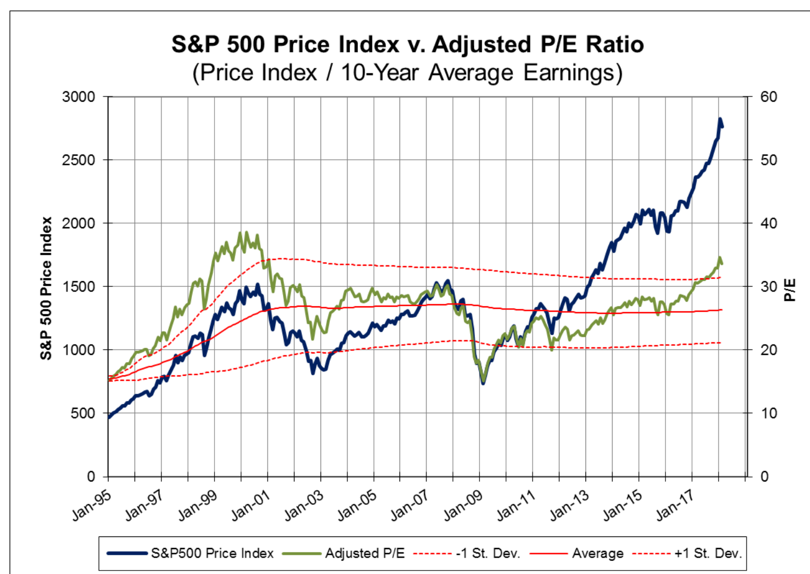
Monthly Market Comment
February 1, 2018

In January, U.S. stock prices continued to rise, but an upsurge late in the month looked like the kind of blow-off that may precede a pullback or correction. Indeed, a drop in bond prices and a rise in yields during January provided a ready excuse for such a pullback in the closing days of the month. Rising bond yields also sparked a sell-off in real estate securities, but commodity prices strengthened.

Stocks

The S&P 500 stock price index continued its long, steady uptrend through the last full week of January, before pulling back in the final days of the month on fears that strong economic growth and the new tax cuts will boost inflation and prompt the Federal Reserve to start raising interest rates faster. Despite the declines at the end of January, the S&P 500 ended the month up 5.6% from the end of December and 23.9% higher than at the end of January 2017. That means the index notched a month-end record high in 14 of the last 15 months. Taking into account dividends, the total return on the S&P 500 was 5.7% in January and 26.4% over the last year.

Even though stock prices pulled back in late January and have fallen precipitously during the first days of February, we suspect those moves were most likely the beginnings of a long over-due correction that will wash out some of the recent excesses in the market and therefore prove to be healthy. As we have noted previously, stock valuations had gotten very high, and rising interest rates logically should force investors to take a more rational view of the market's prospects. All the same, the key fundamentals that have supported the bull market generally remain in place. Not only is the economy continuing to expand, but growth has recently started to accelerate, and it is likely to get a further boost in the near term from the tax cuts signed into law in late December. That should keep corporate profits on the upswing. We do see inflation pressure firming in the domestic production sector, but it doesn't look like it's going to surge, so we still think the Fed is likely to keep tightening monetary policy only gradually. Perhaps most important, we think there are legions of investors who feel left behind by the bull market to date. Once the market stops falling, we think they will start buying and help drive prices upward again.



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Technical indicators also do not look too worrying to us. With its pullback in the final days of January, the S&P 500 price index merely approached its 20-day simple moving average (SMA), and even with its scary drop in early February, it has only moved modestly below its 50-day SMA. Moves like that are actually fairly common. In fact, the market retreated below its 50-day SMA three separate times in 2017, even as it continued to trend upward. In addition, a string of consecutive month-end record highs like the market exhibited through January has historically been followed not by an abrupt, sustained downtrend, but by a continued uptrend where the record highs simply start to come less frequently. Another reassuring sign is that even with the declines of the last few days, over 75% of the stocks in the S&P 500 index are still trading above their 200-day SMA, indicating the market uptrend remains quite broad. An additional important sign is that the Dow Jones Transportation Index has recently been moving in line with the overall market, which has traditionally been a positive indicator for stocks. Finally, the main short-term momentum indicators (such as the "moving average convergence/divergence," or MACD) suggest stocks are now much less over-bought than they had been. It might not take much more of a decline to suggest that stocks are over-sold and are a good bargain. If the market pullback continues, we suspect the S&P 500's next significant support level would be at approximately 2,560, with a secondary support level at about 2,500. If stocks start to rise again, the next significant resistance levels would come around 2,750 and 2,872.

S&P 500 Stock Price Index + "MACD" Momentum Indicator

Source: BigCharts.com

Bonds

Bond prices continued to fall steadily throughout January, reflecting investor fears about accelerating economic growth, firming inflation, and the risk of higher interest rates. As bond prices fell, yields rose, and at the end of January, the yield on the benchmark 10-Year Treasury Note had risen to 2.720%, compared with just 2.405% at the end of December. As measured by the S&P U.S. Aggregate Bond Index, the total return on investment-grade bonds was negative 1.0% in January and a positive 2.0% since the end of January 2017.

Looking forward, we continue to see value in the income, stability, and safe-haven characteristics of fixed-income investments, and it appears that many other investors began to appreciate those characteristics again as the stock market sold off in late January and early February. As the 10-Year

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Treasury yield starts to approach its late-2013 high of about 3.0%, we believe more and more investors will find bond yields attractive and buying will pick up. That could potentially allow prices to stabilize, although there is a risk that bond selling could accelerate again if the policymakers panic and start raising interest rates more rapidly in the face of strengthening economic growth and inflation. On balance, we still don't look for total returns on bonds to be particularly juicy for the foreseeable future, but we do think potential returns are starting to look attractive enough to prompt stronger buying.

Real Estate and Commodities

For publicly-traded real estate investment trusts (REITs), the FTSE NAREIT Price Index dropped by a sharp 3.1% in January, although it was still up 1.3% over the last year. Because of their relatively high dividends, the total return on these REITs was a negative 2.9% in January and a positive 5.3% over the last twelve months. Previously, publicly-traded REITs had spent more than a year bouncing around a trading range, reflecting a tug-of-war between those investors who see moderate economic growth as positive for real estate and those who see gradually rising interest rates as an opportunity to roll out of higher-yielding risk assets and back into bonds. With the big drop in REITs during January, it appears that the concern about rising interest rates has started to overwhelm the market. In the coming months, we think those concerns could continue to weigh on the market.

For commodities, the S&P GSCI Total Return Index ended January up 3.4% from the end of December and an extraordinary 11.0% from the end of January 2017. The rise in January once again came mostly from rebounding prices for crude oil and related energy products, reflecting improved fundamental factors such as rising demand and constrained production. In addition, the gold prices rose strongly in response to a falling U.S. dollar, although prices for industrial metals (such as copper) retreated. In agriculture, grain prices rose smartly, as did prices for cattle, but prices for coffee, cocoa, and hogs fell. Going forward, we agree that fundamentals in the energy market are looking better, but we still worry that rising crude production in the United States could swamp some of the recent increase in demand and offset much of the output cuts that the Organization of Petroleum Exporting Countries (OPEC) and its partners agreed in late 2016 and extended further in May and November 2017. We are therefore neutral regarding the near-term outlook for the broad commodity sector. We still believe that excess supplies in many commodity categories will gradually be brought under control in the coming months and quarters, ultimately allowing prices to rise again, but we think prices will remain volatile and could post meaningful retreats in the near term.

Patrick Fearon, CFA
Chief Investment Officer

Asset Class	Index	Ending Reading, Latest Month	1-Month Change	3-Month Change	12-Month Change
U.S. Stocks	S&P 500 Price Index	2,823.81	5.6%	9.7%	23.9%
Non-U.S. Stocks	MSCI All-Cap World Ex-U.S. Price Index	322.57	5.5%	8.5%	26.5%
REITs	FTSE NAREIT All-Equity Price Index	662.09	-3.1%	-1.6%	1.3%
Commodities	S&P GSCI Total Return Index	2,644.13	3.4%	9.5%	11.0%
Bonds	S&P U.S. Aggregate Bond Index	191.57	-1.0%	-0.7%	2.0%

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