WEALTH MANAGEMENT GROUP

FIRST AMERICAN BANK

INVESTMENT PERSPECTIVES

FIRST QUARTER 2018

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1st Quarter 2018

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Equity Markets

1st Quarter 2018 Recap

After getting off to an exceptionally positive start, global equity markets suffered through a volatile 1Q18. The S&P 500 finished the quarter down 0.76% for its first quarterly loss since 3Q15. Among the major global equity indices we track only the NASDAQ Composite and MSCI Emerging Markets indices posted gains for 1Q18. Valuation was the silver lining in a tough quarter with the S&P 500's P/E falling from a very rich 20.0x to a slightly above 30-year median 16.8x.

Volatility, largely absent for most of 2017, came back with a vengeance in 1Q18. While there were only seven days during 2017 when the S&P 500 moved more than 1% in either direction, there were 23 such days in the first quarter. The volatility felt extraordinary to investors lulled into complacency by its near total absence last year, but 1Q18 was more in line with long-term average volatility levels.

The weakness in equity prices came despite a very strong earnings outlook for 2018. Consensus estimates for S&P 500 earnings growth for 2018 rose from 13% late in 4Q17 to more than 18% by the end of 1Q18. The exuberant growth expectations didn't, however, keep the market rising. The stronger than expected wage growth report on January 29 spurred inflation fears and applied additional pressure to already rising interest rates. This appeared to be the most proximate catalyst that sent the highly valued equity markets tumbling. What might have been a mid-single-digit downturn cascaded into a full 10% correction as the crowded "short volatility" trade unwound amid panic and margin calls. The downturn in stocks was doubly unsettling for many investors as, at least in its early stages, bonds sold off alongside equities rather than benefitting from the typical flight to safety trade. Investors were briefly left with few options beyond cash to avoid volatility.

Even though inflation and interest rate fears eased somewhat as the first quarter progressed, the market remained unsettled as

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evidenced by continued volatility. That volatility was made worse by concerns over trade policy, Facebook's user privacy scandal and President Trump's ongoing legal challenges.

The technology and consumer discretionary sectors (both dominated by mega-cap, technology-focused stocks) were the only two sectors to post positive returns in 1Q18 with both rising more than 3%. Typical flight-to-safety sectors consumer staples and telecom services were the worst performers both falling more than 7%. From a valuation perspective, energy and financials took the biggest hit while technology, consumer discretionary and utilities saw the smallest compression in valuation.

International equities also struggled in the first quarter. The MSCI EAFE Index (developed markets) fell 1.58% or just over twice as much as the S&P 500. The MSCI Emerging Markets Index was the positive standout for the quarter with a 1.24% gain. While both developed and emerging market indices continue to trade at a P/E discount to the S&P 500, that discount narrowed modestly in the first quarter.

Global Equity Index Returns (as of 3/30/2018) *** Periods beyond 1 year annualized.**

	1Q 2018	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500	-0.76%	-0.76%	14.06%	10.77%	13.28%	9.48%
S&P 500 (Equal Weight)	-1.01%	-1.01%	11.81%	9.07%	12.83%	10.88%
Dow Jones Industrial Average	-1.96%	-1.96%	19.42%	13.48%	13.31%	9.85%
NASDAQ Composite	2.59%	2.59%	20.85%	14.36%	18.14%	13.33%
S&P 400 Mid Cap	-0.77%	-0.77%	10.96%	8.95%	11.93%	10.88%
Russell 2000 Small Cap	-0.08%	-0.08%	11.79%	8.38%	11.45%	9.82%
MSCI EAFE (Non-U.S. Developed Markets)	-1.58%	-1.58%	14.66%	6.11%	7.08%	3.32%
MSCI EM (Non-U.S. Emerging Markets)	1.38%	1.38%	25.31%	9.25%	5.37%	3.37%

Equity Markets

2nd Quarter 2018 Outlook

Market fundamentals remain solid despite the increased volatility and price declines among most major equity indices in the first quarter. Domestic equity valuations peaked in 4Q17 when the S&P 500's forward P/E touched 18.5x. Sharp increases in earnings estimates for 2018 due to the impact of the tax reform legislation that passed in late December brought the P/E down 1.5 turns by early January. The market correction that started on January 29 took the P/E down further to a low of 16.1x, a level not seen since the market correction in 1Q16 and not far from the trailing 30-year median.

The volatility in the financial markets in the first quarter clearly dented investor confidence. Potential market concerns (inflation, rising interest rates, the peak in corporate earnings growth for the cycle, Trump's tough trade talk, etc.) that had been simmering for months were suddenly at full boil in the collective investor psyche. The increased anxiety led to decline in valuation referenced above.

Given the long list of potential headwinds for the market, we think the odds are currently against a significant increase in the market P/E over the balance of this year. Perhaps the biggest headwind for equities comes from the fact that for the first time in seven or eight years investors can earn positive real (after-inflation) returns on relatively short-term, risk-free assets. Such alternatives raise the return hurdle for owning riskier assets like equities.

The good news for investors is that the strong earnings expectations in place should make it possible for equity prices to grind higher as the year progresses as long as valuation multiples don't compress materially from here. Maintaining the current market P/E multiple on consensus 2019 earnings estimates (which investors will be looking to by late 2018) would put the S&P near 2,800 by the end of this year. That would produce a 5% gain for the year and a 6% gain from the end of the first quarter.

We continue to believe that international equity indices, especially those focused on emerging markets, have somewhat better return prospects for 2018 than most domestic indices. Broad international valuations remain lower than those in the U.S. and earnings growth expectations are nearly as strong.

Equity Market Valuation

	12-Month Forward 3/29/18	12-Month Forward 3/30/17
S&P 500 P/E	16.5	17.4
S&P 500 Dividend Yield	1.95%	1.97%
S&P 400 Mid Cap P/E	17.5	19.4
Russell 2000 Small Cap P/E	24.9	26.2
NASDAQ Composite P/E	21.0	21.5
MXEA EAFE P/E	13.7	14.8
MXEF Emerging Markets P/E	12.1	11.7

Economics

4th Quarter 2017/1st Quarter 2018 Recap

4Q17 real GDP growth came in at 2.9% marking a slight decline from 3Q17 growth. Personal consumption expenditures and gross private domestic investment both grew in the quarter although investment growth slipped from 3Q17 levels. Net exports were negative for the quarter and detracted from GDP growth. Full-year real GDP growth in 2017 was 2.3% versus 1.5% in 2016.

Core inflation has accelerated steadily since bottoming during 3Q17 and hit 2.1% in March. Retail sales growth remained positive on a year-over-year basis throughout the first quarter but slowed sharply from the strong 2017 Holiday Season. Consumer and business confidence tailed off in 1Q18 but remain at relatively healthy levels likely due to the expected positive impact of tax reform legislation.

Economics

2nd Quarter 2018 Outlook

We expect both domestic and international economic growth to remain near recent trend levels for the remainder of 2018 (global real growth above 3%, developed markets above 2% and emerging markets above 5%) absent shocks to the system from noneconomic events. We also think it is likely that global economic growth momentum may have peaked for now.

The Citi Global Economic Surprise Index has deteriorated sharply so far in 2018, falling from its recent peak of nearly 35 in December 2017 to less than 12 by the end of March.

The index has continued to fall since the end of the first quarter with the most recent reading near -14. All the major country and regional sub-indices also have negative trends although the U.S. and Chinese indices continue to show positive absolute readings.

The Citi surprise indices, while useful measures, are also prone to overreaction as they gauge the difference between expectations (which are prone to hyperbole) and actual results. Other indicators such as the Markit Composite Purchasing Manager Indices continue to point toward solid if decelerating growth in most major global economies.

The number of crosscurrents potentially impacting economic growth continues to expand. In the U.S., the stimulative effects of tax reform and the expansion of federal spending are competing with potential headwinds from the Fed's balance sheet unwind, growing debt levels and higher interest rates. Add in threats of a trade war between the U.S. and China, ongoing political intrigue surrounding the Trump administration and global geopolitical unrest and it's easy to see why financial market uncertainty has risen. Higher uncertainty is the primary driver of the return in financial market volatility we've seen this year and volatility can lead investors to seek stability at the expense of maximizing returns.

Inflation remains an important economic statistic to focus on for the remainder of 2018. Fiscal stimulus in the amount we're currently getting in the U.S. has seldom been tried with the economy as strong as it appears currently and so close to full employment. Rising commodity prices and a weaker U.S. dollar could also add to inflationary pressures.

Internationally, most attention will be focused on China. Credit growth there has slowed substantially and President Xi has absolute power. Trade tensions between China and the U.S. could disrupt both economies, as well as the global economy, if they escalate.

Fixed Income

1st Quarter 2018 Recap

Interest rate volatility rose in the first quarter along with equity volatility but faded more rapidly as the quarter progressed. The yield on the 10-year U.S. Treasury Note ended the first quarter at 2.74%, 34 basis points higher than when the quarter began. The 10-year yield topped out at 2.94% on February 21. Most other benchmark interest rates also moved up in the quarter as heightened inflation fears, increased U.S. Treasury borrowing and the Fed's balance sheet unwind all put upward pressure on rates.

Despite the upward trajectory of rates, the spread between the 2-year and 10-year U.S. Treasuries fell to 47 basis points, its low since 2007. Even with the continued compression, the 2/10 curve remains well above inversion and is thus not signaling a recession in the medium term. The high-yield and investment grade bond spreads versus similar maturity U.S. Treasuries both rose moderately in the quarter.

The Fed met expectations for the quarter by raising the Fed Funds target rate once by 25 basis points to 1.75%. This move followed three rate hikes in 2017.

Even though inflation fears picked up during the first quarter, the Fed's five-year inflation break-even rate ended the quarter at 2.02% or six basis points above where it began. The index hit its highest point since mid-2015 at 2.19% on February 2.

Fixed Income Rates

	3/29/2018	3/31/2017	Change
U.S. Treasury 10-Year Note	2.74%	2.40%	+34 bps
U.S. Treasury 2-Year/10-Year Spread	47 bps	113 bps	-66 bps
U.S. High-Yield/U.S. Treasury 10-Year Spread	345 bps	345 bps	0 bps
Federal Reserve Discount Rate	1.75%	1.00%	+75 bps

Fixed Income

2nd Quarter 2018 Outlook

Solid economic growth, rising commodity prices, declining labor force slack and ever growing debt levels are likely to drive interest rates moderately higher over the balance of 2018. The ongoing unwind of the Fed's balance sheet could add to upward pressure. Furthermore, the end of quantitative easing by the ECB could come by the end of the third quarter and put Euro Zone interest rates on a path back to normalcy.

The Fed will keep a close eye on inflation in determining whether it hikes its target interest rate twice more, as the dot plot indicates and most observers expect, or three more times before 2018 ends.

Perspectives

Goldilocks' Demise?

The U.S. economy appears to have been living a fairytale for most of 2017. Much as Goldilocks found Baby Bear's porridge, the economy has been neither too hot nor too cold but just right. U.S. real GDP growth, stuck at 2% or lower for much of the past eight years, exceeded 3% for the second and third quarters of 2017 and fell only 0.1% shy in the fourth quarter. Historically, when the economy begins to pick up steam prices begin to rise too as demand starts to outstrip supply. That didn't happen in this expansion through the end of 2017 as inflation remained subdued in the U.S. and across most developed economies. This "just right" environment has helped companies post strong earnings growth (sales rose faster than expenses) which has in turn helped drive equity prices significantly higher. The question is, will Goldilocks soon meet her doom?

Goldilocks' staying power will likely be tied to inflation. As noted above, inflation has been notably absent from this economic expansion. That was to be expected early in the expansion as the depth of the recession following the Global Financial Crisis dragged economic growth well below its long-term potential and created considerable slack in the employment market and industrial capacity. We have, however, now consumed much of that slack, especially in the employment market. The unemployment rate has dipped from 9.9% in 4Q09 to 4.1% at the end of 2017. Other than a six month period in 2000 before the Internet Bubble burst, you have to go all the way back to 1967 to find a lower rate of unemployment. Labor force participation among the prime-age cohort (25 to 54-year olds) which bottomed in late 2015 at 80.6% is now above 82%. The flow of people outside the labor force to employment is now larger than the flow in the opposite direction (people giving up looking for a job) was when it peaked in 2010.

Business surveys conducted by the National Federation of

Independent Business and by the regional Federal Reserve banks have consistently shown the shortage of qualified labor to be at or near the top of issues facing businesses of all sizes. On top of this challenge, many sectors also report rising prices on a wide variety of inputs and increasing lead times from suppliers. The availability of freight shipping, especially by truck, has become acutely short in some sectors.

All of these factors suggest that we will continue to see inflationary pressure build in the economy as the year unfolds. We believe that inflation will mostly grind higher rather than leaping. Still, the inflation grind means that interest rates are more likely to rise than fall significantly. Higher interest rates and wage pressures could begin to halt the increase corporate profit margins or press them lower. This would, in turn, likely erode the rate of earnings growth and make it harder for equity prices to rise.

It would appear that for the above scenario to be avoided one of two things must happen: Economic growth must slow materially; or productivity gains must pick up materially. The levels of R&D spending we've seen over the past few years suggest that productivity growth should be improving. We are, however, seeing few signs of that happening to date.

Asset Class Returns

2009	2010	2011	2012	2013	2014	2015	2016	2017	1Q 2018	10-YR Annualized
MSCI EM 78.5%	REITs 28%	REITs 8.3%	REITs 19.7%	Russell 2000 38.8%	REITs 28.0%	REITs 2.8%	Russell 2000 21.3%	MSCI EM 37.5%	MSCI EM 1.4%	S&P 400 10.9%
S&P 400 37.4%	Russell 2000 26.9%	Barclay's Agg. Bond 7.8%	MSCI EM 18.2%	S&P 400 33.5%	S&P 500 13.7%	S&P 400 - 2.2%	S&P 400 20.7%	MSCI EAFE 25.7%	Russell 2000 -0.1%.	Russell 2000 9.8%.
MSCI EAFE 31.8%	S&P 400 26.6%	S&P 500 2.1%	S&P 400 17.9%	S&P 500 32.4%	S&P 400 9.8%	S&P 500 1.4%	S&P 500 11.9%	S&P 500 21.8%	DJ UBS Commodity -0.4%	S&P 500 9.5%
REITs 28%	MSCI EM 18.9%	S&P 400 -1.7%	MSCI EAFE 17.3%	MSCI EAFE 22.8%	Barclay's Agg. Bond 6.0%	Barclay's Agg. Bond 0.6%	DJ UBS Commodity 11.8%	S&P 400 16.2%	S&P 500 -0.8%	REITs 6.0%
Russell 2000 27.2%	DJ UBS Commodity 16.8%	Russell 2000 -4.2%	Russell 2000 16.4%	REITs 2.9%	Russell 2000 4.9%	MSCI EAFE -0.8%	MSCI EM 11.2%	Russell 2000 14.6%.	S&P 400 -0.8%	Barclay's Agg. Bond 3.6%
S&P 500 26.5%	S&P 500 15.1%	MSCI EAFE -12.1%	S&P 500 16%	Barclay's Agg. Bond -2.0%	MSCI EM -2.2%	Russell 2000 -4.4%	REITs 6.7%	REITs 3.8%	Barclay's Agg. Bond -1.5%	MSCI EM 3.4%
DJ UBS Commodity 18.9%	MSCI EAFE 7.8%	DJ UBS Commodity -13.3%	Barclay's Agg. Bond 4.2%	MSCI EM -2.6%	MSCI EAFE -4.9%	MSCI EM -14.9%	Barclay's Agg. Bond 2.7%	Barclay's Agg. Bond 3.5%	MSCI EAFE -1.6%	MSCI EAFE 3.3%
Barclay's Agg. Bond 5.9%	Barclay's Agg. Bond 6.5%	MSCI EM -18.4%	DJ UBS Commodity -1.1%	DJ UBS Commodity -9.5%	DJ UBS Commodity -17.0%	DJ UBS Commodity -24.7%	MSCI EAFE 1.6%	DJ UBS Commodity 1.7%	DJ UBS Commodity -7.4%	DJ UBS Commodity -7.7%

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