ALPHA CUBED
INVESTMENTS

Investment Letter, Q1 2018

January 11, 2018

Momentum, Fundamentals, and Volatility

In the first week of this year, the strength in the equity markets was reflected in various metrics reaching all-time highs. The S&P 500 was up 2.6%; the Dow Jones Industrial Average, 2.3%; and the NASDAQ Composite, 3.4%. This was a continuation of the strength in the market exhibited in 2017. We began last year's investment letter, titled "A Sea Change in Investment Philosophy," by noting that the investment outlook for 2017 would be based on the potential for fiscal policy changes (tax reform) and likely higher volatility. The Tax Cuts and Jobs Act was finally signed into law in late December, but we saw minimal volatility throughout the year as the markets marched steadily higher. While we maintained a margin of safety in most portfolios and were prepared for more price fluctuations, we remained well-positioned to take advantage of this unprecedented market rally. Please see below for a recap of 2017 in the markets:

	2017 Q1	**2017 Q2**	**2017 Q3**	**2017 Q4**	**FY**
S&P 500 Total Return	6.07%	3.09%	4.48%	6.64%	**21.83%**
NYSE Composite Total Return	4.58%	3.06%	4.42%	5.49%	**18.73%**
Barclays Aggregate Bond Index	0.82%	1.45%	0.85%	0.39%	**3.54%**

	12/31/2016	**3/31/2017**	**6/30/2017**	**9/30/2017**	**12/31/2017**
U.S. 2017 GDP Estimates	2.3%	2.2%	2.2%	2.2%	2.2%
S&P 500 P/E (Current)	21.0	21.1	20.9	21.6	22.5
S&P 500 P/E (12-Mo. Forward)	17.0	17.6	17.5	17.8	18.2

Source: Bloomberg

In 2018, we believe that opposing economic forces may accumulate throughout the year. On the positive side, there should be an increase in S&P 500 earnings due to the tax reform. Analysts from Credit Suisse and JP Morgan, to cite just a few, have raised their 2018 S&P 500 targets to $3,000 on earnings in the range of $143-155 per share. There have been modest increases to analyst forecasts for 2018 U.S. GDP as well. We also expect a theme of mergers & acquisitions to emerge as companies repatriate large cash reserves back into the U.S. (see our December research piece for more details on the tax reform and a list of the top S&P 500 companies with the largest cash reserves outside of the U.S.). In addition to strengthening fundamentals, we expect to see some performance-chasing in at least the first quarter of 2018 as investors see the potential returns from 2017 and begin shifting their risk tolerance higher (this is typically a mistake but very normal investor behavior). Also, there is anticipation that an infrastructure bill might make it through Congress this year.

On the other side of the equation, much of the anticipated benefit to the market from the Tax Cuts and Jobs Act may already be priced in after such a strong move, and there are some interesting things that we know will be happening in 2018. First, we have a new Fed chairman, Jerome Powell, who will take the helm in February 2018 when Janet Yellen's term ends. The Federal Reserve is continuing to signal that they intend to raise interest rates three more times this year, although we can't be certain whether they will follow through with these planned increases. Regardless, a tightening monetary policy is never a plus for the equity markets in the longer term.

In addition to the planned rate hikes, there is the increasing velocity of the unwinding of the Fed balance sheet (the "taper") that began last year. The era of easy money is over in the U.S., and the tapering activities are another form of tightening monetary policy. We are still in the early stages of both of these tightening activities, but eventually they could have a cumulative negative effect on the equity markets.

S&P 500 Forward 12-Month P/E

As depicted above, valuations remain historically high at about 18.5x forward 12-month earnings for the S&P 500. Margin levels and other technical indicators are also at cyclical or historic highs (see attached Investment Data Overview for full details). It is also not inconceivable that stronger GDP, higher corporate earnings, a possible infrastructure spending bill, and Fed tightening may cause rates in general to begin rising meaningfully for the first time in many years. We haven't seen the 10-year U.S. Treasury yield hold above 3% since 2011 (chart on following page). Maybe this is the year that the trend reverses toward more historical norms and we see a more traditional competition for capital between stocks and bonds.

10-Year U.S. Treasury Yield

None of these risks allow for precise trading or timing the market globally, but they all suggest that there could be a build-up in the system over the first part of the year leading to more volatility toward the second half of the year (geopolitical conflicts notwithstanding). Ultimately, we are going to need multiple expansion, higher-than-expected earnings, or some combination of both for the S&P 500 to move much above $3,000, which would be about a 12%+ change for 2018. A lot of good things need to fall into place for that to happen and we will update you throughout the year. For this reason, we are generally planning to maintain some cash or a margin of safety in our portfolios for now, depending of course on specific client mandates. When times are good, we have learned to prepare reserves for better values while maintaining our best positions for the longer term. As always, please discuss any changes in your goals or risk tolerance with your advisor to ensure your accounts are allocated properly.

Happy New Year!

Sincerely,

Todd Walsh
CEO
Portfolio Manager

Glendon Trullinger
Director of Trading
Portfolio Manager

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Data presented herein was sourced 1/10/2018 from Bloomberg.