March 2018

Economic & Market

Forecast

A monthly report issued by the advisors at KPP Financial

Economy

Higher interest rates have yet to do major damage to economic indicators, but some signs of softness did emerge in February. The ISM Manufacturing Index dropped to 62 from a high of 65.2 in December, which is still expansionary, but at a slower pace. Vehicle sales also fell 4% month over month as used car prices fall and higher interest rates impact monthly payments. Credit conditions tightened some but remain very loose. Retail sales were soft in January after a strong end to 2017, which is confirmed by weak Personal Consumption Expenditures. The recent tariffs imposed by the Trump administration are likely to increase the level of inflation we are seeing in the economy. Part of this is driven by a tight labor market as unemployment sits near record lows of 4.1% and initial jobless claims remain near the current cycle low. This has driven unit labor costs near record highs which, in conjunction with a weak dollar, is stoking the fears of inflation. The biggest threat currently to the US economy looks to be an increasingly hawkish trade stance which if implemented fully would more than counteract any positive affects of the tax cuts. If other countries begin to retaliate with counter tariffs we would likely see a slowdown in global trade which is not good for any economy globally.

U.S. Equities

Domestic stocks had a rough month of February for the first time since August of last year. As the Fed and other Central Banks (ECB and BOJ) pull liquidity from the market, we are likely to continue to see volatility pick up. This will cause a major shift in the cost of portfolio insurance and rebalancing from risk parity funds that have attracted massive amounts of capital over the past seven years. Rising interest rates also changes the valuation models that are used on Wall Street dramatically. This will be a headwind to higher asset prices more broadly. While the earnings picture remains healthy due to lower tax rates and a still growing economy, but most if not all that headway has been priced in after a stellar 2017 for the broader market. We continue to expect more volatility this year and a more rangebound market to unfold which makes for a good market for stock pickers and value investors.

Foreign Equities

Equities abroad had a rough month as well as liquidity becomes tighter in those markets also. While valuations are more attractive outside of the US, prices have also risen to unattractive levels on an absolute basis. As the ECB, BOJ and BOC all reduce liquidity, there will be heightened risks in those markets. A potential trade war triggered by the Trump Administration will also hit equities globally. The Italian elections coming up could also ignite more upset in the European currency bloc as BREXIT remains in negotiations. North Korea looks to be calming down after a smooth Olympics, but China remains on watch for credit problems as global liquidity tightens. A weak dollar continues to give foreign stocks a tailwind, but that can switch the other way very easily.

Fixed Income

Interest rates hit levels not seen since 2013, which is disrupting market expectations and valuation models. The Fed is very likely to raise rates again in March, but that is now fully priced into the market. It looks like we will get at least 3, maybe 4, rate hikes this year from the new Fed Chief as long as financial markets are not disrupted too much. High yield bond spreads are beginning to widen out and the LIBOR TED spread is on the move as well, both developments are not friendly to risk assets. Higher rates are tolerable to a degree for an economy that is still expanding and earnings that remain solid. We expect the 10-year rate to begin a choppy period as market data about inflation comes in and Central Bank policy globally evolves. Now is a great time to be deploying a laddered strategy to your fixed income portfolio as rates will likely be higher in the coming years.

Commodities

Commodity prices were broadly down for the month of February on the back of a firmer dollar. You saw pockets of strength from the agriculture area, but oil and gold were weak after a strong start to the year. The precious metals market is giving conflicting signals, but we still expect higher prices by year end. Oil prices remain high, but with domestic production reaching all time highs we are likely to see a ceiling on prices near these levels. We expect a rangebound market for oil through the balance of the year. The ratio of commodity prices to equity prices remains near historic low levels which makes us bullish the commodity space vs domestic equity exposure. The dollar has hit some support recently on a technical basis, which could give the commodity space some pause near term.

Recommended Portfolio Weightings

As of February 28, 2018

Equity Sectors

Overweight	Neutral	Underweight
Energy	Materials	Technology
Utilities	Industrials	Health Care
Telecom		Consumer Staples
		Financials
		Consumer Discretionary

Asset Classes

Overweight	Neutral	Underweight
Agriculture Commodities	Emerging Market Stocks	U.S. Mid-Cap Stocks
Resource Commodities	Intermediate-Term Investment Grade Bonds	U.S. Large Cap Stocks
REITs	Precious Metal Commodities	International Developed Stocks
Cash Alternatives	Long-Term Investment Grade Bonds	U.S, Small-Cap Stocks
Short-Term Investment Grade Bonds	International Developed Fixed Income	International Emerging Market Fixed Income
		High Yield Bonds

Fixed Income

Overweight	Neutral	Underweight
TIPS	U.S. Treasuries	Mortgage-backed Securities
	Bank Loans	Preferred Securities
	Agency Securities	Corporate Bonds
		Municipal Bonds

Economic & Market Forecast

Data Point	Current	Year-end Projection
S&P 500	2,714	2600-2700
NYSE	12,653	12,000 -13,000
10-Year	2.87%	2.7-2.9%
Crude Oil	$61.64	$60-65
Gold	1,316	1,475-1,525
Dollar Index	90.28	85-90
Effective Fed Funds Rate	1.42%	2 %

Disclaimers

There is no assurance that any of the target prices or other forward-looking statements mentioned will be attained. Any market prices are only indications of market values and are subject to change. Past performance is no guarantee of future results.

The prices of small and mid-company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment. Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility.

All fixed income investments may be worth less than original cost upon redemption or maturity.

Although Treasury Inflation-Protected Securities (TIPS) are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and the securities to underperform traditional Treasury securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity.

The yield, average life and the expected maturity of mortgage-backed securities are based on prepayment assumptions that may or may not be met. Changes in prepayments may significantly affect yield, average life and expected maturity.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in the energy sector are subject to the adverse economic events within that industry. A downturn in the energy sector of the economy, adverse political, legislative or regulatory developments or other events could have a large impact on a portfolio's investments in this sector.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Real Estate investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Additional information available upon request.

Past performance is not a guide to future performance.

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