Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

May 2018

As of April 30, 2018

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Economic Conditions

The US economy grew at an annual rate of 2.3% in the first quarter of 2018, according to the advance GDP estimate from the Bureau of Economic Analysis. This was a slight slowdown compared to the 2.9% growth seen in the fourth quarter of 2017, but first quarter growth tends to be slower compared to the latter three quarters in the year. The current economic expansion is now the second longest in history at 107 months. It would need to extend through July of next year to become the longest economic expansion in history.

The Federal Open Market Committee (FOMC) made no changes to interest rates after their meeting on May 2 which is what the markets had expected as inflation continues to get closer to their 2% target but not quite hitting it. The statement released by the FOMC did little to change the consensus that two more rate hikes are expected before the end of the year and the possibility of a fourth rate hike before year-end continues to linger. The statement made a point to cover the fact that the FOMC is equally as concerned with preventing inflation from falling too far below 2% as much as it is with preventing inflation from rising too far above 2%.

Market Conditions

Index Returns	Apr '18	YTD
S&P 500	0.27%	(0.96%)
DJIA	0.25%	(2.25%)
NASDAQ	0.04%	2.36%
MSCI EAFE	1.89%	(0.35%)
Barclays Aggregate	(0.74%)	(2.19%)

The US markets took investors for another ride last month as the S&P 500 got off to its worst start to a second quarter in recorded history, falling over 2% on the first trading day in April. While tech stocks dragged the index down at the start of the month they were also the catalyst that brought the index back to life mid-month, as major tech stocks reported upbeat earnings reports. Less than a week later things quickly turned as the CFO of Caterpillar Inc. pointed out that profits in the first quarter looked to be the "high-water mark for the year." It seemed at that point that the market may have priced in the short-term future benefits of the recent fiscal stimulus as the index just barely came out of the month in positive territory, up 0.27%. The Dow met a similar fate in April returning 0.25% and the NASDAQ was basically flat. Bond prices continued to fall as the 10-year Treasury rate hit a psychological 3% level for the first time since 2014. Remember as yields increase, bond prices fall. The Barclays US Aggregate was down 0.74% in April and is now down 2.2% for the year. International stocks continue to outperform the broad US market as the MSCI EAFE returned 1.89% for the month and is down 0.35% for the year, slightly outperforming both the S&P 500 and the Dow.

Rising Interest Rates Revisited

Over the past several updates and newsletters we have repeatedly touched on the topic of rising interest rates and what that means for bond prices and clients' portfolios. And although it may seem like we've been beating a dead horse, we still believe it's important to clarify what is happening, as well as why it's happening, as many of our clients may have been noticing the declines in their bond allocations for the past year. While the stock market may be more exciting to follow than the bond market, it's also much simpler. The reasons for rising interest rates are several fold and may be the most salient feature of the financial environment in 2018.

First and foremost, as we pointed out in the economic update on page two, the US economy is growing at a healthy rate relative to the current stage of the business cycle that we are in. Additionally, with just over 80% of S&P 500 companies reporting earnings for Q1 2018, over three-fourths of those companies have reported positive earnings per share (EPS) surprise. The blended earnings growth rate in Q1 is 24.2% according to FactSet and is on pace for the highest growth rate since Q3 2010. This should make the case for the Fed to increase the discount rate in June with at least one, if not two, more rate hikes before the end of the year. Rising rates from Fed actions are mainly due to an improvement in economic conditions and are a necessity to ensure that inflation does not run too high.

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Rising Interest Rates Revisited

Which brings us to our next reason behind rising interest rates – inflation. With economic growth comes rising inflation which at the current moment is just under 2%; about in line with the Fed's target. The Fed is committed to reigning in inflation to ensure that the economy does not "overheat," at which point the Fed's hand would be forced to increase rates by larger amounts and at a quicker pace which could send the economy into a recession. Interest rates are cut during an economic pullback (e.g. during a recession) in order to spark inflation and prevent *deflation*. But too much inflation in the late stage of a cycle could put an abrupt end to the expansion. As labor markets continue to tighten (i.e. unemployment remains low, currently just under 4%) inflation expectations begin to rise. This is because there are fewer workers available in the labor pool and could cause wages to increase. Not only is unemployment falling, but job openings are increasing. In fact, at the end of March the number of unfulfilled jobs hit a record high of 6.55 million with only 6.59 million unemployed Americans, creating the narrowest gap between available jobs and those actively seeking work in almost 20 years, according to the Wall Street Journal. On top of that, the WSJ also reported that the number of people quitting their jobs in March was at its highest level since 2001 and the number of layoffs was at its lowest since September 2016 which shows that companies are trying hard to retain employees while many of those

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Rising Interest Rates Revisited

employees have the desire and the ability to leave their jobs in search of higher salaries and/or improved benefits. Although inflation has not been rising as quickly as history would suggest in an environment where unemployment is this low, it is certainly something to continue watching.

The last item to touch on is the supply and demand aspect of bonds in the market, specifically U.S. Treasuries. Interest rates aren't just influenced by monetary policy, but also by supply and demand – specifically the demand, which has been fairly high given the fact that most other countries' real interest rates have been negative for quite some time now. U.S. Treasuries have offered the highest yield relative to the safety provided by the U.S. government's guarantee in repaying its debts which has put strong downward pressure on yields over the past several years. The higher the demand, the higher the price and the higher the price, the lower the yield. However, very rarely does the government implement stimulative fiscal policies this late in a business cycle. Traditionally, a government will implement fiscal policies to stimulate the economy such as increase spending (and in the U.S.'s case, the budget deficit) and cut taxes during a recession in order to give the economy a boost. The recent actions by the current administration have been the opposite with the Tax Cut and Jobs Act and the increased spending bill. When the government increases the budget deficit while at the same time decreases tax revenues, it

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Rising Interest Rates Revisited

naturally translates to more debt being issued which leads us back to the supply and demand aspect. As the U.S. government continues to push a greater supply of debt into the market, lenders (i.e. investors) are naturally going to demand lower prices and higher yields. While it is unlikely that the supply of U.S. Treasuries will vastly overtake the demand – again due to the lopsided demand for safe U.S. debt by underfunded pensions, sovereign wealth funds, and other countries' dollar denominated foreign cash reserves – there is still a risk that an excess supply of U.S. Treasuries could push rates higher.

As the 10-year Treasury yield once again broke the psychological level of 3% in early May, the Barclays U.S. Bond Aggregate has fallen over 2% for the year. In anticipation of this move clients may have noticed a change in their bond allocations with increased allocations to shorter duration bonds and bond funds. Duration is essentially the sensitivity of a bond/bond fund to changes in interest rates. The lower the duration the lower the sensitivity. Also, while the pain of lower returns due to short-term price declines is never comfortable, increasing interest rates are very much needed for investors in later stages of life who cannot afford to take on additional equity risk. As bonds mature they will be reinvested in higher paying bonds in order to relieve a portion of those losses.

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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Investments in bonds will be subject to credit risk, market risk and interest rate risk. Interest rates will have an inverse effect on prices of bonds. Bonds of lower credit ratings, also known as High Yield bonds which hold a rating of less than investment grade (BB+ and below), will have greater risks attached than will those of investment grade bonds and will experience greater volatility.

All dates are as of April 30, 2018 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.