ALPHA CUBED
INVESTMENTS

Investment Letter, Q2 2018
April 4, 2018

The Return of the Dynamic Market

(Protectionism, Privacy, Interest Rates, and Volatility)

The Greek philosopher Heraclitus advocated that, "the only thing constant is change." The market demonstrated this when the Dow was down 2.5% in the first quarter of 2018, which ended a streak of gains for nine previous quarters. MarketWatch points out that this was the longest such rally since an 11-quarter rally ended in the third quarter of 1997, and investors were once again reminded that the market is not a one-way street. In anticipation of such a change in the market, as discussed below, Alpha Cubed Investments had already adopted a more conservative investment policy, including an increase in liquidity.

The first quarter of 2018 was characterized by more volatility than in the whole of 2017, driven by an almost non-stop barrage of alarming headlines. The equity markets began the year with a strong rally that resulted in a gain of 5.73% for the S&P 500, while the yield on the 10-year U.S. Treasury Note jumped from 2.405% to 2.720%—all in just the first month. Since then, we have witnessed an onslaught of reports of potential new tariffs and emerging privacy scandals involving market-leading companies like Facebook. For some time in prior investment letters, we have been discussing the potential for rate increases and possible protectionist sentiment to be a headwind for the markets, and the new privacy concerns haven't done anything to quell investor concerns. The markets digested all this input and closed slightly down for the quarter. Please see below for a recap of Q1 2018 in the markets:

	2018 Q1
S&P 500 Total Return	-0.76%
NYSE Composite Total Return	-2.22%
Barclays Aggregate Bond Index	-1.46%

	3/31/2018
U.S. 2017 GDP (Actual)	2.3%
U.S. 2018 GDP (Estimate)	2.8%
S&P 500 P/E (Current)	20.80
S&P 500 P/E (12-Mo. Forward)	16.37

Source: Bloomberg

Potential tariffs, trade wars, and protectionism are all issues we highlighted after the presidential election as potential sources of future volatility. The president was clear throughout his campaign that "fair trade" would be among his top priorities, and it looks like the time for him to address those issues is now. The process of trade negotiations is always a messy one as both sides pursue their vested self-interest—sometimes aggressively at first to set the tone. We are still optimistic that cooler heads will prevail and compromise will be struck over time in an effort to avoid an economy-crushing trade war that nobody ultimately wants.

The recent privacy scandals have been roiling market leaders and causing concerns all the way to the halls of Congress. We believe there is strong intrinsic value in many of the leaders of the new economy and social networking stocks but that there will ultimately be regulation protecting user privacy and limiting what customer data can be disclosed to outside companies, which could impact bottom lines. There is also the potential for changes in taxation or even antitrust actions against some of the larger market-leading companies at some point in the future. However, in many cases historically, breaking larger companies up into smaller constituent businesses ends up increasing shareholder value (think about when AT&T was broken up into the seven smaller "baby bells" in 1982). These processes will take time to play out, and whether they have a material impact remains to be seen.

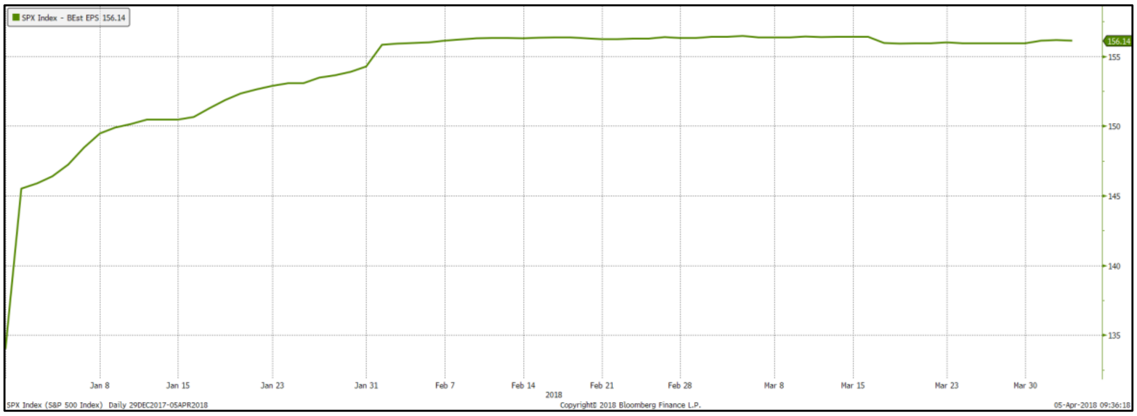
Through all the alarming headlines, we have kept our eyes focused on the three main components of market health: valuations, the direction of interest rates and Fed policy, and U.S. GDP/corporate earnings. As we have pointed out for quite a while, valuations remain high at 20.80x earnings for the S&P 500.

The Fed continues to raise the Fed Funds rate along with their tapering activities, but the pace remains incremental. As of this writing, the 10-year U.S. T-Note is at 2.74%, the high end of the Fed Funds target is 1.75%, and the dividend yield on the S&P 500 is ~1.8%. This is important as many businesses face increased lending costs, and investors have an expanding array of opportunities to achieve their required return. There has not been the traditional competition for capital between bonds and stocks for many years now, but as rates rise, we expect this dynamic to return to the markets in the form of the volatility that we have been seeing as of late. Below is a long-term chart of the 10-year U.S. Treasury Note yield that shows that it could be meaningfully breaking its downward-sloping trend. We expect that potential future increases in interest rates would represent the biggest potential headwind to the markets. Higher U.S. corporate earnings and higher U.S. GDP also add to the reasoning that our current environment is one in which we could see the decades-long drop in rates come to an end.

10-Year U.S. Treasury Note Yield (1994-2018)

According to analyst consensus, U.S. GDP and S&P 500 corporate earnings estimates are both coming in higher for the year. Earnings are expected to grow approximately 25.6% in 2018 and 10.5% in 2019. These estimates are usually pared back as the year progresses, but as you can see from the chart below, there has been a powerful increase in earnings expectations since the Tax Cuts and Jobs Act was passed late last year. We also expect an M&A theme to emerge at some point during the year as the tax reform will allow corporations to repatriate billions of dollars of offshore capital which will probably find its way into large domestic acquisitions. Barring a major geopolitical incident or interest rates moving appreciably and rapidly above the 3% area on the 10-year U.S. T-Note, higher corporate earnings are supportive of a solid U.S. stock market and can provide a good cushion to some of the negative inputs we expect throughout the year.

S&P 500 Consensus EPS Estimates (2018)



Because of our expectation for higher volatility in 2018, we went into the year with a generally higher-than-normal margin of safety (cash and bonds/income securities) in most portfolios. We also undertook an effort to further decrease risk as the market ramped up during January. In a traditional "two-way" market, it makes sense to take some chips off the table when the market is higher and add a bit when it is low. We will continue with this approach until the fundamentals and/or technical environment change, depending of course on specific client mandates. Warren Buffet said it best in his most recent Berkshire Hathaway annual report:

> ***"There is simply no telling how far stocks can fall in a short period. Even if your borrowings are small and your positions aren't immediately threatened by the plunging market, your mind may well become rattled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."***

Having a good margin of safety and making sure your investments align with your goals and risk tolerance are the best way to make sure you can stay the course while attempting to build long-term wealth. As always, please discuss any changes in your goals or risk tolerance with your advisor to ensure your accounts are allocated properly.

Sincerely,

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