JOHN D. DOVICH & ASSOCIATES, LLC

Market Update — First Quarter 2018

First Quarter 2018 Review

Stocks started the year on a strong note, rallying to all-time highs in January, but entered a correction phase in February. As seen in the table below, both stock and bond indices posted losses in the first three months of 2018. This is the first quarter since the September 2015 quarter in which the S&P 500 posted a loss. Emerging market stocks were the winner during the quarter with a gain of 1.42%. Bonds posted a loss of 1.46% during the quarter, the first quarterly loss since the December 2016 quarter.

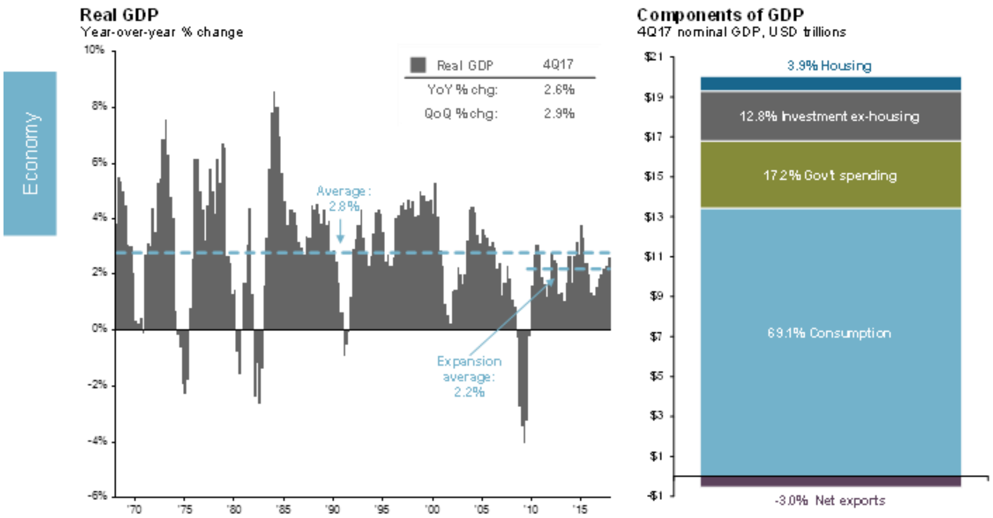
Index (Total Returns)	1st Qtr 3/31
S&P 500 (large cap US stocks)	-0.76%
Russell Mid Cap	-0.46%
Russell 2000 (small cap US stocks)	-0.08%
MSCI EAFE (large cap foreign)	-1.53%
MSCI Emerging Markets	1.42%
MSCI ACWI All Cap (global stocks)	-0.88%
Barclays US Aggregate Bond	-1.46%

Market volatility returned to the financial markets in the first quarter. Last year, the S&P 500 had no days with more than a +/- 2% return. In the first quarter of this year, we experienced six days exceeding a 2% move in the market, with one day exhibiting a gain of greater than 2% and five days with more than a 2% loss. To amplify this a bit further, in 2017, there were only 10 out of 251 trading days where the S&P 500 moved more than +/- 1%. During the first quarter, there were 23 out of 61 trading days with a +/- 1% return. Yes, volatility has returned to the markets after low volatility in 2017.

The January Bureau of Labor Statistics report triggered weakness in both stocks and bonds in early February. This report hinted that inflation may be returning to the economy as average annual earnings increased 2.9% year-over-year. Rising inflation sparked fears that the Federal Reserve may need to become more aggressive in raising interest rates. Other factors contributing to a weak first quarter included concerns regarding the Trump administration announcing tariffs and a sharp selloff in social media stocks related to the controversy with how Facebook handled its user data. After a very strong 2017, it is not surprising the markets are pausing to digest these gains.

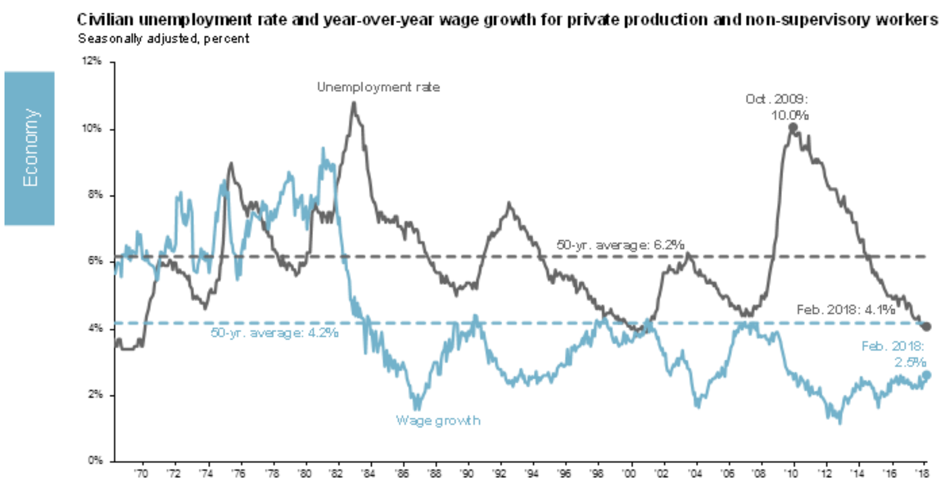
Economy

Economic growth remained solid as the U.S. economy entered its ninth year of expansion. In the chart below, the average annual GDP growth over the current expansion has been 2.2%. This is expected to accelerate to nearly 3% GDP growth in 2018, which remains well below historical recoveries. Fiscal stimulus in the form of tax cuts and government spending should facilitate this increased growth for 2018 and into early 2019.



Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of March 31, 2018.

The strengthening U.S. economy is contributing to a continued decline in the unemployment rate and gradually rising wage growth. As you can see in the chart on the next page, we are at the lowest levels of unemployment in 18 years. In past economic expansions with low unemployment rates, wage growth accelerated to 4%. The last three months of labor data show annual growth rates for wages of 2.9%, 2.6% and 2.7% for January, February and March, respectively. As the year progresses, we expect to see a further drop in the unemployment rate and continued firming in wage inflation. However, wage growth remains shy of a 3% annual growth rate.



Source: BLS, FactSet, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of March 31, 2018.

The global economic picture remains strong as well. While economies around the world are at various stages of the economic growth cycle, all regions are showing solid growth. In other words, there is no recession in sight for the U.S. and other major developed international markets.

Geopolitics

As of this writing, policy risks are more elevated after the White House's $50 billion tariff announcement was followed quickly by a $50 billion tariff response from China. The White House announced an additional $100 billion in tariffs a few days later. China has responded that they will not hesitate with a 'major response' to new tariffs. This has contributed to continued volatility in the financial markets early in the second quarter. Outside the White House, there are few business, economic, and investment professionals that believe initiating a trade war is a sound strategy. Make no mistake, China has abused our trading relationship for many years. However, business leaders (small and large) are concerned about this increasingly protectionist approach. While this may be a negotiating tactic, we are concerned this negotiating strategy may damage business confidence if trade discussions lead to a more significant trade war. Creating uncertainty with our trading partners is currently throwing cold water on the euphoria from corporate tax cuts. While business confidence has not yet suffered, uncertainty may eventually take a toll on future business confidence and conditions.

Another risk factor is the NAFTA (North American Free Trade Agreement) negotiations. This is a 24-year old trade agreement between the US, Canada and Mexico. There have been a number of negotiations since President Trump took office. President Trump has often characterized this agreement as "the worst trade deal in history." There is a significant amount of uncertainty about how this agreement will be renegotiated.

We hope these trading issues will be resolved with a satisfactory agreement among our trading partners. However, we expect to see a continued rocky path with these negotiations, which may create additional market volatility.

The Federal Reserve

As we have cited in the past, the Federal Reserve has been a powerful influence in the overall direction of the economy. In past economic cycles, the Fed has been too aggressive in raising interest rates when GDP and wage growth accelerated too quickly, which led to previous recessions. The Fed has raised interest rates six times by 0.25% each in the current rate hike cycle that began in late 2015. This has been a slow and steady pace the financial markets have accepted. The Fed is expected to raise rates another two or three times in 2018 depending on economic data. The Fed remains in a policy normalization phase for both interest rates and its balance sheet, which remains bloated from its previous quantitative easing programs.

The result of all these actions is that we expect to see both short-term and long-term interest rates gradually rise. As we have noted in previous commentaries, we expect moderate bond returns in the future. If there is no unexpected data that would force the Fed to increase rates faster, like higher than expected GDP and/or wage growth, the measured approach the Fed is taking with rate increases should not upset the financial markets.

Conclusion

While a moderate loss in the first quarter was disappointing, it followed an exceptionally strong year in 2017. The prospects of strong economic growth from fiscal stimulus may be counterbalanced by rising interest rates and global trade risks. Valuations in the stock market are reasonable and provide an opportunity for solid returns ahead, despite the possibility of continued volatility.

All of us at John D. Dovich & Associates, LLC thank you for the opportunity to serve you and your family. We welcome the occasion to discuss any financial related issues you may have and look forward to speaking with you soon.

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Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

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