Northport Investment Management, LLC
A Registered Investment Adviser

Market Commentary – 1st Quarter 2018

It was a generally down quarter for stocks. A turbulent one, in which the stock market produced a dizzying series of record highs followed by a dramatic collapse, and the return of long-dormant volatility. In the end, the Dow lost 2.5% for Q1 2018, ending its nine-quarter winning streak. The S&P 500 fell 1.2% for the quarter, also breaking its nine-quarter winning streak. The tech-heavy NASDAQ Composite, despite its extreme volatility, advanced 2.3% for the quarter. Only two of the eleven S&P 500 Sectors had positive returns for Q1 2018. Technology (+3.2%) and Consumer Discretionary (+2.8%) were the best sectors. The Telecom (-8.7%) and Consumer Staples (-7.8%) sectors were the worst. Mid-Cap stocks (S&P 400 Mid-Cap Index, -1.2%) and Small-Cap stocks (Russell 2000 Index, -.4%) depreciated in Q1, as did developed international equities (MSCI EAFE Index, -2.2%). Emerging market equities (MSCI BRIC Index, +2.0%) were modestly positive for the quarter.

Bonds, whose prices move in the opposite direction of yields, produced negative returns for the first quarter. Bond yields were higher across the board in Q1, with shorter maturities seeing the bulk of the rise. As stocks soared (peaking on 1/26/18), so did concerns that a pick-up in inflation would push the Federal Reserve to raise interest rates faster than expectation. This led to the overall bearish bond action in the past three months. The yield on the benchmark ten-year Treasury note rose from 2.409% to 2.741% during the quarter, the largest quarterly rise since 2016.

Although higher for the quarter, bond yields drifted lower toward quarter's end, as a flight-to-safety, during the rout in tech stocks, helped to keep yield moves in check. U.S. treasury yields also continue to be restrained by lower overseas rates. We expected higher bond yields at this point. We thought that the benchmark ten-year Treasury note yield would have eclipsed 3% by now. We still expect the Fed to raise short-term rates 2 or 3 more times this year. We expect to see 3% on the ten-year Treasury note before year-end. Gradual rate increases are positive. Lower interest rates are a sign of weakness, not strength. The Fed wouldn't be raising interest rates if they thought the economy couldn't handle it. Interest rates are gradually rising for good reasons; a strong economy, and a need to normalize. A rising interest rate environment fosters our preference for stocks over bonds.

The relatively modest changes in the major stock indices for Q1 2018 mask the roller coaster ride that stocks experienced during the quarter. Volatility is back in a big way. The fear index is rising. Coming off one of the least volatile stock market years ever in 2017, an uptick in volatility in 2018 should not be surprising. Last year's calm was abnormal. The current volatile market is more the norm. What we experienced in Q1 2018 was an expected, normal, and overdue, 10%+ stock market correction. We then had a decent bounce, and now, we're most likely having a normal re-test of the lows. We do not see a bear market occurring, defined as a 20% drop from market highs. We see ongoing consolidation and eventually another sustained advance. A likely catalyst for another advance would be strong corporate earnings. Q1 2018 earnings are projected to be up in the mid-teens. The stock market melted up in January 2018. Too much greed. Too many momentum players. Now we may be approaching the too-much-fear stage. Momentum goes both ways. We will probably also overshoot on the downside.

There are some fundamental reasons behind the wildly fluctuating stock market. These would include rising interest rates and a hawkish Fed, rising deficits, trade issues, and a social media crisis. At this point, we feel that some of these issues may not be as serious as some think. Some of these issues may be more political than economic. Trade issues may be part of a negotiation process. It will be weeks, or months, before they may, or may not, be implemented. The U.S. economy is strong enough to handle some uncertainty. We are not headed toward recession in the near-term. Evidence continues to show that economies around the globe are chugging along in a synchronized manner. The underlying fundamentals of our companies remain solid. Price-to-earnings multiples have come down and will support equities at these levels. It will continue to be volatile, but the economic reality tells us to stay invested.

The enclosed performance report offers investing perspective in that it details portfolio investment performance for the past three months, and since inception. This past quarter was painful, but it pales in comparison to the wealth created over multiple years (earliest NIM clients have a 2/28/2009 inception date). It also illustrates the dramatic positive difference in stock returns, versus bond returns, over time. The tone of the market may have changed over the past three months, but this doesn't mean we should make sweeping changes to the composition of our long-term investment program.

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