March—In Like a Lamb, Out Like a Lion

April 9, 2018

While the weather for March may be much more unpleasant at the beginning of the month relative to the end of the month, the same could not be said for the markets. At the beginning of the month, stocks were recouping the losses from early February; however, as the month neared its close, stocks reversed course and dropped 7% before bouncing back in the final week. The sell-off was pretty widespread, affecting large and small domestic stocks, as well as foreign stocks.

Index	*YTD*
Dow Jones 30	-2.0%
S&P 500 Index	-0.8%
EAFE	-1.5%
Barclays Bond	-1.5%
90-Day T-bills	0.4%

Source: Eaton Vance Market Monitor
Note: EAFE represents the MSCI index of foreign stocks; Dow Jones 30 represents the Dow Jones Industrial Average; Barclays Bond represents the Barclays Capital Aggregate Bond Index.

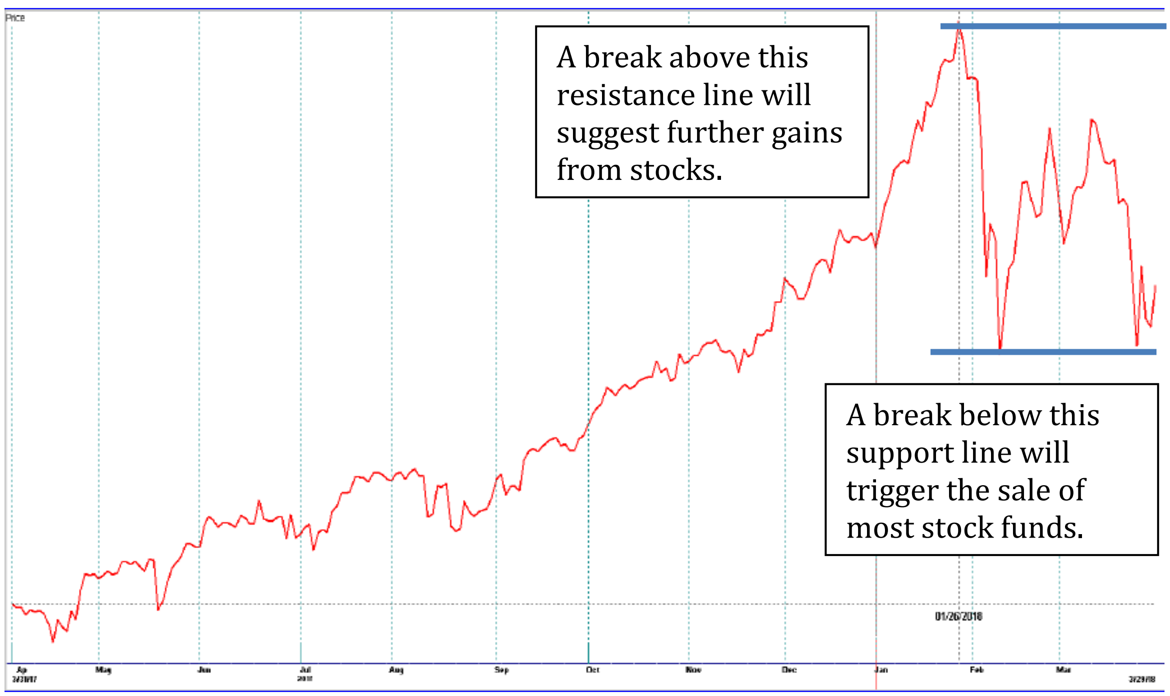
In the table above, you can see that the final results from the last quarter don't seem too negative, with most areas of the market down only 1%-2%. What has jarred most investors, however, is the return of volatility, which was pleasingly absent for the past year or more. There were only eight trading days in 2017 when the S&P moved either up or down by more than 1%. Already in 2018 we have seen 23 such days (27 if you include the first few days of April). And the first quarter of this year brought the first three-month downturn since the third quarter of 2015.

Within the broader realm of U.S. stocks, there were only two sectors (out of 11) that managed gains in the first quarter: Technology and Consumer Discretionary (think Amazon). Even though oil prices rose during the quarter, energy stocks managed to lose over 5%. It was also a tough quarter for areas of the market sensitive to rising interest rates. As a result, utilities, REITs, and telecommunications stocks lagged, as did bonds in general.

What May Lie Ahead

The first quarter was a stark reminder to investors that investing is a risky business. The calm environment of 2017 was the exception to the rule that to reap the rewards from investing in stocks we should expect there will be periods of volatility and concern. More volatility may lie ahead. Five stocks—Apple, Microsoft, Facebook, Google, Amazon—make up 14% of the S&P 500 index, and as their fortunes rise and fall, they will take the overall index with them. Such a high concentration in a few stocks seems eerily similar to conditions in 1999, which suggests we could see sharp swings in market returns for the rest of the year.

The chart below shows how things look to us from a high level. This chart plots the S&P 500 index over the past year. The index hit a peak on January 26 and dropped 10% in nine days. Since then, we have been in a trading range between those two points (marked by blue lines). As long as we remain inside this trading range, we will maintain somewhat elevated money market levels. If the index breaks below the lower blue line, we will move the portfolios to minimal (or no) stocks. A move above the upper blue line will be a signal that the bull market has resumed and we will bring the money market levels toward zero.



Portfolio Review

Below, we review first quarter results in FSA's six broad investment strategies. Keep in mind that because we manage clients' portfolios individually, the results for your particular account may differ somewhat from the averages.

Income (Strategy 1)

It was a difficult quarter for the Income strategy to make money, with both high yield and high quality bonds posting negative returns. Fortunately, we were able to find a few funds that managed positive returns for the quarter, which kept the losses at a modest level. During the quarter we reduced our allocation to high yield bonds, while adding floating rate and international bonds.

Income & Growth (Strategy 2)
As stocks began to roll over in early February, we reduced the equity allocation from 50% to 10%. As stocks recovered through late February, we increased the equity allocation back to 20%. We also invested modestly in a floating rate bond fund, which is designed to do well as interest rates rise. This strategy currently has 50% in bond funds and 30% in money market funds.

Conservative Growth (Strategy 3)
During the sharp correction at the end of January, we reduced the equity allocation of these portfolios from 75% to roughly 40%. We continue to have an allocation of international stocks but we have reduced the level to 10%. We also invested modestly in a floating rate bond fund to benefit from rising interest rates. The overall bond allocation in this strategy is 25%, with 30% in money markets.

Core Equity (Strategy 4)
Clients in this strategy saw cash levels rise to 30% by the quarter's end, as we exited several sector funds (Transportation, Semiconductors), while reducing our international and Nasdaq holdings. At the same time, we added an emerging markets fund, as well as a commodities fund, as these two areas have managed to perform well in this volatile period. The cash level bumped up to 45% in the first week of April as volatility continued into the second quarter.

Tactical Growth (Strategy 5)
The fireworks in the first quarter led to a good bit of trading in this strategy. During the first wave of selling in late January, we raised the cash level from 5% to 45%. Then, as stocks rebounded in late February, we began to reinvest some of the cash. By the end of the quarter, the portfolios held about 20% in cash but also held a market hedge in the form of an exchange-traded fund that tracks a popular volatility index known as Vix. In addition, we bought a commodities fund because that asset class has moved into an uptrend, and we also added a small-cap fund, as these stocks began to show signs of life late in the quarter. The cash level bumped up to 30% in the first week of April.

Sector Rotation (Strategy 6)
This strategy is not designed to move to cash, except in more prolonged market declines, so these portfolios remained fully invested throughout the quarter. For the most part, the mix of sector funds held during the quarter cushioned these portfolios amid the volatility. Technology sectors have been held all quarter as this area has been among the strongest. For April, the rotation picked up an inverse S&P fund, which has been rising as stocks have sold off. In addition to the inverse fund, the portfolio currently holds technology, internet, electronics, retail, and health care.

Please remember to inform your advisor of any changes in your life that could affect your investment objectives.

FSA Investment Team

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