# ECONOMIC REVIEW

**Steve Scranton, CFA**
Chief Investment Officer & Economist

Although official results will not be available until April 27th, the economic data indicates that the economy put in a solid performance for the 1st quarter. The New York Federal Reserve's real time forecast for Gross Domestic Product (GDP) stands at a 2.7% annualized rate as of March 31st while the Atlanta Federal Reserve's real time forecast is 2.8%. If GDP growth comes in close to the estimates, it will be close to 3%, similar to the 2.9% growth in the 4th quarter of 2017 and a break from the pattern of weak 1st quarter results.

## Business:

The economic data from the industrial side of the economy began the year slowly and gained momentum as the quarter progressed. Several factors helped the industrial sector:

- A weaker dollar helped sales for exporters;
- Rising oil prices helped spur capital investment from the energy sector;
- Businesses appeared to be replacing equipment that is wearing out as well as beginning to invest in some new plant and equipment thanks to the 100% expensing feature of the tax reform bill.

## Housing and Real Estate:

The housing and real estate data had the opposite pattern from the industrial data. Housing and real estate started the year with data that was stronger than expected, and then saw the economic data weaken as the quarter progressed. This was due to three primary factors:

- The continued rise in residential home prices and lack of supply is creating affordability issues which slowed sales;
- Rising interest rates made homes less affordable and commercial projects, at the margin, less profitable;
- Labor shortages affected the construction industry's ability to increase production to meet the demand.

## Consumer:

The data from the consumer side of the economy was the sector that showed weakness during the quarter. Retail and wholesale trade data weakened as the quarter ended.

- Consumers appeared to spend some of their anticipated tax savings during the holiday season, and the first quarter may well be a case that they were now facing their holiday bills coming due.

## Confidence:

Confidence among individuals, small businesses and large company CEOs remained at or near record levels.

- The first quarter was a time for individuals and businesses to assess what the new tax reform law meant for them.

## Conclusion:

The economy headed into the 2nd quarter with momentum. The unanswered question is whether the drama and noise emanating from Washington, D.C., causes individuals and businesses to hold off on more spending as they wait to see what unfolds.

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## ALTERNATIVE STRATEGIES

**Rick Cloutier, CFA**
Chief Investment Strategist

Equities continued their recent selloff, with the S&P 500 dropping close to its February lows — its first major pullback since early in 2016. At that time, stocks declined 6% due to investor anxieties about slowing growth in China. Now, investors are worried about too much growth and the potential for the Fed to raise interest rates too quickly and choke off the growth. The Fed raised rates ¼ point and expectations are for further increases this year. The new Fed chair has spoken with a more hawkish tone and that has investors worried.

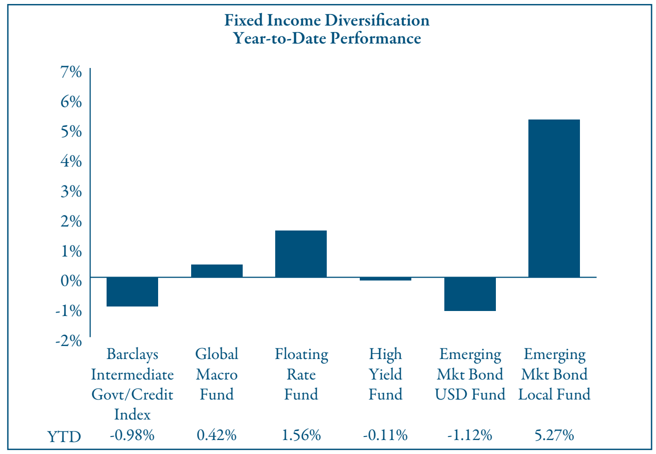
In addition, President Trump has initiated tariffs which has raised fears of protectionism. While the tariffs have been watered down from the original announcement, concerns still exist over future trade policy. While improving trade agreements would be welcomed, elimination of treaties and raising protectionist borders would not be good for corporate America, job creation, and for the economy as a whole.

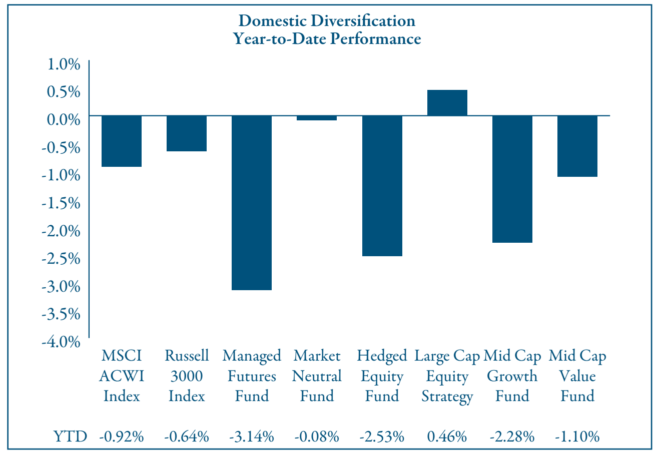
So what started out as a continuation of the nine-year market run has turned into a pause. Volatility spiked from its historic low and triggered our dynamic hedging strategy. Though the strategy was only in place for a short period, it performed as expected and cushioned the downturn for our investment clients.

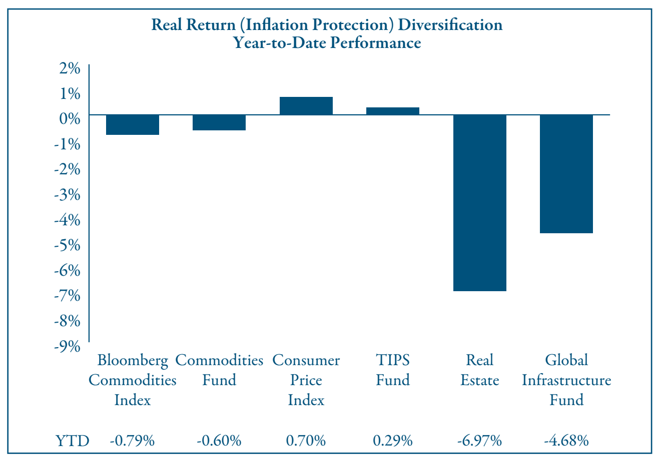
Our risk management strategies provided returns that fell between the returns provided by stocks and bonds. For some of our inflation hedging strategies, there was a reversal of fortune. Real estate and global infrastructure have been stellar performers for our portfolios, but so far this year, they have provided negative returns.

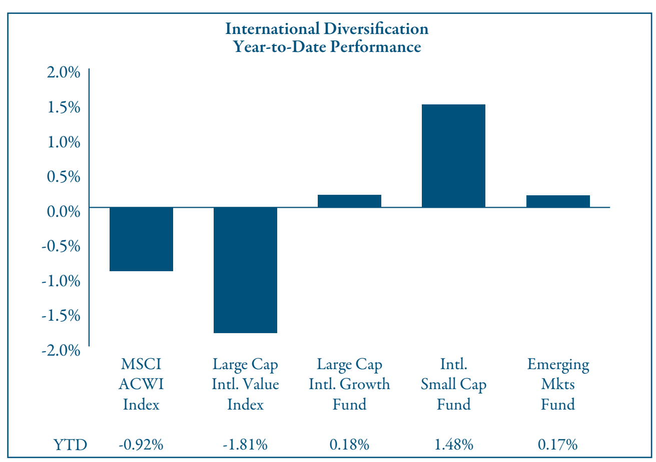
Oil prices continued to climb and hovered around the $65/barrel price range. As a result, commodities were basically flat for the quarter.

As the year progresses, we'll see if the tariffs and interest rate hikes offset any gains from tax reform. However, given good domestic and global economic growth, the backdrop remains supportive for equities. For now, the more hawkish tone of the Fed, coupled with equity prices that are already elevated, could mean volatility remains higher than it was last year.



## DOMESTIC EQUITIES

**Gayle Sprute**
Senior Portfolio Manager

Uncertainty and volatility were dominant themes during the first three months of 2018. Although enthusiasm about anticipated tax reform and fiscal policy benefits got 2018 off to a strong start, the rally was short-lived. Excitement evaporated in late January and was replaced by concern about rising inflation and the possibility that it could influence faster-than-expected interest rate increases. A rising wall of worry ensued and spawned an official "correction" (a market decline of between 5% and 10%) between January 26th and February 8th. So ended the 2017 rally, which had been one of the longest in history without a correction.

The market tried to regroup, as the S&P 500 staged a 7.8% rally between February 8th and 26th. But President Trump's moves to institute tariffs on imports drove a renewed sell-off, as concern surged about a possible global trade war. The S&P 500 ended the quarter re-testing the February 8th lows, and was down 7.7% from its January 26th record high. As the quarter closed, the market seemed to be seeking its balance point after two months of dramatic volatility. However, corrections don't end that easily. The process needs time, along with some positive catalysts to counter concern.

Although the macro and geopolitical landscapes have been challenging, the fundamental backdrop remains constructive. Positive factors remain in place, including rising corporate earnings, solid economic data, and benefits accruing from tax cuts and fiscal policy. Meanwhile, the market became much less expensive this quarter, with its valuation dropping to a current price/earnings (P/E) multiple of 16.3X forward 4 quarter earnings — down significantly from 18.5X on January 26th. With 1st quarter earnings season on the launch pad, investors could refocus on how earnings (as represented by the S&P 500 group of companies) are expected to rise meaningfully.

Analysts are currently forecasting that 1st quarter earnings will grow by 18.4% year over year and that full year 2018 earnings will rise by 19.7%. These fundamentals could gain recognition if macro and geopolitical concerns subside. But at this point, investors are grappling with an opaque view of the future.

## FIXED INCOME

**Brian Brill, CFA**
Senior Portfolio Manager

The 1st quarter started with a bang as fixed income investors factored in a combination of recently-enacted domestic tax cuts and global economic data that showed strengthening economies and rising inflation globally. In fact, for the first time since the financial crisis a decade ago, all the major world economies were growing at the same time.

Some analysts anticipated months earlier that the deficit was going to increase dramatically and thus be funded with more Treasury borrowings. The realization became today's news when Congress passed the budget agreement in February after a temporary delay. The agreement, which included higher government spending that equated to 0.5% of GDP, could provide as much short-term stimulus as tax reform but unfortunately also increases the government's borrowing needs to over $1 trillion this year.

As a result of these factors, interest rates rose strongly in January. But starting in February, the economic growth-rising inflation scenario seemed to have stalled and, if anything, receded a bit.

This is where it gets interesting for some other asset classes. Volatility increased dramatically in the equities market as the prospect for higher rates started to become strong competition for already stretched valuations. As the equities markets gyrated, the flight to safety of US Treasuries, curiously, never really happened. Bond yields have been locked at levels between the fear of what may happen because of this stimulus and the reality of the economic data.

The previously strong economic data of December and January now began to disappoint. The rapid increase in longer-term interest rates, as a result, began to pause. Short-term interest rates, however, had a different force to reckon with: increased supply. With tax reform and the budget agreement, the Treasury needed to come up with a lot more funds to cover the difference. This is being accomplished by increasing the amount of debt, specifically short-term debt, it sells. Because of this dynamic, short-term interest rates have increased.

It is easy to get caught up in the headlines of trade wars, geopolitical tensions and the White House soap opera. Headlines make for great press, but the more relevant explanations come from the boring facts.

## INTERNATIONAL REVIEW

**Derrick Wilson**
Portfolio Manager

Volatility increased throughout the global equity markets in the 1st quarter. The year started off strong, posting gains in January. These gains vanished in the first week of February as a selloff occurred in all major equity indices with declines ranging from 3% to 10%. Emerging markets continued to outperform developed markets, eking out a slight gain for the quarter.

The driving force behind the international markets during the quarter was largely geopolitics and, more recently, the fear of potential trade wars. Central banks and their interest rate policies also continued to be a focus of investors who were looking to anticipate any changes that could occur.

A consolidation of power was taking shape in China as the Communist Party eliminated a constitutional provision that limited presidential term limits to two. Following this, plans were presented to make significant changes to how the government would work, ultimately handing more power to President Xi Jinping.

In Europe, the Brexit saga continued with some signs of progress. An agreement was made in March on the transition phase between Britain and the European Union. The agreement, however, is not legally binding until a final withdrawal agreement is signed early next year. How long the transition phase will take remains unclear at this point.

Both the European Central Bank and the Bank of England continued to hold interest rates steady. The ECB has slowed the pace of its asset purchases and is set to conclude by year end. In contrast, the Bank of Japan remained accommodative, continuing purchases with little indication of tightening anytime soon.

| | Year-to-date | Latest 12 Months |
|---|---|---|
| MSCI ACWI All World Index | -0.97% | 14.85% |
| MSCI EAFE Index | -1.53% | 14.80% |
| MSCI Emerging Markets Index | 1.42% | 24.93% |
| JPM GBI Global Diversified Index | 4.44% | 12.99% |

*Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.*

## Contact Our Advisors

### Western Washington

**Seattle**
601 Union Street, Suite 4747
Seattle, WA 98101
206.667.8954 · 888.254.0622

**Bellevue**
10500 NE 8th Street, Suite 1100
Bellevue, WA 98004
425.467.1781 · 888.445.7166

### Spokane
717 West Sprague Avenue, Suite 900
Spokane, WA 99201
509.353.3898 · 800.725.4449

### Portland
760 SW Ninth Avenue, Suite 1900
Portland, OR 97205
503.778.7060

### Southern Idaho/Boise
945 West Bannock Street
Boise, ID 83702
208.345.3343

### North Idaho
218 Lakeside Avenue
Coeur d'Alene, ID 83814
208.667.7993

**watrust.com/wealth-management**

# HIGHLIGHT



## ECONOMIC OUTLOOK

**Steve Scranton, CFA**
Chief Investment Officer & Economist

**Perhaps the best way to describe the current state of the US economy is to modify one of Sir Isaac Newton's laws: the law of motion. The modification would describe the economy as follows: An economy in motion will stay in motion until an outside force changes that motion.**

**Currently, the following are the major factors that should provide momentum to help the economy stay in motion.**

- **Global Growth:** Global economic growth is rising. Even if the US percent of sales to foreign buyers stays the same, the growth of the global economy will contribute to higher sales for the US — all else being equal.
- **Dollar:** The weak dollar benefited US exporters in 2017 and the dollar remains weak so far in 2018. All else being equal, a weak dollar makes US products cheaper and supports stronger foreign sales.
- **Fiscal Stimulus:** The Tax Reform & Jobs Act of 2017 and the 2018-19 spending bill will provide approximately $300 billion in stimulus to the US economy in 2018. It is hard to argue that none of that will flow into the economy, so some level of increased spending should occur from this stimulus.
- **Capital Expenditures:** The nation's inventory of plant and equipment is the oldest on record and logic argues that this equipment will be replaced as it breaks down. The 100% expensing feature of the tax reform bill and the repatriation of dollars back from overseas may well inspire businesses to begin investing in new plant and equipment to expand capacity.

**Given the momentum that the economy has, we need to consider what could be the outside force that changes the direction of the economy.**

- **Rising Interest Rates:** Purchases could slow if income does not rise fast enough to offset higher interest payments caused by rising interest rates. This is especially true for businesses (operating lines) and consumers (credit cards) with adjustable rate debt.
- **Tariffs:** Tariffs are essentially a tax on people and businesses who buy the products that have tariffs assessed against them because of the higher costs that result. This risks not just a slowdown in US economic growth, but also a slowdown in global growth since multiple countries are affected. If incomes do not rise sufficiently to offset the higher cost of the products, consumers and businesses will have less income available to buy more products.
- **Uncertainty:** The uncertainty that exists around some of the President's policy pronouncements risks causing businesses and individuals to hold off on new purchases while they wait for clarity.

**Conclusion: At the risk of sounding like a broken record, now is the time to ensure that you or your business puts a plan in place to deal with the next recession. We do not know the exact date for the next recession but we do know that the business cycle is not broken and that we are closer to the end of this business cycle rather than the beginning. Manage your risk while you enjoy the benefits of economic growth.**

## Market Overview

**Cumulative Periods** *as of March 31, 2018*

| | Year-to-Date | 1 Year | Annualized 3 Years | Annualized 5 Years | Annualized 10 Years |
|---|---|---|---|---|---|
| **Russell 3000 Index** | **-0.64** | **13.81** | **10.22** | **13.03** | **9.62** |
| S&P 500 Index | -0.76 | 13.99 | 10.78 | 13.31 | 9.49 |
| Russell Mid Cap Index | -0.46 | 12.20 | 8.01 | 12.09 | 10.21 |
| Russell 2000 Index | -0.08 | 11.79 | 8.39 | 11.47 | 9.84 |
| **FTSE NAREIT All Equity REITs Index** | **-10.00** | **-6.13** | **2.00** | **6.51** | **7.13** |
| **Bloomberg Commodity Index** | **-0.40** | **3.71** | **-3.21** | **-8.32** | **-7.71** |
| **MSCI ACWI All World Index** | **-0.97** | **14.85** | **8.12** | **9.20** | **5.57** |
| **MSCI EAFE Index** | **-1.53** | **14.80** | **5.55** | **6.50** | **2.74** |
| MSCI EAFE Small Cap Index | 0.24 | 23.49 | 12.25 | 11.10 | 6.48 |
| MSCI EM Index | 1.42 | 24.93 | 8.81 | 4.99 | 3.02 |
| **Barclays Govt/Credit 1-5 Yr. Index** | **-0.50** | **0.19** | **0.77** | **0.95** | **2.11** |
| Barclays US Treasury TIPS Index | 0.12 | 0.14 | 1.14 | 0.07 | 1.61 |
| BOAML US High Yield Master II Index | -0.91 | 3.69 | 5.18 | 5.01 | 8.12 |
| JPM GBI Global Diversified Index | 4.44 | 12.99 | 5.43 | -0.67 | 3.78 |
| **Barclays Municipal 1 Yr. Index** | **0.38** | **0.61** | **0.66** | **0.66** | **1.34** |
| **Barclays Municipal 3 Yr. Index** | **0.11** | **0.40** | **0.84** | **0.98** | **2.15** |
| **USTREAS Stat US T-Bill 90 Day Index** | **0.25** | **1.09** | **0.51** | **0.32** | **0.31** |