PARTNERVEST

First Quarter 2018 Commentary

April 11, 2018

Dear Investor,

The first quarter of 2018 brought to bear a market tempest worthy in power of the stock rally that preceded it. A complex of forces – political and fiscal risk, a perceived buckling of synchronized global growth and the specter of recession – defied still-solid market and economic fundamentals. Frank appraisals from new Federal Reserve Bank Chairman Jerome Powell once and for all impressed markets of the reality of policy normalization and rising borrowing costs to come. There was jarring volatility and the humbling of the same tech giants that weeks earlier had driven indices to record highs.

All of these things came to nest by the end of the first quarter - just in time for spring.

Markets:

Equity markets were defined by volatility, from the early-February hiccup that foreshadowed a full correction and the sequential sell-offs that followed - particularly among ETFs - to the punishing “Tech Wreck” at the quarter’s end. "The volatility 'tail' is once again wagging the US equities 'dog'," warned Nomura, an Asia-headquartered financial services group, in early March after the initial recovery sputtered and investors bolted “the bullish bandwagon,” as the American Association of Individual Investors (AAII) described it. By mid-March, bullish sentiment plummeted on the AAII index, falling from 37.28% down to 26.4%, the lowest weekly reading since the end of August 2017 and the largest two-week decline since June 2013.

What had been a clear investment horizon was by mid-quarter cluttered with all manner of risk, including the end of the Great Liquidity, the resignation of President Trump’s top attorney, fear of a trade war, spiking credit markets and the Facebook scandal. Market specialists responded in kind. Cantor Fitzgerald worried over the relentless ascent of LIBOR – over the last 18 months it has doubled from 1.0% - which may slow company cash flows. It also pointed out that the Trump tax cuts, though welcomed, have generally realized their expansionary effects and are baked into equity markets. At the same time, the budget resolution, which happily avoided a government shutdown, will leave as its legacy a late-cycle ballooning deficit and has chased treasury yields higher amid “sloppy” auctions for government paper. Finally, according to Cantor, the tailwind from earnings is unlikely to overcome higher cost of capital after last quarter’s bullish earnings and revenue growth, which looking forward will be difficult to beat.

3/31/2018	Economic and Market Review									
Overall	Indicator Name	Value	1 Mo. Ago			3 Mo. Ago		1 Yr. Ago		
▼	S&P 500 Total Return	5,173	5,265	▼	-1.75%	▼	-0.76%	4,538	▲	13.99%
▼	Russell 2000 Total Return Index	7,548	7,555	▼	-0.09%	▼	-0.08%	6,752	▲	11.79%
▲	MSCI EAFE Total Return	8,020	7,976	▲	0.55%	▼	-1.41%	6,954	▲	15.32%
▼	MSCI Emerging Markets Total Return	2,559	2,578	▼	-0.75%	▲	1.47%	2,041	▲	25.37%
▼	10 Year Treasury Rate	2.74%	2.86%	▼	-4.20%	▲	0.74%	2.40%	▲	14.17%
▲	Barclays US Aggregate Total Return	2,016	2,003	▲	0.66%	▼	-1.46%	1,993	▲	1.20%
▲	AMEX Dollar Index	90.03	90.0	▲	0.06%	▼	-2.46%	100.56	▼	-10.47%
▲	Euro to US Dollar Exchange Rate	1.23	1.23	▲	0.07%	▲	2.73%	1.07	▲	15.25%
▼	US Dollar to Chinese Yuan Exchange Rate	6.27	6.34	▼	-1.11%	▼	-3.59%	6.88	▼	-8.87%
▲	US Dollar to Japanese Yen Exchange Rate	106.20	105.65	▲	0.52%	▼	-5.76%	111.41	▼	-4.68%
▲	Gold Price in US Dollars	1,324	1,322	▲	0.12%	▲	2.54%	1,245	▲	6.34%
▲	WTI Crude Oil Spot Price	64.87	61.19	▲	6.01%	▲	0.08%	50.5	▲	28.35%
▲	VIX	19.97	19.59	▲	1.94%	▲	47.49%	12.37	▲	61.44%

Source: yCharts

Steen Jakobsen, Chief Investment Officer and Chief Economist of Saxo Bank, cautioned investors to embrace "capital preservation" in the face of what he forecast would be a 15% correction due to "over-inflated asset prices, over-crowded trades, anemic market liquidity and a continued decline in the credit impulse." Pointedly, he declared that assets of every class are illiquid. "If you look at the breadth of the stock market over the last couple of weeks, it's very, very, very narrow," Jakobsen wrote. "So we're all chasing the same investments." Steven Vannelli, a CFA at Knowledge Leaders Capital, admonished investors to "be alert" to disturbing similarities between the S&P 500's performance since it reached its record peak in late January and its movements after it struck record highs prior to the 1929 and 1987.

Stock markets ended the quarter with a route of tech stocks, the very sector that, as Bloomberg pointed out, powered much of the current bull market in global equities. The S&P 500 had its first quarterly loss since Q3 2015. The sell-off came as investors were already spooked by signals from the Trump administration that it may crack down on Chinese investment in US technologies for the sake of national security.

It could get worse, according to Bloomberg. The wire service reported that traders are pulling out of corporate bonds as the spreads on investment-grade paper post their widest levels in six months and yields reached their highest levels in more than six years – this, just as stock investors were digesting the first S&P 500 correction in two years. As corporate bonds have proven a leading indicator for the direction of stocks, Bloomberg cautioned, the trend may frustrate investors looking for value in equity as a late-cycle outperformer.

Bloomberg also suggested that markets are still too skittish to absorb monetary normalization. As central banks bought some $21 trillion worth of government debt globally they pushed investors to search for yield in riskier markets, creating a pyramid of trades dependent on stable interest rates. As central bankers attempt to normalize policy – at a time of historically high rates of volatility - there is a risk that carry trades in financial markets will collapse, with negative consequences for the real economy.

A trio of bond heavyweights expressed their own concern about the near-term future of bond markets. In an interview with Goldman Sachs' Senior Strategist Allison Nathan, Paul Tudor Jones argued that US inflation will accelerate sharply at the expense of bonds, which will obligate the Fed to raise interest rates to preempt financial bubbles fueled by years of easy money. Meanwhile, Bill Gross and Ray Dalio forecast yields on the 10-year will rise to 3.75 percent by year-end, a "conservative" target given signs of oversupply, faster-then-anticipated growth, and "glaring" bond valuations.

Contrarians included State Street Global Markets, which announced that its monthly index of global institutional investor confidence soared to the highest level since March 2016. The increase in confidence was driven by North America, followed by Europe and then Asia. At the same time, more than 20 Wall Street strategists participating in a Bloomberg News poll forecast the S&P 500 ending the year at 3,000, an increase of about 14 percent from its current level. That's unchanged from the February survey and up slightly from the median estimate of 2,950 in January's poll.

In spite of all this negative news, Earnings looked strong, as analysts in late February increased earnings estimates for S&P companies for the first quarter to $36.32 from $34.37, or 5.7%. Seeking Alpha credited share buybacks for the healthy numbers, noting they surged after the launch of the Trump tax cuts and are now provided crucial support for shares despite reduced demand for them generally. "Reduce demand for stocks and prices fall," it reported, "unless of course, the supply of stocks available to buy falls more - as has been the case recently."

Seeking Alpha also reported buybacks will fall dramatically once the economy starts to slow and the impact of repatriated money dissipates - as soon as early 2019.
As far as earnings go, earnings growth for Q1 2018 is expected to come in strong; in fact, Q1 could be one of the strongest quarters in years. According to recent data from FactSet, the estimated earnings growth rate for the S&P 500 is 17.3%, and if actualized, will mark the highest earnings growth since Q1 2011 (19.5%). If companies report strong earnings throughout April and on into May, we could see volatility dampen as investors are reassured about current (and future) market prices.

US Economy:

Is the longest economic expansion coming to an end? In its analysis of the "term spread" — the difference between long-term and short-term interest rates — Research Advisers for the Federal Reserve Bank of San Francisco concluded that, should the yield curve become inverted (short term rates are higher than long term rates) a recession is probable in the next two years. Currently, the curve is flattish with the probability of a recession at 11% as the gap between the ten-year and one-year Treasury yields stands at less than one percent even as the Fed phases out quantitative easing. In December, the median projection of the federal funds rate rose from 1.4% to 3.1% in 2020, even slightly overshooting its long-run projected value of 2.8%. As a result, many observers and forecasters therefore expect the term spread to shrink even further, including the possibility that it could turn negative.

3/31/2018	Economic and Market Review							
		Last Reported	1 Mo. Ago			3 Mo. Ago	1 Yr. Ago	
Overall	Indicator Name	Date	1 Mo. Ago		% Change	% Change	1 Yr. Ago	% Change
▲	US Core Inflation Rate	2/28/2018	1.82%	▲	1.44%	▲ 7.96%	2.22%	▼ -16.91%
▼	ADP Change in Nonfarm Payrolls	3/31/2018	246	▼	-2.01%	▼ -3.36%	122	▲ 97.00%
▬	US Unemployment Rate	2/28/2018	4.10%	▬	0.00%	▬ 0.00%	4.70%	▼ -12.77%
▼	US Producer Price Index: Savings Institutions	2/28/2018	95	▼	-1.06%	▼ -1.47%	94	▬ 0.00%
▼	ISM Purchasing Managers Index	3/31/2018	61	▼	-2.47%	▬ 0.00%	57	▲ 3.67%
▼	US Housing Starts	2/28/2018	1,329	▼	-7.00%	▼ -4.85%	1,288	▼ -4.04%
▲	US 30 Year Mortgage Rate	3/22/2018	4.40%	▲	1.14%	▲ 11.53%	4.14%	▲ 7.49%
▲	US Consumer Price Index	2/28/2018	249.2	▲	0.15%	▲ 0.89%	244.1	▲ 2.26%

Source: yCharts

Significantly, the Fed pointed out, every US recession in the past 60 years was preceded by an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one occasion, by a recession. The Fed conceded that the current environment is unique given low interest rates and risk premiums but concluded, "the power of the term spread to predict economic slowdowns appears intact."

Other analysts, including Guggenheim Global, Seeking Alpha and blogger Mike Shedlock, have implied or forecast recession on the basis of the term spread. However, Bloomberg columnist Cameron Crise offered a contrarian view, pointing out that "the data strongly suggest that a flat curve doesn't really matter - until and unless it inverts." Crise argued that "the correlation between curve and subsequent growth is 0.36 during inversions and 0.04 for everything else …. So no, it doesn't appear the level of the curve matters much until and unless it inverts. At that point, though, stay tuned."

Either way, the economy performed well during the first quarter despite some disappointments. The Atlanta Fed on March 14 revised its overheated 5.4% February estimate for first quarter growth to 1.9% in response to lower-then-expected inflation and retail sales results. The February CPI printed higher than January, rising 2.2% on a year-on-year basis as expected, though Core CPI slowed from January to 1.8%.

February job growth outstripped estimates as nonfarm payroll employment increased by 313,000, well above month's previous month's upwardly revision of 239,000. Wage growth was muted, however, with average hourly earnings up 2.6 percent on an annualized basis, 0.2 percentage points below expectations, while nonfarm labor costs rose just 0.35% YoY for the whole of 2017, the weakest growth in American worker compensation since 2010.

In contrast, the Fed's quarterly housing report revealed that household net worth as of the end of last year was almost $99 trillion, up $7.1 trillion over the past year. In addition, small business owners remain bullish about the economy. The NFIB Small Business Economic Trends Survey reported in March that respondents reported "unprecedented confidence" in the economy as the optimism index continued to rise at record high numbers, rising 0.7 points in February to 107.6 and above the 107.1 expected, the second highest level in its 45-year history.

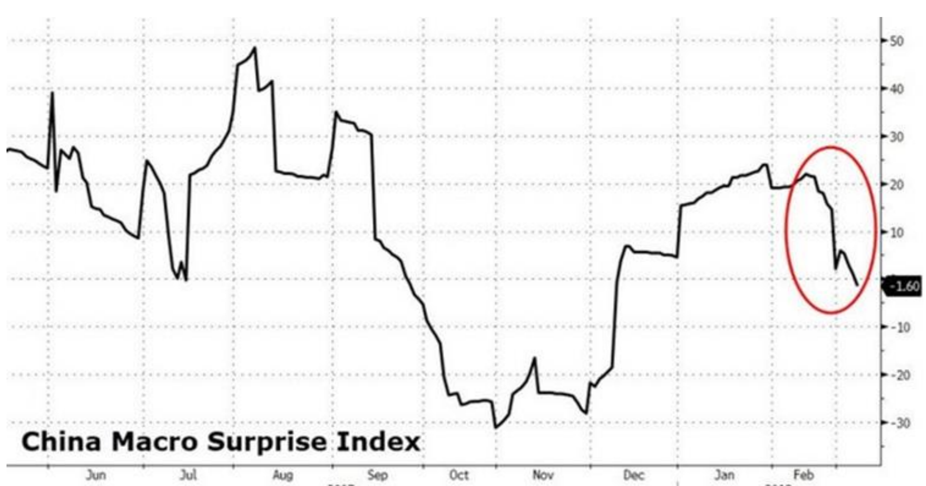
Personal income rose 0.4% in January, according to the Bureau of Economic Analysis, as disposable personal income increased 0.9% percent and personal consumption expenditures climbed 0.2%. The January PCE price index increased 1.7% YoY and the October PCE price index, excluding food and energy, increased 1.5 percent year-over-year. At the same time, consumer spending, the fuel of American's consumption-driven economy, remains weak. Economists blame muted wage growth, a consequence of the fact that job creation has been mostly in low-wage sectors, and rising household savings rates which suggest consumers are buying less and saving more. In addition, consumers are relying heavily on debt finance, especially for autos purchases, which accounted for the weakest sales in the February retail sales number. A tighter credit environment in general hobbled spending, a common feature of a mature economic cycle.

Debt – in ever-growing magnitudes - continues to stalk the US economy. At a time when much is made of the record ratio of U.S. nonfinancial-corporate debt as a percentage of GDP, Moody's revealed that total US private and public nonfinancial-sector in 2017 weighed in 249% of GDP — or just a tad under 2016's record 250%.

Moody's also noted that the volatility rocking equites markets is due in part to rising US fiscal and political risk and concerns that companies cannot pass on higher costs to a diminishing and indebted middle class.

International:

ZeroHedge announced that "the global synchronous recovery narrative is fading fast" due to a slumping China Macro Surprise index, lukewarm global growth indicators and disappointing data from China. That verdict followed a similar outlook from Goldman Sachs, as seven of the ten underlying components of the its Global Leading Indicator weakened in February to 3.46%. The GLI momentum decreased to 0.23% from 0.25% last month, the lowest level for the index since March 2016.



Source: ZeroHedge

Beijing is moderating growth as it promotes service activity and domestic consumption while diminishing debt. A deliberate, gradual approach to correct internal imbalances, he said, would allow for a broader, more stable foundation for growth that can be counted upon to lead the global economy for generations to come.

The European Central Bank (ECB) appeared to hedge on its commitment to policy normalization. On the one hand the ECB dropped its pledge to "increase the asset purchase program in terms of size and/or duration" if necessary and suggested it would define a clearer path for the direction of stimulus – a gesture greeted as a show of confidence that it was prepared to phase out quantitative easing. On the other hand, the bank confirmed – almost insolubly - that "the net asset purchases, at the current monthly pace of €30 billion, are intended to run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim."

In yet another sign that the world's economies are no longer growing in harmony, the US Composite PMI slipped notably from one-year highs following the collapse of Europe's Composite PMI, to 14-month lows. Commenting on Europe's PMI data, an IHS Markit spokesman acknowledged that "the loss of momentum since the buoyant start to the year has been quite dramatic." However, he noted that the first quarter average reading was robust, indicative of GDP rising by 0.7-0.8%. On a more redemptive note, Greece's own Manufacturing PMI reading represented a 17-year high.

Multi-Asset Portfolios

Attribution Based on Asset Classes

Equity:

- Positive Contributors: U.S. Large Cap and Emerging Markets
- Negative Contributors: Non-U.S. Developed

Fixed Income:

- Positive Contributors: U.S. Investment Grade
- Negative Contributors: Emerging Market Bonds

Alternatives:

- Positive Contributors: Frontier Markets and Private Equity
- Negative Contributors: REITs

Portfolio Changes for Multi-Asset Portfolios

Equity and Fixed Income -Based: There were no changes to the Portfolios as they were repositioned at the end of Q4 2017.

Option-Based Changes: Models Impacted: VEGA and VEGA ENHANCED
We sold the long protective puts to recognize the gains and increased our notional exposure on our covered call writing to take advantage of the increase in premiums due to the run up in volatility.

In conclusion, while the markets have shown an increase in volatility and choppiness, this is something we have been watching for over the past 18 months. Our disciplined approach to investing and managing risk within a diversified portfolio remains more important than ever as we navigate through this. As always, we are here to answer any questions you may have and appreciate your continued support.

Sincerely,

David Young, CFA
Chief Investment Officer

DISCLOSURE