Main Street Advisors, LLC

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First Quarter 2018 Key Takeaways

Volatility returned to the financial markets in the first quarter, for the first time in a while. Stocks surged out of the gates in January, then corrected sharply, before rebounding into mid-March, clawing back much of their losses. They then dipped again into quarter-end, buffeted by a potential trade war and a Facebook data scandal. When the dust settled, the Dow Jones Industrials Average ended down 2.0% and the S&P 500 -1.2% for the quarter.

Developed international stocks also got off to a strong start to the year, before suffering similar losses to U.S. stocks during the sharp correction in early February. They made up ground relative to U.S. stocks in March and ended the quarter down 2.4%.

European stocks (unhedged) lost a bit more than 1%. This could be due to a variety of reasons from European politics to a lower exposure to technology. Our views have not changed and we are maintaining our modest overweight to Europe.

Emerging-market stocks held true to their higher-volatility reputation. They shot up 11% to start the year, fell 12% during the mid-quarter correction, and then once again outgained U.S. and international stocks to finish the quarter with a 2.5% return.

Overall, our active U.S. equity managers in aggregate added value relative to the benchmark, led by our active growth managers (Harbor Capital Appreciation), who crushed the large-cap growth index (yet again) by several percentage points. Foreign stock funds did not fare as well in the first quarter. Active developed international equity managers outperformed, however that meant a smaller loss than the MSCI average of -2.4% while T. Rowe Price New Asia roughly matched its peer group with a roughly 1% return.

Core bonds didn't play their typical "safe-haven" role in the first quarter. They posted losses during the sharp stock market correction in February and delivered a 1.5% loss for the quarter overall, as Treasury yields rose across the maturity curve.

Our absolute-return-oriented and actively managed fixed-income funds outperformed the core bond index for the period. This has been the case over the trailing three- and five-year periods as well. We continue to expect these positions to outperform over the next several years, particularly if interest rates continue to rise.

Finally, the performance of our energy, pipeline, and utility stock ETFs underperformed the market. The first two are now arguably the "cheapest" sectors of the stock market, and we have remained patient because of this fact. Utility stocks have been strong performers for our clients since 2003, and have outperformed the stock market in several multi-year periods. With their -15% return since last fall, they are now fairly priced and boast attractive dividends.

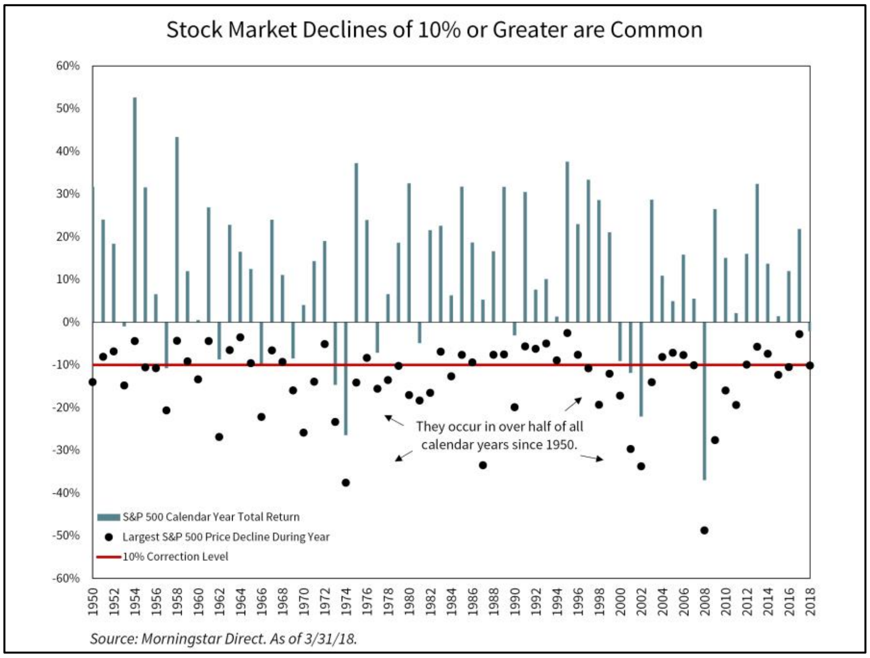
At the end of last year, by some measures U.S. stock market volatility was the lowest it had ever been in *90 years* of market history. While the 10% market correction this year was short-lived (bottoming February 9th nine days after an all-time high January 26th), it provided a reality check for equity investors. Additionally, U.S. stocks have re-traced almost all of that correction two times since (March 23rd and April 2nd) and likely will take several weeks to either recover (and resume the bull market) or drop sharply lower and enter a bear market. Odds favor the former; the global economy still looks solid in the near term, corporate earnings look hyper-strong for 2018, and signs of imminent recession are nil. As you know, looking ahead we have positioned our portfolios for further volatility and likely lower equity returns as the markets ride out what is already a longer-than-usual economic cycle.

First Quarter 2018 Investment Commentary

Market and Portfolio Recap

Needless to say, it was a bumpy start to the year for financial markets—something we'd suggest getting used to in the months and years ahead. After years of record-low volatility, the 10% market correction this quarter was a reality check for investors: Stocks can go down as well as up.

Equity investors should understand that stock market declines of 10% or more are *normal*. They've happened in over half of all calendar years since 1950. In exchange for their higher long-term expected returns, you must be willing and able to ride through these inevitable periods of decline.



Portfolio Attribution

In what was a difficult quarter for most asset classes, our portfolios notably included a handful of positive-returning investments. Domestic growth-oriented equity managers were among the top contributors, with gains in the low- to mid-single digits. Our investments in emerging-market stocks also benefited portfolio returns.

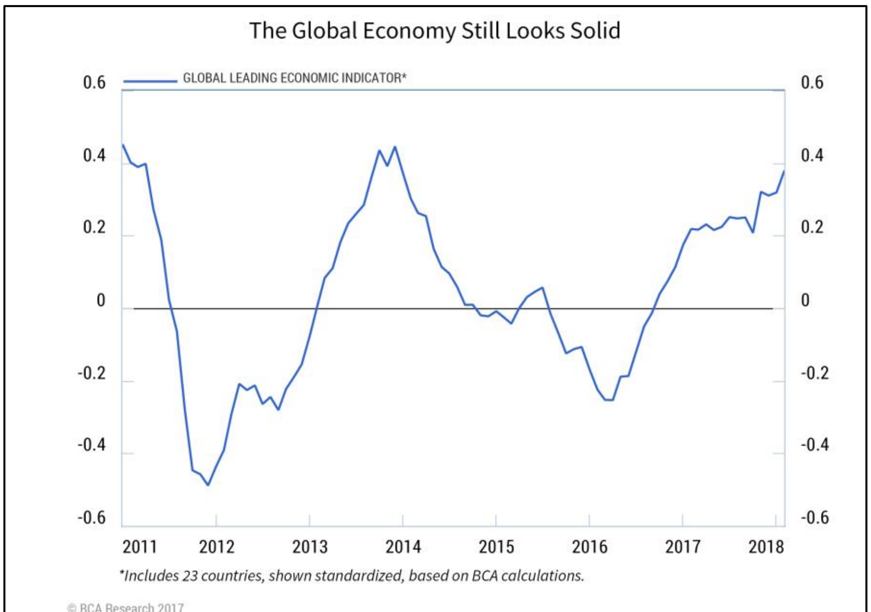
Our active fixed-income positioning also helped to support portfolios during a period when core bonds failed to play their typical "safe-haven" role. Absolute-return-oriented and flexible bond funds were in positive territory for the quarter, and helped to offset declines in the highest-quality bonds (PIMCO Total Return, DoubleLine Total Return, Vanguard Intermediate Fixed-Term Corporate, and all municipal bond funds). Our gold positions also provided some downside ballast versus stocks and core bonds.

Among the portfolio detractors for the quarter were our energy, pipeline, and utility stock ETFs. Energy stocks and (especially) pipelines remain the market's cheapest, while utilities have treated us very well for many years and have simply given back some over-valuation. March and April have been kinder to all, and political winds appear to be thwarting energy pipelines the most. We long viewed them as a kind of utility (substituting pipes instead of the wires), moving natural gas and oil from fields to refineries and power plants. We bought in 2012, pipeline unit prices peaked in 2014, then energy prices crashed and while energy stocks have begun to recover pipelines continue to languish.

Market and Portfolio Outlook

We have two primary observations about the quarter's rocky ride. First, the declines witnessed serve as a good reminder that markets do not exclusively go up. Until the recent drop, the S&P 500 had rallied for more than 400 days without registering even a 3% decline from its high. That was the longest streak in 90 years of market history. So, from that perspective, the return of market volatility is a return to "normal" market form. We believe investors should be prepared for continued volatility rather than expect things will revert back to the unnaturally smooth markets we experienced in 2017.

Our second observation is that despite the dramatic news headlines and market volatility that might suggest otherwise, the global macroeconomic and corporate earnings growth outlook has not materially changed or deteriorated from what it was at the start of the year. In fact, the economic news that triggered the recent selloff was not a report of economic weakness but one that suggested the economy might be getting a bit too *strong*, with a tight labor market finally translating into higher wage growth and broader inflationary pressures. Fundamentally, even after the correction, the U.S. and global economies still look solid. Global growth may no longer be accelerating, but it remains at above-trend levels and the likelihood of a recession over the next year or so still appears low (absent a macro/geopolitical shock).



Source: BCA Research. Data as of 1/31/18.

The U.S. economy is getting later, if not late, in its cycle. We are experiencing the unwinding of an unprecedented period of global monetary policy influence, and geopolitical tensions fill the headlines—the latest being the potential for a trade war between the United States and China.

It is not in our nature to speculate on whether any of these factors will trigger more market volatility, and what their impact will be if and when markets react. However, it *is* in our nature to ensure we've properly assessed and managed risk in our client portfolios across a wide range of shorter-term outcomes, while positioning them to capture longer-term returns. With very little portfolio protection offered by core bonds in this flat to rising interest rate environment (i.e., returns more in line with this quarter's losses), we continue to look to add positions in bank CDs as replacements for some high-quality bonds as well as maintain our gold positions to generate returns independent of stock and bond markets.

We also remain defensively positioned in our equity risk allocation and tilted in favor of more attractive foreign market valuations. While not table-pounding in an absolute-return sense, the outcomes we see for European and emerging-market stocks continue to be more relatively attractive than U.S. stocks.

Our analysis suggests the positive economic outlook has already been discounted to a meaningful degree in current U.S. stock market prices. So while the economy is strong, the stock market has been reflecting this for a while. The valuation of the S&P 500 is well above our estimate of its fair-value range on a normalized (longer-term) basis. As the valuation multiple comes down, it will be a significant drag on the total return of the market index over our five-year investment horizon, regardless of the earnings outlook.

The Best Defense

As we reflect on the volatility levels we have witnessed so far this year, it's worth reiterating why we emphasize a five-year or longer time horizon as the basis for our expected-returns analysis. It is over those longer-term periods that valuation (i.e., what you pay for an investment relative to its future cash flows) is the most important predictor of returns. Over the shorter term, markets are driven by innumerable and often random factors (i.e. noise) that are impossible to *consistently* predict (although that doesn't stop lots of people from trying).

There are a lot of paths financial markets and the economy can take to reach our base case scenario destination. And there is a wide range of reasonably likely outcomes around that base case. Simply put: markets and economies are unpredictable. But when it comes to the investment world, we are often our own worst enemy. We fall prey to performance-chasing, our natural inclination to "do something," and other behaviors that may have helped our ancestors, but hurt us as investors. Some experts believe that the debt crisis and market crash of 2007-2009 has essentially been ring-fenced and can not occur to that magnitude again. We believe differently and have discussed this with you. Overall market prices are so high because most investors assume today's overall economic climate matches the ones of past decades. The best defense is a sound, fundamentally grounded investment process like ours that you can have the confidence in to be able to stick with for the long term.

Thank you for your continued confidence and trust.

-Main Street Advisors, LLC (04/13/2018)