment strategy designed specifically for your risk tolerance. We will not waver on this recommendation regardless of how long this correction lasts, or even if it turns into a bear market. Long term wealth is created by having an extended period of time in the market, not timing the market.

Sincerely yours,

McGill Advisors

Wealth Management Team
McGill Advisors