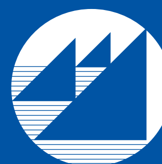
FUNDAMENTAL EQUITY

SMALL CAP



MANAGER COMMENTARY
FIRST QUARTER 2018

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Market Review

The Russell 2000 Index was virtually unchanged in the first quarter of 2018, declining by 0.1%. Nine of 11 sectors declined in the period, although both Technology and Health Care gained more than 6%. The broader large company S&P 500 Index also declined slightly, losing 0.8%. Despite increasing volatility and the first down quarter in more than two years, most equity indices continue to trade near all-time record levels. Investors reacted cautiously to firmer interest rates as the yield on the 10-Year Treasury Note rose from 2.40% to almost 3% in February, finishing the quarter at 2.74%. Global markets were mixed. Latin America gained almost 10%, Russia was up 7%, and Emerging Markets as a whole were up 2.5%. The MSCI EAFE index was in line with U.S. markets, losing about 1%; the U.K. and German markets both declined 3% while the Indian market fell 6%.

Crude oil prices gained more than 7% and closed the quarter at about $65/barrel. Natural gas lost more than 10% as cold January temperatures gave way to warmer than normal weather across much of the U.S. The U.S. dollar lost about 2% in value against a basket of currencies, with the Japanese Yen (+6%), British Pound (+4%) and Euro (+2%) all gaining. Cryptocurrencies were hammered, as Bitcoin lost almost one-half of its value in the quarter.

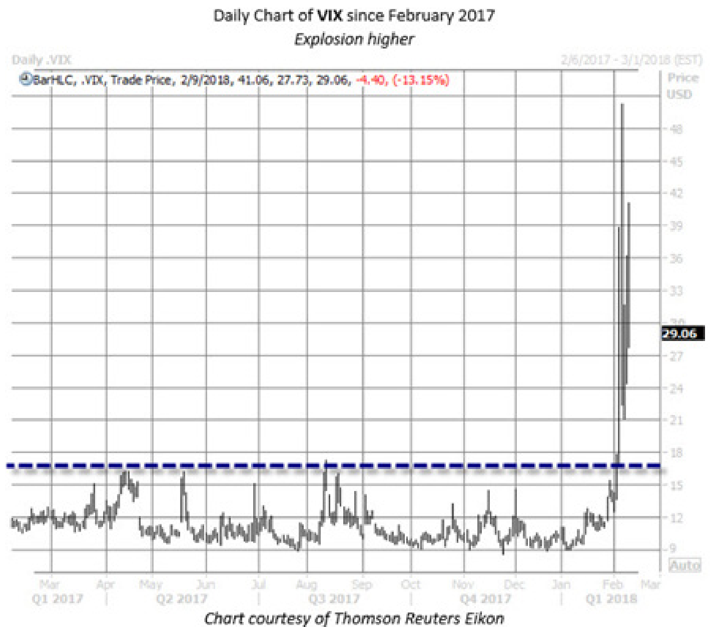
As noted, the yield on the 10-year Treasury Note rose 34 basis points in the quarter. As expected, the Federal Reserve raised the Federal Funds rate by another 25 basis points in March, the sixth such increase since the financial crisis was declared over. Members of the FOMC stated their belief that the outlook for growth in the U.S. economy has "strengthened in recent months", signaling that at least two more rate hikes are likely before year-end.

Market Outlook

Equity markets could not maintain January's wild pace in which the broader equity market gained almost 6% (though small cap stocks advanced by "only" 2.6%) and finished the quarter about where they started. The investment climate, however, changed rather substantially. Interest rates climbed higher in the first half of February, driven by growing inflation fears, which fueled concerns that the Federal Reserve may have to raise short-term interest rates faster than otherwise anticipated.

Investors have reason to be concerned with inflation. The Trump Administration's tax "reform" comes at a time when the Federal Reserve is attempting to reverse almost ten years of accommodative monetary policy. The unemployment rate stands at 4.1%, its lowest level in more than 17 years. In fact, prior to February 2001, the

unemployment rate had not been at today's levels since the late 1960s.



And while wage growth remains tepid when compared to pre-crisis (2008-2009) levels, it is about 1% higher in the last two years than it had been in the prior five. With a growing number of employers complaining of difficulties filling jobs with qualified candidates, it is possible we may see a spike in labor costs if economic growth continues at its current pace.

These fears led to a substantial sell-off in U.S. equities in early February, with most indices selling off 10% or more between February 2nd and February 9th. More indicative of the change in sentiment, market volatility (as measured by VIX, a measure of short-term expected market volatility) spiked on February 5th to as high as 48, having spent much of the last eight years well below its historical average of 20, and trading below 9 just one month earlier. The VIX has traded in the 17-25 range since, suggesting that the days of steadily rising markets with little volatility might be behind us.

Investors have a lot to ponder in the current environment. The economy is growing at a reasonable rate, the job market is healthy, and wage growth may be picking up. We believe corporate profit growth will be solid in 2018, in part due to the impact of the Trump tax cut. Interest rates appear poised to go a bit higher, though the flatness of the yield curve suggests concerns of slowing economic growth.

The Trump Administration's recent imposition of selected tariffs are ill-advised and ill-informed, in our opinion, and could impede profit and economic growth in the U.S. Despite the claims the we lose billions in annual trade with China – we do receive goods and services. Presumably, we would source those goods and services elsewhere, including domestically, and presumably at higher prices. Those higher prices could lead to inflation, or dampen consumer spending, which accounts for about 70% of U.S. economic activity. Despite Federal Reserve Chairman Jerome Powell's assertion in a March press conference that "there's no thought that changes in trade policy should have any effect on the current [economic] outlook", we see no winners in trade wars with other countries only disruption and distrust that are impediments to global economic growth.

In his *Letter from Birmingham Jail* written 55 years ago next week, Martin Luther King said *"Injustice anywhere is a threat to justice everywhere. We are caught in an inescapable network of mutuality, tied in a single garment of destiny. Whatever affects one directly, affects all indirectly."* Through innovation, technological advancement, increased cooperation, and improved communication, much of the global economy has increasingly become a "network of mutuality," resulting in a higher standard of living for many of its inhabitants. The United States is at the hub of that network, and hopefully we will fulfill the obligations that come with that position in a responsible and prudent fashion. Prolonged reckless conduct in areas such as immigration, budget deficits, and foreign trade puts the health of the U.S. and global economies at risk, and endanger the nine-year equity bull market enjoyed by global investors.

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