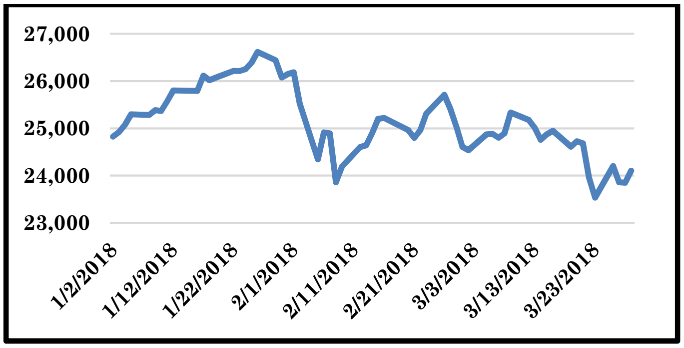
Quarterly Commentary

US Equity

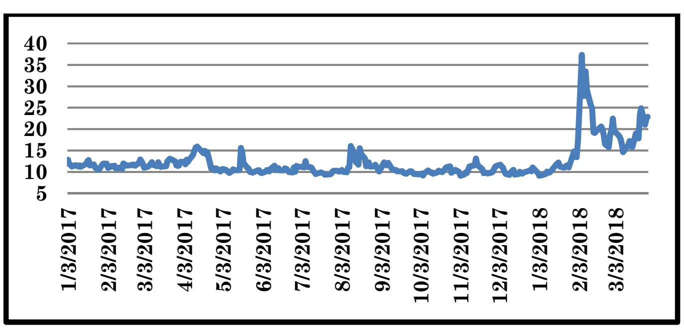
For the first time in ten quarters, the domestic stock markets went down. At the same time, volatility spiked, interest rates rose and threats of tariffs reappeared.

Dow Jones Industrial Average



The spike in volatility was overdue and often predicted, yet still caught many by surprise. In fact, many analysts point to the lack of volatility as the cause of the dramatic market behavior we eventually received. Investors became complacent and the market was wound up to levels it could not sustain, just waiting for an excuse to sell off. The market downturn was sparked by a wage growth report that signaled a possible uptick in inflation. The prospect of higher inflation caused bond traders to sell longer maturities, which drove rates higher.

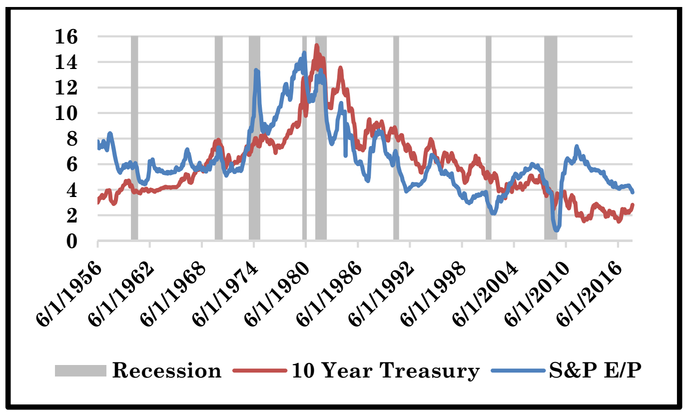
VIX



The Fed Model

The Fed Model tells us that equity earnings yields (earnings/price) should seek equilibrium with 10-year treasury yields. As with any model, there are situations where it works better than others. Most economists feel the model is most accurate when rates are over 4% and the economy is in expansion, but the market expected it to work at much lower levels during the first quarter as seen in the chart below. The bottom line is, investors will chase yields wherever they can find them. If rates rise, that means some will sell stocks to buy bonds.

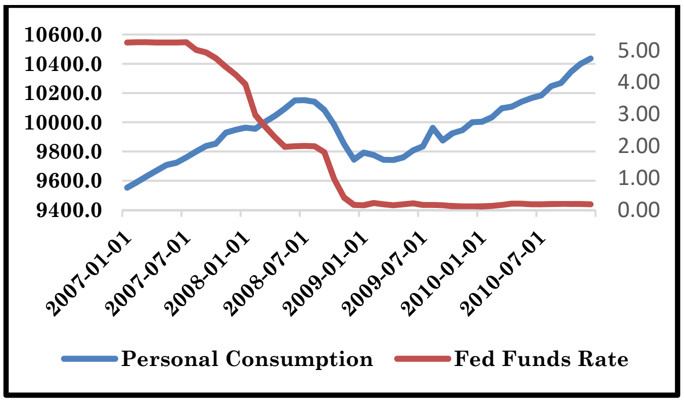
Fed Model



It is worth examining why some economists feel the model will not work below 4%. It goes back to Friedrich Hayek's critic of Keynesian economics. He said Keynes overlooked the fact that the borrowing rate for those seeking loans is roughly the same as the return investors will get on their bonds. If central banks drop rates hoping the lower rates will incent borrowing, they will hurt those living off of fixed income. Those bond or CD buyers will see their incomes slashed and will consume less. Since consumption is two-thirds of GDP, the economy will stall despite their best intentions.

Quantitative easing did not work as intended for the same reasons Hayek observed. When the Fed cut rates to 4%, it allowed high-risk companies to borrow at more affordable rates. When they cut rates to 3.5%, it allowed homeowners to refinance their mortgages. When they dropped rates to 3%, it allowed municipalities to refinance their bonds. When they cut rates to 2.5%, savers felt the pinch and slowed their spending. Obviously, the drop in personal consumption cannot be blamed solely on interest rates, but the chart is compelling.

Fed Funds vs Personal Consumption



If the model does not work on the way down, it will probably not work on the way up, either. As rates rise, savers will feel a little more confident in their spending, which will drive consumption and corporate profits. Once rates get over 4%, home ownership becomes more expensive for new buyers and the model begins to work again. So rising rates might not be so bad after all, at least in the short run.

Tariffs

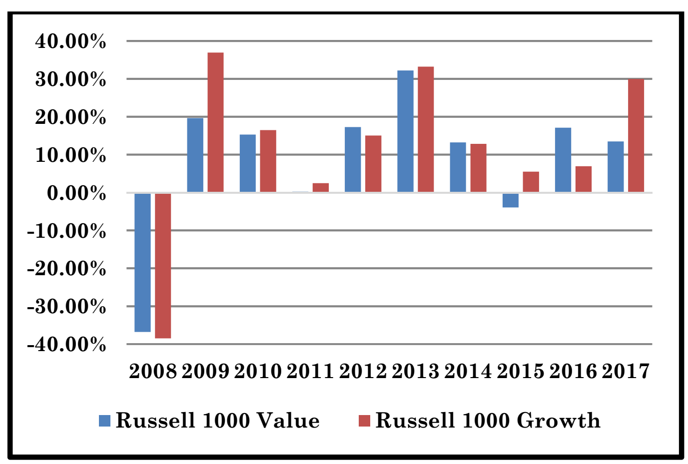
The debate on tariffs will go on forever. It seems to raise its head whenever the trade deficit grows and nationalist politicians come into office. While some believe tariffs will level the playing field, it puts the government in the business of picking winners and losers. For instance, if we impose a 25% tariff on imported steel, it helps domestic steel producers, but it hurts steel users who will see input costs rise and, in turn, their customers who will pay higher prices for finished goods. Most economists feel the number of people who suffer from tariffs far outnumbers those who benefit. In the case of steel tariffs, it is especially pronounced because so many products use steel.

Larry Kudlow, the current director of the National Economic Council, insists that the current round of trade war threats is mere bluster and that both sides are just posturing. In any case, the markets take the near daily exchanges seriously, and 2% market swings are becoming all too common.

Concerns/Strategy

The stock market's rally from its March 2009 low point is stretching valuations and defying historical norms. It has been fueled by low interest rates and, most recently, by tax cuts. Given that the Fed is overtly raising rates and that tax cuts could be reversed by a change of control in the House, there are causes for concern. That said, it is not time to panic. As stated earlier, rising rates could give a boost to the economy in the short term, and elections are hard to predict. The rally could continue for quite a while longer, although volatility is a near certainty. This is where having an appropriate asset allocation, wide diversification and a proactive plan comes in. Expect a downturn and have sufficient cash on hand to weather it. Most financial planners say 3-6 months' worth of expenses are sufficient.

Value vs Growth

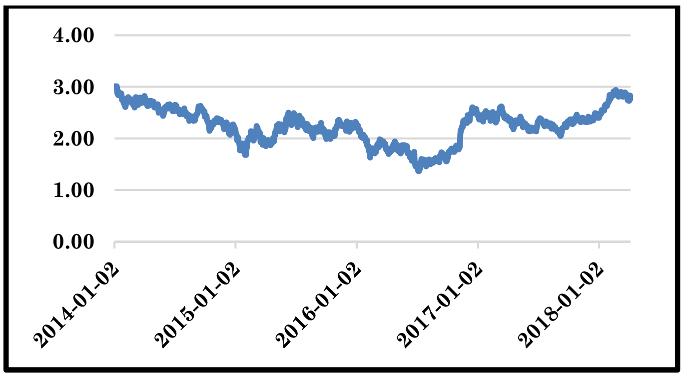


In seeking diversification, also consider style. Whenever one style outperformers the other by a wide margin, things usually reverse the following year. Last year, growth blew away value, so take a look at some classic value stocks for safe keeping. Finally, consider non-correlated asset classes such as commodities, emerging markets and hedge funds as a way of spreading risk.

Fixed Income Markets

Bond yields spiked in the first quarter as key economic data indicated that inflationary pressures had picked up. The 10-year Treasury note reached 2.94% in February, levels not seen since early 2014. When interest rates rise, bond prices fall, and it has been quite some time since investors have experienced lower market values in their bond portfolios. Naturally, this can be cause for concern and can increase anxiety about where yields are heading.

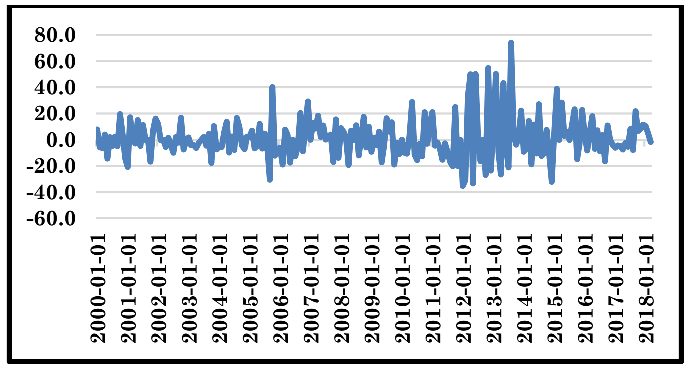
10 Year Treasury Yield



As was expected, the FOMC raised the Fed Funds rate in March. There was a slight improvement in the language of the released statement, and monitoring of US economic conditions will continue to determine the actual track of further hikes. The Fed reaffirmed its projected three rate hikes in 2018, but signaled a tighter policy path by indicating three rate increases in 2019 and two in 2020. Economic activity continues at a moderate pace as the labor market continues to strengthen, with a declining unemployment rate. Household spending has moderated from a strong 2017 4th quarter. Overall, inflation (minus food and energy) continues to run below the Fed's target of 2%. Durable goods orders moved higher along with aircraft demand.

One key economic indicator of increasing inflationary pressures is wage growth, which has increased but remains historically low. Average hourly earnings reported in February 2018 saw a sharp increase of 2.9% year-over-year, which caught the markets off guard. Rates rose quickly and equity markets declined sharply. The concern was that the Fed may have to be more aggressive with its rate hikes, which could potentially stunt economic growth. Data released since then shows a downward revision of the January data and while wage growth is improving, it lacks some consistency. The sharp increase in wage growth was just the first headline to resurrect volatility in the bond market.

Average Hourly Earnings

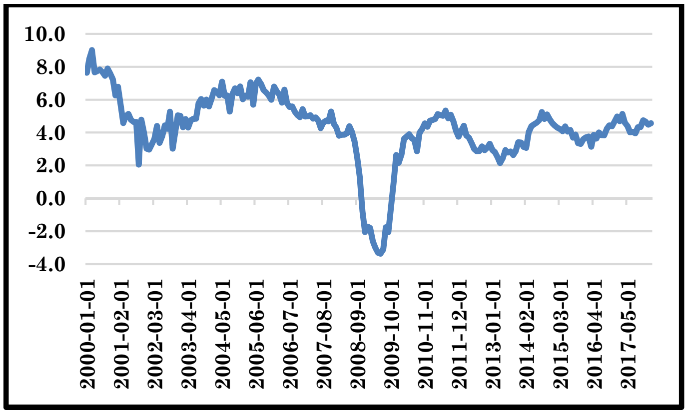


Markets are likely to see more frequent swings in fixed income prices in the near term, particularly if volatility in the equity markets continues. The more recent fears surrounding potential trade wars and tariffs, retaliation and the effects on our economy are weighing on investors' minds.

During the past several decades, globalization has stimulated free trade and most countries, including the majority of the world's major economies, experienced an increase in trade openness. While this benefited the global economy, it also had negative effects and created winners and losers across countries, industries, and companies. If more restrictive trade policies were to make imported goods costlier, it would at least initially put upward pressure on the prices of consumer goods, and emerging markets and multinationals could suffer.

As a barometer for inflation, the Federal Reserve prefers to monitor Personal Consumption Expenditures. This is a measure of goods (durable and non-durable) and services which are targeted and consumed by individuals. It is viewed by the Fed as a more accurate reflection of spending/potential inflation than the consumer price index. While it remains below its long term growth rate, there has been a steady increase over the past several years. As tax cuts make a difference in consumers' paychecks, spending should increase.

Personal Consumption Expenditures



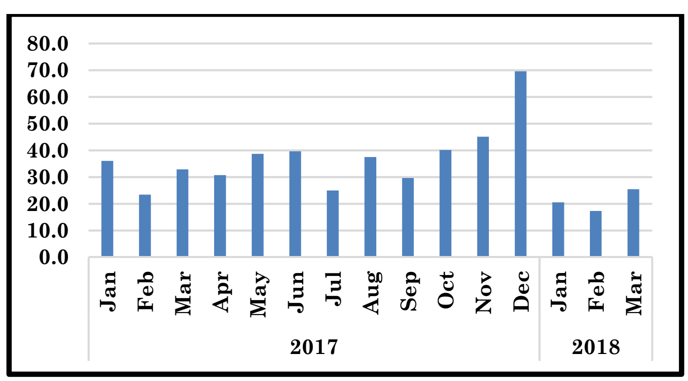
So the real question is, where do we go from here? While it is somewhat difficult to be precise, there are some factors that indicate interest rates will be moving higher as the year progresses. Until recently, the largest buyers of U.S. debt have been the Federal Reserve, foreign governments and mutual funds. The Federal Reserve is well under way in reducing its $4.5 trillion balance sheet by not reinvesting the principal of securities as they mature. The intention is for this to be a gradual process, avoiding a substantial increase in supply of U.S. debt, but the amount of decrease is substantial. The European Central Bank and the Bank of Japan are poised to reduce their accommodative monetary policy and as yields rise globally, the demand for U.S. debt may not be as compelling as once was. Like anything else, as demand fades, prices will need to come down (yields will move higher) to attract investors.

The passage of the Tax Cuts and Jobs Act in December 2017 was well received by the equity markets and is expected to provide a boost to consumer and business spending and overall economic growth. To further this objective, the most recent spending bill was signed into law in February. As federal tax revenues decrease from the tax cuts and outlays for infrastructure and capital expansion grow, so will the deficit. The need to finance a growing federal deficit will result in an increase in U.S. debt issuance. With more Treasury debt in the market, and fewer buyers, the natural progression is for rates to increase. Some would anticipate the 10-year Treasury note to rise above 3% by year end, so the data will dictate.

Tax-Exempt Markets

Investors have been waiting for supply to pick up in the muni market. The 4th quarter of 2017 saw a surge of issuance, in part because municipalities raced to sell bonds before new tax rules took effect. But issuance all but dried up as we entered 2018. As of the end of February, issuance was down 47% from the previous year. If an increase in supply does materialize over the year, it is expected to be met with strong demand from investors. The forecast for 2018 is that the muni market's net supply will still be in negative territory, which is providing a good tailwind in supporting values on tax-exempt bonds. In spite of the tax cuts, investors in the top marginal rate will still benefit from tax-exempt income. CWM continues to focus on very high quality, general obligation and essential service municipal bonds. In this environment where interest rates are expected to rise, we also focus on more defensive, higher coupons to help cushion against duration risk.

National Muni Debt Issuance



With continued expectations of economic growth and upward movement in inflationary pressures, we expect for interest rates to rise throughout the year. As long as rates are rising for the right reasons (steady growth), it is a good thing for the economy. Navigating through these periods require effective management of a fixed income portfolio. Chesapeake Wealth Management constructs bond portfolios where average credit quality is on the high end of the spectrum, and the duration target is on the low side, in comparison to most industry benchmarks. We continue to position our portfolios in a conservative way to protect our clients' wealth during these types of cycles. We monitor the ever-changing market and economic conditions, but focus on our clients' goals and objectives when customizing a portfolio.

Rationale for owning fixed income assets remains the same: to provide a dependable level of income and reduce overall portfolio volatility.

Richard L. Ware, CFA

Elizabeth D. Swartz

March 31, 2018

References

1. DJIA 2018
Dow Jones Industrial Average: Price weighted index of 30 U.S. large cap stocks.

2. VIX
Chicago Board Options Exchange: Implied volatility of the S&P index options.

3. Fed Model
Federal Reserve Economic Data/Standard & Poors: Trailing 12 month earnings/S&P price, monthly average yield on 10 year bonds.

4. Fed Funds vs Personal Consumption
Federal Reserve Economic Data/Bureau of Economic Analysis: Monthly average of Fed Funds overnight rate, national personal consumption expenditures by month.

5. Value vs Growth
Morningstar: Calendar year returns fo the Russell 1000 Growth and Russsell 1000 Value.

6. U.S. Treasury Yield Curve
Federal Reserve Economic Data

7. Average Hourly Earnings
Federal Reserve Economic Data: Average amount employees make per hour in a given month.

8. Personal Consumption Expenditures
Federal Reserve Economic Data: Price change in consumer goods and services.

9. National Muni Debt Issuance
Securities Industry & Financial Markets Association: Municipal debt issues by quarter.

Disclaimer

Northern Neck Office
97 North Main Street
Post Office 1419
Kilmarnock, Virginia 22482
toll-free 800-434-1181
804-435-3652

Williamsburg and Middle Peninsula Office
4804 Courthouse St., Suite 1A
Williamsburg, Virginia 23188
toll-free 888-653-9088
757-253-9088

Richmond Office
5501 Patterson Avenue
Richmond, Virginia 23226
804-939-6422

chesapeakewealth.com