MONTHLY UPDATE AND COMMENTARY
FEBRUARY 2018

Dear Investor,

While economic fundamentals and corporate earnings growth are strong, we see turbulence as the market adjusts to the specter of higher interest rates. Certain rate thresholds will be important to monitor, with the first level being 3% on the 10-year Treasury, and more importantly the four-year high mark of 3.03%. For reference, we currently stand at 2.89%. Should we break above that 3.03% level, we could see continued pressure on both stocks and bonds. That is the short-term scenario.

From a longer-term perspective, the best way to digest this increase in volatility is to step back and look at recent 10% corrections, their causes, and how the market reacted one to two years after the drawdown. It would also be helpful to find which correction best matches the one we just went through by comparing the economic backdrop and valuations at the time, relative to where we are now. Below is a grid of the seven most recent selloffs of 10% or more, and the two-year cumulative return that followed. We are intentionally excluding the bear market of 2007-2008.

Post-Correction Market Performance

DATE	% DROP S&P 500	FOLLOWING 2-YEAR CUMULATIVE RETURN
May 21, 2015 to Feb 11, 2016	-14.2%	45.1%
April 29, 2011 to Oct 3, 2011	-19.4%	52.5%
April 23, 2010 to July 2, 2010	-16.0%	33.6%
Nov 27th, 2002 to March 11, 2003	-14.7%	49.5%
July 16, 1999 to Oct. 15, 1999	-12.1%	-12.5%
July 17, 1998 to Aug 31, 1998	-19.3%	58.7%
Oct 7, 1997 to Oct 27, 1997	-10.8%	49.3%

Source: Bloomberg LP

What is obvious from this historical analysis is that it paid off to hold or add to stocks after corrections in all but one case, with only a single negative two-year follow-on period. However, if we drill a little further into the environment behind the numbers, our current economic and valuation environment best matches the period cited in 1998-1999. At that time, we were in the late stages of a ten-year economic expansion and valuations were stretched. We hit a forward P/E ratio of 24 in 1998-1999 versus a forward P/E of 19.2 in January of this year. For comparison, the 25-year average is 16x. In late 1998-1999, we were also in the late stages of the longest bull market in history, 113 months. We are currently in the midst of the second-longest bull market at 105 months. And finally, during 1998-1999 the 10-year Treasury yield spiked from 5.29% to 6.63%.

So what is our final conclusion from this historical analysis? While we think this bull market has a ways to go, our recession and valuation radar is now effectively on alert. The risks of a recession are increasing with the rise in rates, length of the economic expansion, and level of asset valuations. As always, we will continue to keep a close eye on all relevant metrics, and make the appropriate portfolio adjustments should our outlook shift toward a risk-off stance.

Please call or email with any questions.

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