North American Management

Q1 2018 INVESTMENT LETTER

Weak Start to 2018, the Stock Market Gets De-FAANG'ed

Global stock markets have risen dramatically since early 2016 and were due for a pullback.

After a wild ride, global equities and most fixed income assets ended the quarter with modest declines. Inflation's "first responders" did better: emerging markets, floating rate bonds, agricultural commodities, oil and gold all rose slightly, and most hedge funds are performing well again after a long drought. Volatility was the clear winner, however. The CBOE VIX index, which measures expectations of future equity volatility, rose from obscurity to make the evening news, gaining 81% on the quarter after tripling in early February. One doesn't need to follow the VIX to know that investors have become less certain about the future: the S&P 500 saw 23 daily moves of +/- 1% in the first quarter compared to 8 in 2017.[1] Looking back further, perhaps we shouldn't be too unnerved to see global equities (MSCI All Country World Index) retrace 1% year-to-date after rising 24% in 2017. The ACWI is still up a remarkable 49% from the depths of its last correction in Q1 2016.

Traditionally defensive portfolio components performed poorly this quarter.

The nature of the recent selling is worth thinking about. As we wrote in our February 9 Market Perspectives note, the first wave seemed to reflect a rather frantic attempt by equity investors to price in higher inflation expectations after a surprisingly strong employment report. This upended a number of ill-conceived and risky short positions in the volatility derivatives market. In plain English, a number of market participants were betting the unusually placid, bullish conditions of 2017 would persist in 2018 and they lost big. Meanwhile, bond investors had already adjusted their growth and inflation expectations significantly in January, with ten year yields rising briskly from 2.41% to 2.72%. When sentiment changed in February and stock indexes dropped, long-term bond yields *continued to rise* until they peaked at 2.94% later in the month and "defensive" equity sectors like consumer staples and health care underperformed the financial sector. Not the type of "risk-off" selling we've come to expect this past decade.

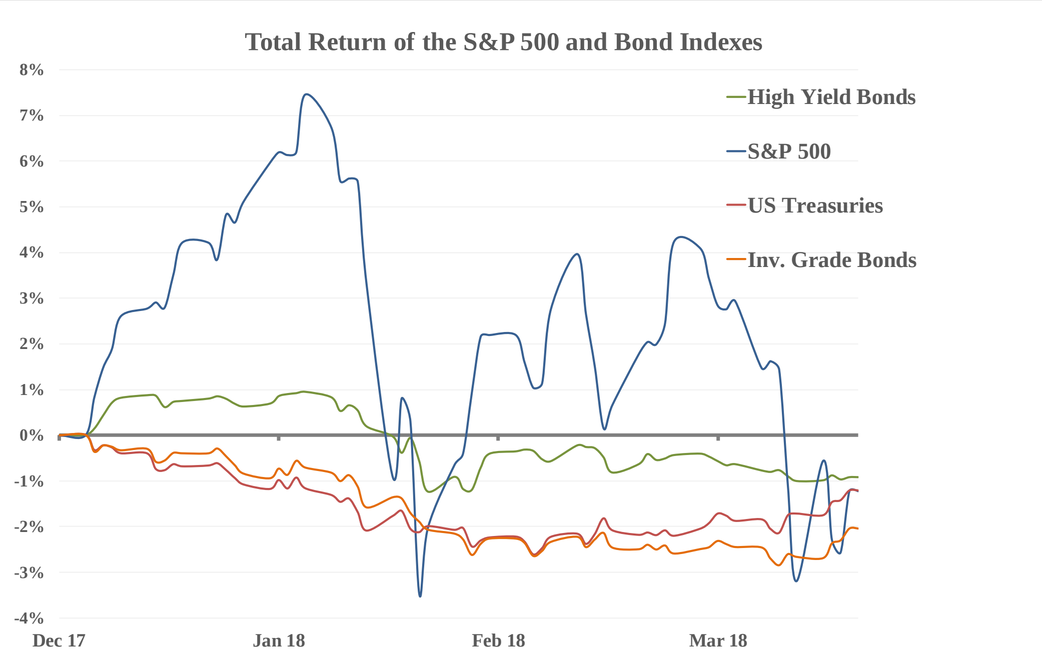
In March and again in early April, investors perceived more immediate threats to global growth. Protectionist rhetoric from the White House, the specter of aggressive global regulatory backlash against stock market leaders like Facebook, Amazon, Apple, Netflix and Google (Alphabet) and hawkish comments from the Federal Reserve have all caused the market to "re-test" its lows. As stocks tumbled again, the so-called FAANG stocks dropped 10%-15% and bond prices improved only modestly. The popular U.S. fixed income benchmark, the Bloomberg Barclays Aggregate, still ended the quarter down 1.46%, underperforming most U.S. stock indexes.

We trimmed a large cap technology stock in early February, and added to designated lower volatility international equity weightings.

Portfolio Actions We Took During the Quarter

On February 2 our Investment Committee voted to rebalance a large cap technology stock in several strategies where it had become one of our largest weightings. Other strategies sold a large cap technology ETF. We used the proceeds to add incrementally to low volatility strategy and other ETFs in developed foreign markets.

Chart of the Quarter: *Why Aren't Bonds Helping More?*[2]



In Search of Stability During Changing Times

Why have long-term bond prices barely budged in response to higher equity volatility? We shouldn't read too much into one quarter's trading patterns, nor should we get too complacent about interest rates – especially ultra-low interest rates. Many investors may not be aware that long-term bond prices are more sensitive to movements in low rates than they are to high rates. That retail bond inflows over the past ten years surged while rates plummeted to multi-decade lows surely demonstrates this point. The fact is, all "long duration" asset prices are highly sensitive to interest rates, including stocks, houses, office buildings and more. In our opinion, the February correction was more violent because recent long term rate rises were so swift and meaningful, because the *pace of change* matters. Investors have just lived through a rare event: we looked for other quarters when the S&P 500 was negative *and* the Bloomberg Barclays Aggregate Bond Index underperformed. We found only one in the last forty-two years (1st quarter 1980)[3].

The relationship between bond prices and bond yields is not static, or linear. Ultra-low yields can lead to greater price risk.

When we design asset allocation frameworks, we consider how our clients' fixed income portfolios might behave under a variety of stresses, including sudden interest rate rises. Two years ago, when rates were a good deal lower, we constructed a portfolio of fixed income mutual funds and separate accounts that exhibited less sensitivity to interest rates than our benchmarks. We were pleased to see this positioning benefitted client portfolios in the first quarter, as we expect further rate rises and eventually some signs of credit stress as this long business cycle ages.

Two years ago, we constructed diversified fixed income portfolios in all of our strategies with duration targets significantly shorter than our benchmarks.

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Chairman & CEO

Fraser J. McLean
Chief Investment Officer

Endnotes

[1] *Strategas Research Partners*. 1Q in Review in Charts: Requiem for the "New Normal." April 2, 2018.
[2] Total Return of the S&P 500 and Bond Indexes: *FactSet*. About the data: High Yield Bonds are represented by the ICE BofAML U.S. High Yield Index, U.S. Treasuries by the ICE BofAML U.S. Treasury Index, and Investment Grade Bonds by the Bloomberg Barclays U.S. Universal Credit Investment Grade Index.
[3] S&P 500 Total Return versus Bloomberg Barclays U.S. Aggregate Indexes: *FactSet*.

Source of data not specifically cited: BlackRock, FactSet.
All return data through March 31, 2018, in U.S. Dollars, unless otherwise stated. All equity returns include dividends.

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