



# SilverOak

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WEALTH MANAGEMENT LLC

## First Quarter 2018 Market Summary

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## First Quarter 2018 Market Summary

The first quarter left a lot of investors feeling like the mountain climber in the Price Is Right game, as equity markets steadily ascended until the end of January when they fell precipitously. Many market participants entered the year expecting last year's historically low volatility to continue. However, in our 4Q 2017 letter, we encouraged investors to be prepared for higher volatility and even a 10% correction. Well volatility returned and that 10% correction came in February over the course of two weeks! This certainly rattled a few investors and was great fodder for the news outlets. The correction we experienced was certainly overdue, and while painful, it put the markets roughly back to where we started the year. It is important to be reminded every now and again that stocks can go down, as well as up.

The relative calmness of the equity markets in 2017 can be expressed by the fact that the S&P 500 recorded only 8 days in which the index returned +/- 1%, the fewest days during a year over the past 30 years. So far in 2018, we have already seen 27 such days. Fourteen days in which the S&P 500 was up over 1% and thirteen days with a return of less than negative 1%. Volatility tends to cluster as days with large negative returns are often followed by days with the largest positive returns. We feel the volatility during the quarter was a repricing of risk and not as a result of a significant change in fundamentals.

U.S. large company stocks, represented by the S&P 500 Index, were down 0.8% during the first quarter of 2018. The S&P 500 experienced only its second quarter with negative returns in the past 23 quarters. U.S. small company stocks, represented by the Russell 2000 Index, were down 0.1% during the quarter. Growth stocks continued their outperformance over value stocks in the U.S. and international markets. The only sectors in the S&P 500 that had positive returns were technology and consumer discretionary. International stock markets, represented by the MSCI ACWI ex US Index, were down 1.2% for the quarter. Emerging markets performed better with a positive return of 1.4% for the quarter. The depreciation of the U.S. dollar added to international returns.

For the quarter, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was down 1.5%. Bond returns were negative as interest rates moved higher. The Federal Reserve raised the Fed Funds rate 0.25% in March to 1.50% - 1.75%, which was widely expected, and the Fed continues to forecast two more rate hikes in 2018.

Despite negative returns in the first quarter, our fixed income managers are expecting bond funds to have a positive return for the year. Many bond funds are yielding 3% - 5% currently, which will help offset any additional price declines from rising rates. Although bonds can experience negative returns, they are often temporary in nature and they typically have less downside risk than equities.

### Broad Market Index Returns First Quarter 2018



There are many positive fundamentals currently as the improved earnings and sales outlook for companies is being driven by the increased global economic activity. After a lull in corporate news, the market will likely shift focus to the Q1 earnings season, which should stabilize the market due to the strong fundamentals. U.S. geopolitics will continue throughout the year with trade negotiations, attempts at immigration reform and the Iran nuclear agreement, which needs to be recertified in May. The U.S. economy is in the 9<sup>th</sup> year of the current economic expansion, the second longest on record, though the later stages of economic cycles can last for several years.

## HIGHLIGHTS

### MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of first quarter 2018 real GDP, an annual rate increase of 2.3% from the preceding quarter. The estimate was higher than analysts were expecting.
- The University of Michigan Consumer Sentiment Index final reading for March was 101.4, which was an increase from the fourth quarter. Consumer sentiment remains very strong.
- The ISM Manufacturing Index remained high during the quarter, finishing at 59.3 in March. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In March, the Conference Board Leading Economic Index increased 0.3% month-over-month to 109.0. The Index has shown a pick-up in economic growth over the past six months.
- The price of WTI Crude Oil was \$64.87 at the end of March, which is 7.3% higher than \$60.46 at the end of December. The price of Brent Crude Oil increased 3.4% in the quarter to \$69.02. Strong demand, OPEC supply cuts and geopolitical events have caused the oil market to tighten faster than investors expected.
- In March, headline CPI increased 2.4% year-over-year, an increase from 2.1% in December. Core CPI, which does not include food and energy, had a 2.1% increase. Inflation is expected to remain low but has increase modestly due to wage growth and commodity price stabilization.

### HOUSING

- The housing sector remains strong with increasing sales and rising home prices the past few years.
- Preliminary existing home sales decreased in the quarter with a monthly average annualized rate of 5.51 million units from 5.59 million units in the fourth quarter. The March annualized rate is 1.2% lower than the 5.67 million units in March 2017. Unsold home supply remains at very low levels.
- Median existing home sale prices increased during the quarter. The preliminary prices for March were 5.8% higher than the levels of one year ago and have been trending up since the beginning of 2012. Prices are now higher than the previous peak in 2007.

- New home sales were strong during the quarter, up 8.3%, and have been increasing since 2011. However, new home sales remain slightly below average due to the below average housing starts since 2009.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 6.8% year-over-year in February.

### EMPLOYMENT

- The labor market data has generally been healthy. The job growth rate has slowed slightly as the labor market is at or near full employment. Wages have been slowly rising over the past few years.
- During the quarter, nonfarm payrolls averaged 202,000 jobs added per month, which is slightly higher than the average over the past two years.
- The unemployment rate remained at 4.1% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1969, reflecting a tight labor market.

### DOMESTIC CORPORATIONS

- Corporate operating earnings in the fourth quarter 2017 were much higher than the previous year. Estimates for the first quarter show an acceleration of earnings growth. Corporate earnings in 2018 are expected to benefit from the recently passed tax reform bill.
- Operating margins remain well above historical averages. Margins could contract from record levels if interest rates rise and wages increase. However, net margins will get a boost from lower taxes.
- Forward and trailing P/E multiples are above historical averages.
- The U.S. dollar continued to depreciate and is down almost 12% vs. major currencies since the beginning of 2017, which has benefited non-U.S. securities.

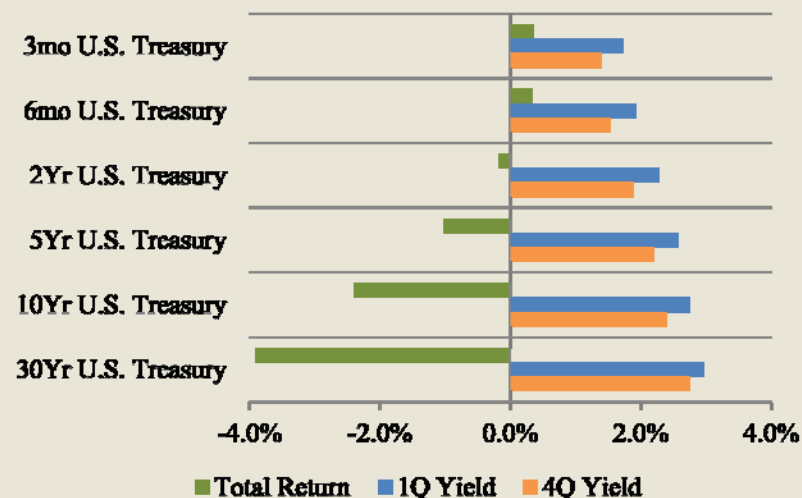
## FED POLICY

- In March, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate 0.25% to 1.50% - 1.75%, which was widely expected. The Fed's assessment of economic conditions was upgraded as the committee revised higher their growth estimates for 2018 and 2019. They noted the economy is expanding moderately, the labor market continues to strengthen and inflation remains stable.
- The Fed is forecasting they expect to raise rates two more times in 2018 and increased their expected hikes in 2019 and 2020. Market expectations believe the Fed will increase rates through the end of the year but will not follow through on its rate hike projection in 2019-2020. The unwinding of the Fed's balance sheet may put upward pressure on interest rates and financing costs for corporations and consumers.

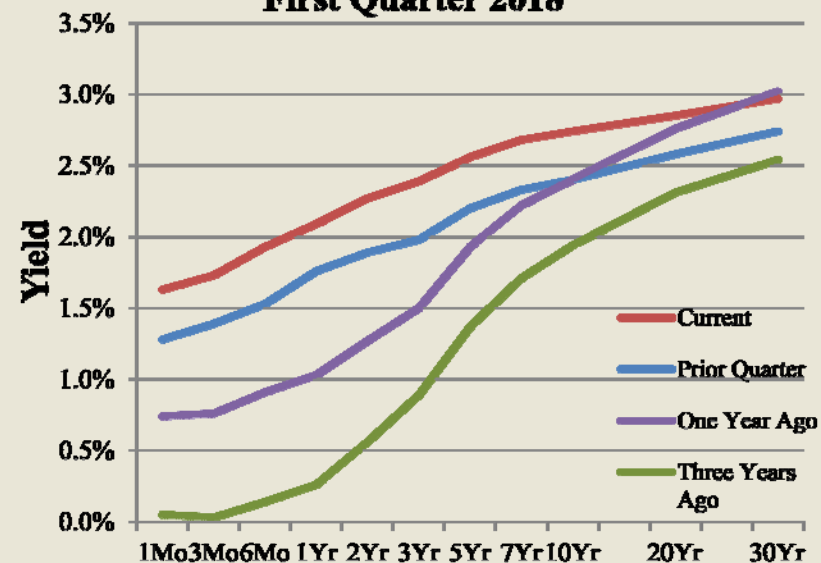
## FIXED INCOME

- Long term yields increased quarter-over-quarter; while, the short and intermediate end of the curve rose marginally more, causing the yield curve to flatten. Economic growth and slowly increasing inflation helped lift long-term rates higher. Short-term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth. Historically, the yield curve has flattened as the Fed raises interest rates and the business cycle matures.
- Volatility in the U.S. Treasuries spiked during the quarter on concerns of rising interest rates and inflation. As global central banks unwind their stimulative policies, the market may have continued bouts of volatility.

### Treasury Yields & Returns First Quarter 2018



### U.S. Treasuries Yield Curve First Quarter 2018



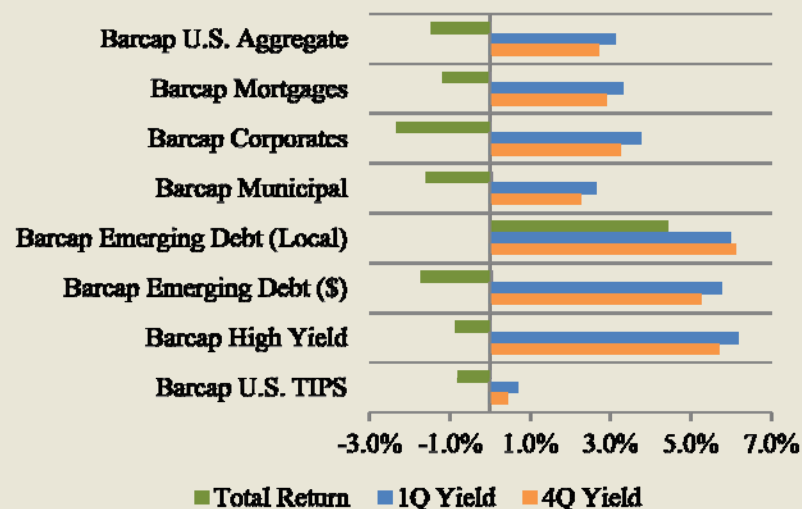
## FIXED INCOME (continued)

- Returns across fixed income sectors were generally negative, with the Barclays U.S. Aggregate down 1.5% during the quarter. Municipal returns outperformed taxable bonds, though were still negative. Corporates performed worse than the broad market. Emerging market local debt was one of the few positive areas of the bond market due to emerging market currency appreciation.
- Evidence of late cycle indicators are showing up such as poor valuations, weakening credit standards, and high leverage in corporate and consumer balance sheets. Rising interest rates and higher funding costs will create problems for companies with weak balance sheets.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are still at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. Despite the low rates and muted expected returns of fixed income, it remains an important part of a diversified portfolio as it provides stability when equity markets decline.

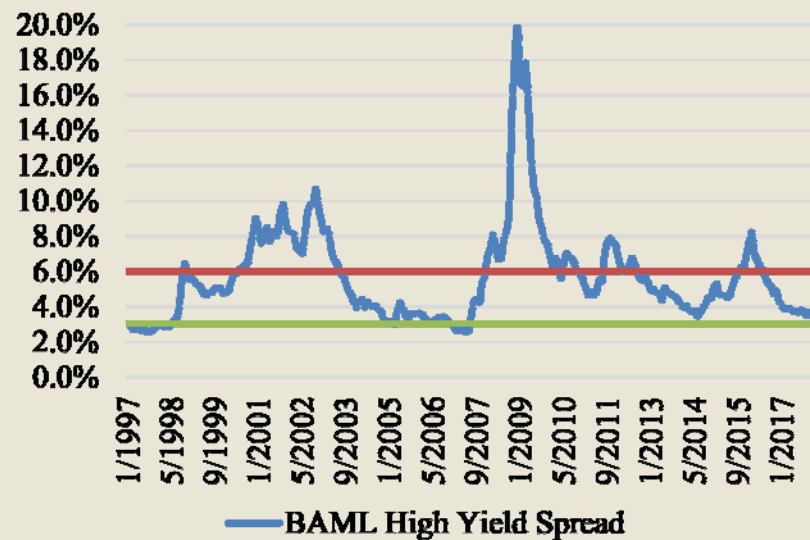
### 10-Year Treasury Yield



## Fixed Income Yields & Returns First Quarter 2018

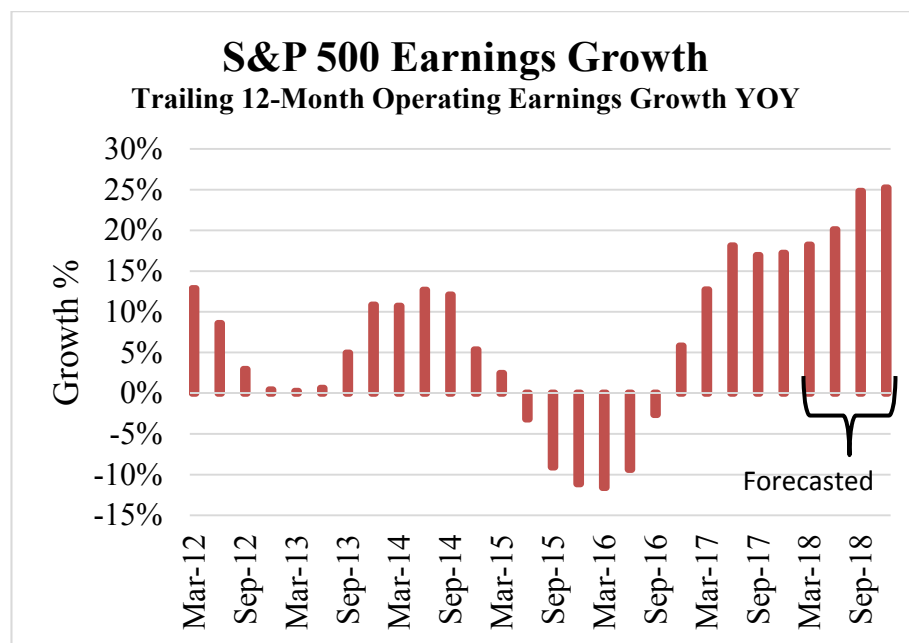


### Credit Spreads - High Yield

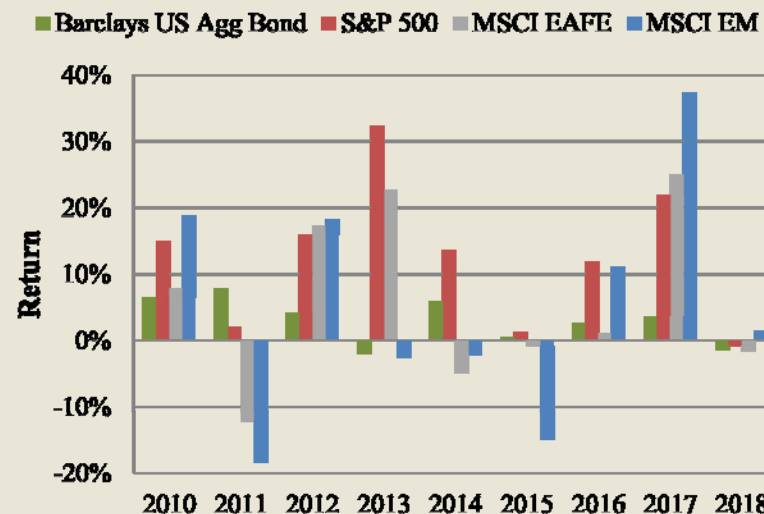


## EQUITIES

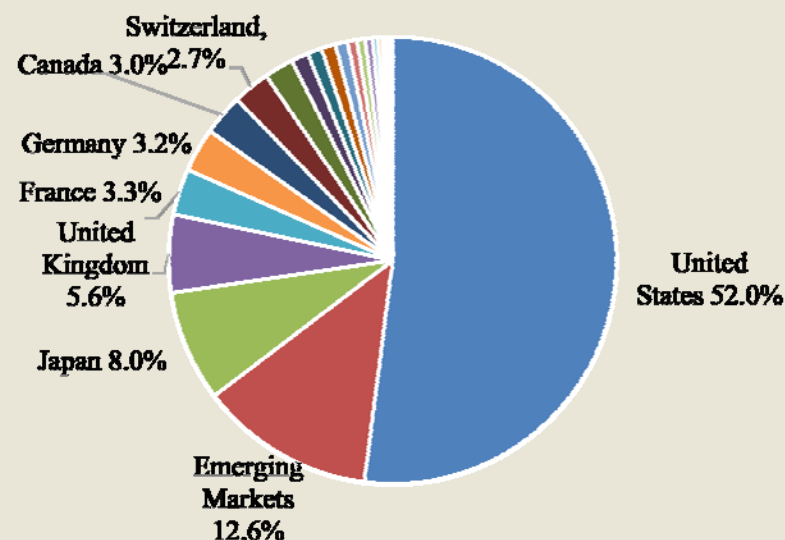
- Equities started the year strong and were up 7-10% through most of January. The party ended with a 10% correction over the course of two weeks as sentiment turned. The market may remain more volatile as the environment goes through a regime change. For much of the past few years we have seen good economic data, strong corporate earnings, low rates and accommodative central bank policy which has led to low volatility. Now interest rates are rising and central banks are pulling back on stimulus. This has caused investor sentiment to be rattled and asset allocations to be examined. Nonetheless, corrections are normal and healthy for markets.
- Global growth continues to support equities. However, geopolitical events such as trade tensions continue to be a risk. Rising earnings expectations and peak margins create a high hurdle for equities and may contain returns. Correlations among equities has fallen to levels last seen in the early 2000's. Low correlations increase the benefits of a diversified equity portfolio.



## Equity & Fixed Income Market Annual Returns



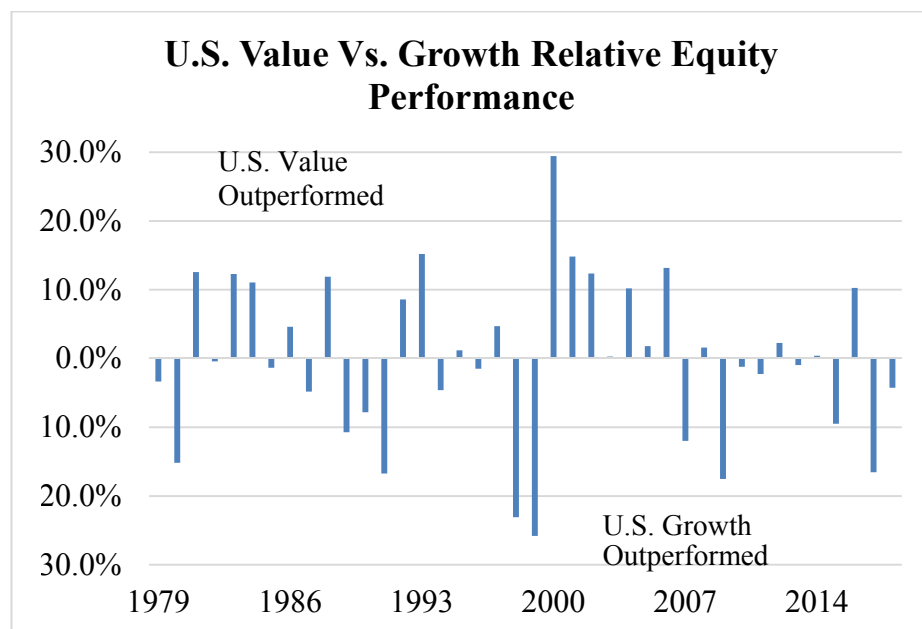
## Country Weighting in MSCI ACWI (as of 4/19/2018)





## DOMESTIC EQUITIES (continued)

- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of negative 0.7% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 14.0%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of negative 0.1% during the quarter. On a year-over-year basis, the index has increased 11.8%.
- Growth companies continued to lead the market, specifically technology companies. Interest rate sensitive sectors such as Telecommunications, Real Estate and Consumer Staples lagged during the quarter as interest rates rose.
- Growth companies have outperformed Value companies over the past 1-, 3-, 5-, 10-, and 15-year basis. However, Value has outperformed over the past 20 years and all-time. The market cyclicalities can be seen below.

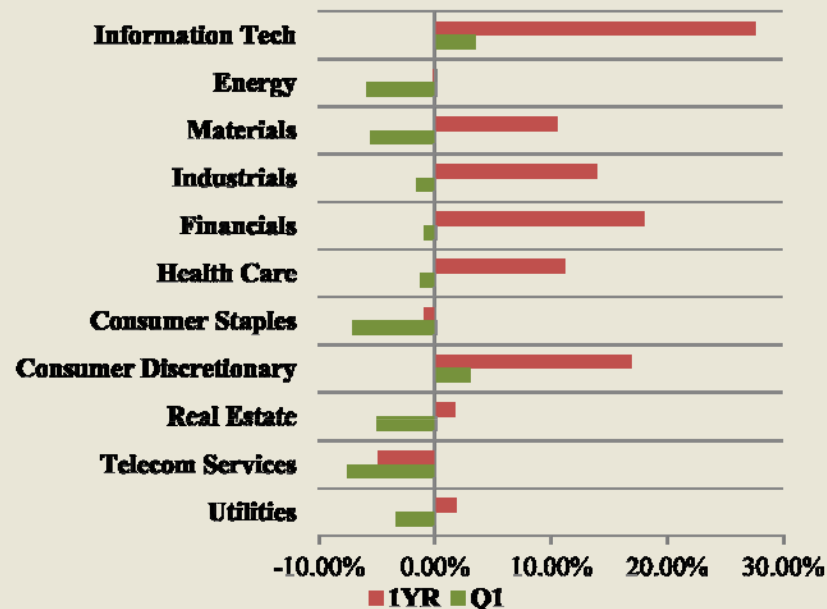


Russell 1000 Growth TR vs. Russell 1000 Value TR

## First Quarter 2018 Returns

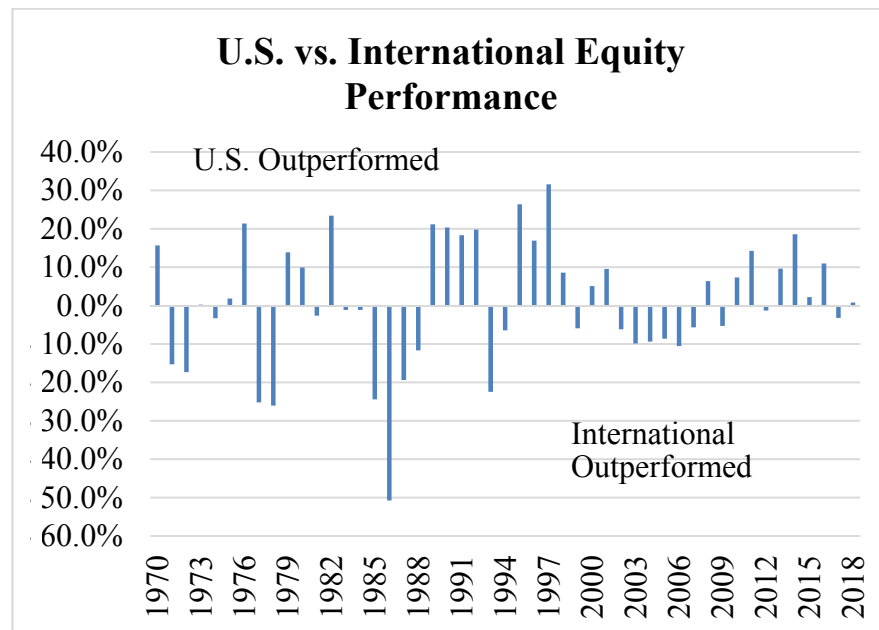
	Value	Core	Growth
<b>Mega Cap</b>		-1.9%	
<b>Large Cap</b>	-2.8%	-0.7%	1.4%
<b>Mid Cap</b>	-2.5%	-0.5%	2.2%
<b>Small Cap</b>	-2.6%	-0.1%	2.3%
<b>Micro Cap</b>	0.5%	0.7%	1.0%

## U.S. Equity Market Returns by Major Sector (Securities in S&P 500, First Quarter 2018)

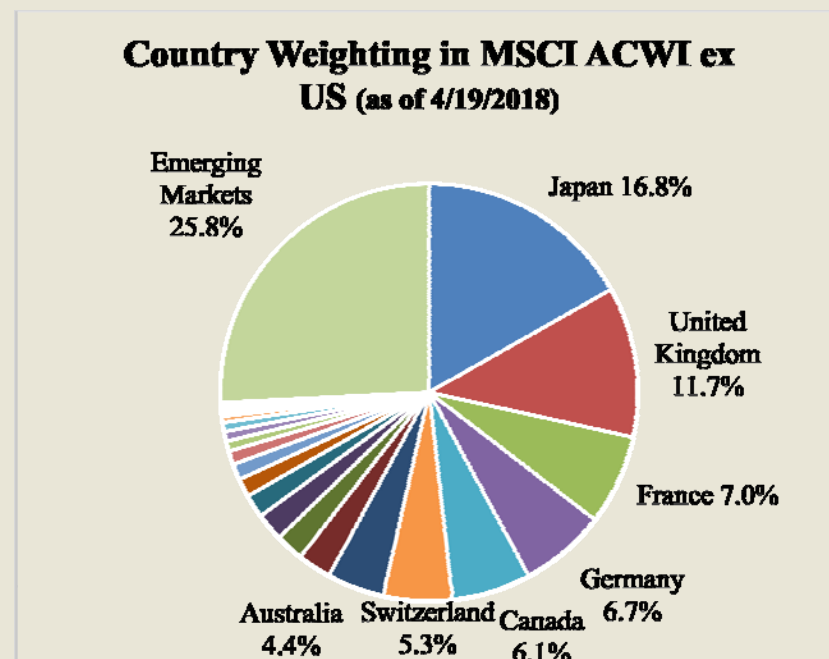
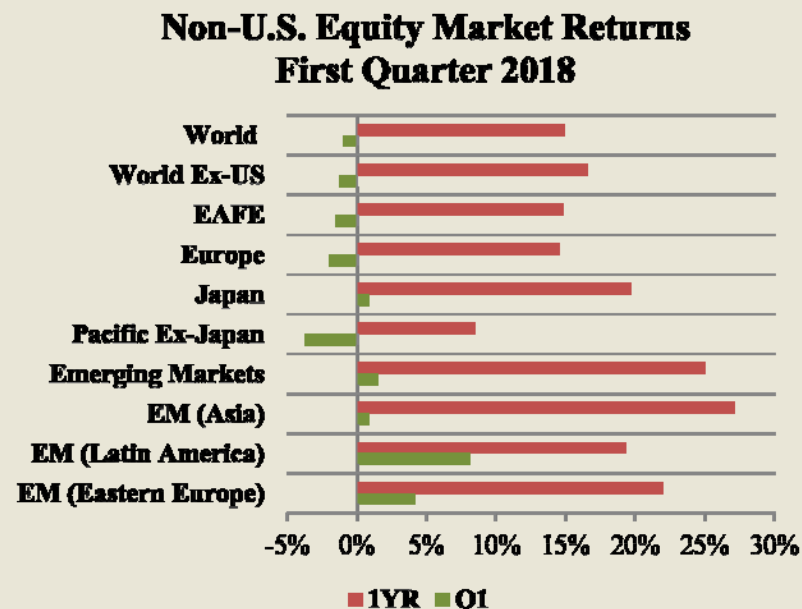


## INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were down 1.5% during the quarter. On a year-over-year basis, the EAFE is up 14.8%, performing better than U.S. domestic equities.
- Emerging market stocks outperformed developed markets during the quarter. The MSCI Emerging Markets Index increased 1.4% in the quarter and has increased 24.9% over the past year.
- Internationally, earnings trends and less demanding valuations remain supportive for equities. Certain global markets such as the Eurozone and Japan appear to be in earlier phases of the economic cycle than the United States. The cyclical nature of U.S. and international equities can be seen below.



S&P 500 TR vs. MSCI EAFE NR





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