First Quarter - 2018

Market Commentary

Economic & Political Overview

Last year saw a multitude of important events that affected markets both here and abroad. Donald Trump was sworn in as the 45th President of the United States. He began to imprint his style of leadership and negotiation on Capitol Hill with some notable success and some efforts that left a lot to be desired. A massive tax plan was passed along party lines which affected virtually every individual and business in the country. More than 140 million consumers were potentially exposed to hackers when Equifax reported a breach in their security systems. North Korea showed surprising military advancement through missile tests showing the capability to hit many Western targets including the continental U.S. Sexual harassment grabbed headlines in every field from sports to entertainment to politics putting a harsh spotlight on previous clandestine deeds. Bitcoin mania had many asking whether this was a sure bubble sign or a bold new direction. Meanwhile, domestic and foreign equity trading desks saw a record-breaking year which brought smiles to investors who saw gains continue through the holiday season.

Though there were plenty of happenings, one of the most newsworthy events was the changing of the guard at the Federal Reserve Board. There is little doubt that the United States is the de facto banker to the world. Though the Treasury Department is a key member of the economic machine, it is the Federal Reserve which really determines the “price” of money. Janet Yellen became the first female head of the powerful seven member board when she was sworn in on February 3, 2014. President Trump decided late last year to replace her in that role with another board member, Jerome Powell, ending her role as Chairwoman after only one term. Though she could have stayed on longer, as her term as a board member does not expire until 2024, she will move on as a courtesy to give Powell clear leadership of the group.

That assemblage will have a decidedly different feel with the departure of Yellen following the unexpected departure of Vice Chairman Stanley Fischer last October. When New York Fed President William Dudley announced his desire to retire, effective in the middle of 2018, the three key figures that helped steer the U.S. through the financial crisis of 2008-2009 will be gone. Though the Fed has been identified in past cycles by the leader alone—characteristics of the Volcker and Greenspan eras—in recent years, it has been run more as a team where consensus and buy-in were paramount to personalities. We do not expect Powell’s period to be much different, but that will depend greatly upon how the other members of the board and regional presidents get along. Highly astute economical acumen is a minimum requirement, but we must never forget the tricky political environment that these professionals must navigate while being in charge of a $17 trillion nation.

What they have helped achieve is an economy that, according to Yellen, “by most metrics, is close to achieving the Federal Reserve’s statutory objectives of maximum employment and price stability.” According to a gauge compiled by Citigroup Inc., the U.S. economic surprise index reached its highest reading since 2011 last month. This means that more and more readings on the economy are coming in better than consensus economists’ forecasts. The Fed raised its benchmark federal-funds rate last month by a quarter percentage point to a range between 1.25% and 1.50%, the fifth such increase in the past two years as a nod to the burgeoning strength. According to their latest projections, U.S. GDP is expected to grow 2.5% next year, up from 2.1% they predicted in September. The after-effects from Hurricanes Harvey and Irma have not had the profound dampening on growth as first expected. The Fed also expects the unemployment rate will fall to 3.9% by the

end of 2018, down from their earlier forecast of 4.1%. December's unemployment rate was 4.1% in the latest data from the Labor Department, down from the 4.7% rate in December 2016. Average hourly earnings were up 2.5% last month versus a year ago which is a good sign that not only have the quantity of jobs increased but workers are getting more each pay check. Minimum-wage levels were boosted in a number of states at year end including the large pools of workers in New York and California.

These forecasts were made before the Tax Cuts and Jobs Act was passed by Congress late last year. Thus, there could be upside to these projections if, as the GOP anticipates, tax savings gets reinvested in more hiring and consumers are less incentivized to save because their marginal income toll is lower. History has shown that the tax changes which have had the most pronounced effect on GDP growth have been ones that are targeted at the middle class and are permanent in nature. For the most part, this tax cut is neither. While some benefit from increased standard deductions, others see valuable itemized deductions taken away. Some businesses structured as pass-throughs get a break while the perks of home ownership in some states get more limitations. Though the economy may get a short-term boost, the longer-term implications are less positive especially as at least another $1 trillion will be added to the nation's deficit.

The tone on Capitol Hill will not help matters much given that it has only become worse over the course of the year. The GOP majority in the Senate is a slim 51-49 margin which inflates the role of Vice President Pence who would hold a tie-breaker vote on any deadlocked decisions. With mid-term elections this November, do not be surprised if various politicians are more distracted than usual and less committed than ever to needed legislation like immigration reform, the debt ceiling and discretionary vs. non-discretionary spending. While 2017 marked a year unlike any before in a number of aspects, when it comes to politics, 2018 is unfortunately likely going to be more of the same.

Market Review & Outlook

The records fell often last year as stocks went on a tear. The S&P 500 gained 21.8% on a total return basis including dividends on its way to making 62 new record highs during the year. On a more detailed level, 51 stocks out of the 500 gained at least 50% last year while 125 finished the year in the red. The S&P has been positive for each of the last nine years which ties the record for consecutive positive years set previously between 1991 and 1999. Since the bear market low on March 9, 2009, the S&P has gained 378%. It has been positive for 14 of the last 15 calendar years. For the past 50 years, the index has gained an average of 10.1% per year on a total return basis.

The impressive performance in 2017 was not just limited to the U.S. In euro terms, the Deutsche Boerse AG German Stock Index, known as the DAX, rose 12.5%, with France's CAC 40 Index up 9.3%. South America did even better with Chile's IPSA up 30.6% and Brazil's Bovespa index 26.9% higher in local terms. In Asia, South Korea's Kospi Composite rose 21.8% while China's Shanghai Shenzhen CSI 300 was up 6.6% in local terms. No major stock index in the world was negative last year, with the Israeli Tel Aviv 25 barely staying positive, squeezing out a 2.3% gain in shekels. The S&P Global Broad Market Index includes most stocks from 48 countries, and it rose 22% last year thereby adding nearly $10 trillion to global equity market value. The S&P Emerging Broad Market Index rose nearly 32% while the S&P Developed Ex-U.S. Broad Market Index climbed 23% both in dollar terms.

It is this relentless push higher which has investors giddy while at the same time keeping a nervous eye on the punch bowl lest someone spirit it away during the festivities. The last time the S&P 500 had at least a 2% pullback was nearly two months before last year's U.S. presidential election. Last year, there were only four days which saw at least a 1% drop. That is nearly unprecedented. The Chicago Board of Options Volatility Index (VIX), also known as the "fear gauge", measures expected stock swings over the next 30 days. It did not top its long-term average of 19 at all last year, finishing at a yawn-inducing level of 11 at year's end. Since the last 10% correction which ended on February 11, 2016, it has been over 700 trading days without a similar event. A 5% or 10% correction would be "healthy" for the market because it would wipe out some excesses that have seeped into the markets without leading to widespread panic. We do not see any red flags on the horizon because the usual signs of a recession are not present.

There are three general causes of a recession. One trigger is a supply shock to an important factor of input. That is what happened in the 1970s when oil prices spiked which basically crippled the U.S. as its dependency on Arab oil was extremely high. With the U.S. currently pumping the most daily oil ever that is an unlikely issue for years to come. Second is a demand shock which is what we saw in the 2008-2009 financial crisis when high levels of leverage led to margin calls and shrinking consumption across the land as various asset bubbles popped. These recessions are especially malevolent because debt does not merely disappear. In this case, in the U.S. it was shifted from corporations and individuals to the Federal government. It has not gone away, but it has changed form. The third cause is usually some sort of policy mistake. It can be an ill-timed tax or tariff but most of the time it is related to monetary miscalculations. In 2011, the European Central Bank raised rates much too soon thereby prolonging that continent's recession and straining the EU constituents. Sometimes, it is an error of omission as the Federal Reserve kept interest rates too low in the aftermath of the 2001 recession. In reality, the causes can often weave together one leading to or resulting from another. The inflation of the 1970s led the Fed to levy punitively high interest rates which resulted in a rare "double-dip" recession in the early 1980s. The Fed's ultralow rate policy from 2002-2006 precipitated the leveraged economy which culminated in the Lehman Brothers bankruptcy in 2008 and resulting pecuniary disaster.

Are there signs that any of these causes are happening now? As the saying goes, one doesn't know there is a bubble until it pops. If an investor was out of the market for the best five days of 2017, the 22% return would fall to 15%. Still not bad, but not as good as it could have been. So, at the risk of being redundant, we will quote ourselves from last quarter: "Markets that become more and more overvalued are called bull markets—until they are not… So really, the question is not when they will fall, because they will, but am I comfortable with how I am situated to achieve my long-term goals."

There are plenty of reasons why stocks can continue to climb. The 1982-2000 bull market surged 1,150% before it imploded so the current 378% gain over eight years is comparatively trifling. In years after calendar gains of at least 15%, the stock market is higher 70% of the time. Nonetheless, as we argued before, the key is not to get caught up in how far it has risen but get more secure in the position we are in. Is the portfolio balanced to take advantage of steady cash flow from bonds as well as dividends from stocks? Are my holdings diversified so that one or two bad sectors do not overwhelm the entire portfolio not *at any point* in time but *over* time? Do I have enough liquid assets to cover emergencies without taking fuel from future growth? Can I accurately gauge the level of risk being taken versus an appropriately blended benchmark over a full economic

cycle? If an investor can check these boxes, the portfolio, in our opinion, is not immune to market events but it is fortified.

That said, we continue to be cautious of overbought names which do not accurately reflect trends we believe will be prevalent over time. Technology stocks in general have spearheaded the market's march higher. About 25% of the S&P's market value creation has come from five names in this sector: Apple Inc., Alphabet Inc., Amazon.com Inc., Facebook Inc. and Microsoft Corp. While the first and last names in that list continue to be part of our Core holdings, neither is particularly cheap. But fairly valued companies, which have the ability to compound earnings, are more highly coveted than good firms trading at rich metrics. Amazon, Facebook, Netflix and Google are not going to grow forever. How do we know? Because this list of Top 5 names was different 10 years ago until they, too, fell off. As the German proverb goes: "Bäume wachsen nicht in den Himmel." Trees don't grow to the sky. The hard part is always finding the next top candidates.

We will be keeping a sharp eye on the yield curve as well. The spread between the yield on 2-year Treasury notes and 10-year bonds have fallen over the past twelve months. That is a sign that fixed income traders believe that the economy will enter a slowing phase in the year. For equities, there is nothing to fear, until the yield curve actually inverts and short-term yields are above long-term levels. On average, the curve inverts about 16 months prior to a recession hitting and 13 months before the accompanying stock-market correction according to research from Bloomberg Intelligence. As usual, there are no guarantees, but these are the signs among numerous other metrics we will be watching in the year ahead. Information is constantly changing, and we have technology at our disposal to stay on top of it. The key is separating noise from insightful information. Our goal as always is to be prudent investors of our clients' wealth today and into the future.

If you would like to schedule a meeting with SGK, please contact Marcia Bisaga at 703-777-8826 or marcia@sgkwealthadvisors.com

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Steigerwald, Gordon & Koch Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Steigerwald, Gordon & Koch Inc.. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Steigerwald, Gordon & Koch Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Steigerwald, Gordon & Koch Inc.'s current written disclosure statement discussing our advisory services and fees is available upon request.