Lassus Wherley
Building Better Futures
...a View from the Top

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The Roller Coaster is Back!

Here are our thoughts on the recent happenings in the financial markets and answers to some great questions from clients.

It was really nice while it lasted but all good things must come to an end. You know that boring move upward we saw in the financial markets which has now turned into a rollercoaster ride. That crazy ride is going to continue for some time since it is driven by so many disparate decisions and uncertainties in terms of decisions from Washington. We are all asking many questions and not really getting many reasonable answers.

What happens next with the people caught in limbo with the DACA decision or really the lack of a decision? Are we going to have a trade war with China and other countries? If so, how will that impact our economy and the financial markets?

These questions will remain unanswered for now as we work through the challenges. In the short term the most relevant question for the financial markets remains whether or not companies are profitable, and if they are profitable how does that translate to the valuation in the financial markets.

We discuss more of these challenges and issues and provide thoughts in the following market discussion.

Fasten Your Seatbelt

The US stock market in 2017 was characterized by an extreme lack of volatility with stocks moving regularly upward throughout the year with very few exciting moves either up or down. That has changed in 2018. By the end of February, 2018, the S&P 500 had

already registered 15 days in which it had moved 1% either up or down. That was about twice as many days as the market had moved by that much in all of 2017.

In March 2018, we saw an exacerbation of this trend. Most recently, the market has seen a lot of

A Closer Look

extreme whipsaw motion on consecutive days, with the prevailing direction being down. Such dramatic moves in short time periods are unusual in bull markets and are, of course, unsettling.

The market is no longer focused on the positives of improved earnings resulting from the tax cut enacted in late 2017 and synchronous global growth. Focus has changed to possible trade wars, possible increased regulation of market-leading technology stocks and the fact that the Federal Reserve is gradually raising rates and pulling back on the economic stimulus provided by quantitative easing (bond buying).

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March 1st brought the initial announcement by President Trump of blanket tariffs of 25% on steel and 10% on aluminum under Section 201 of the Trade Act of 1974 and Section 232 of the Trade Expansion Act of 1962. This first salvo has been largely watered down after the fact with several of the US's main trade partners, including Australia, Brazil, Canada, the EU, Mexico and South Korea receiving exemptions. It still meant that the issue of aggressive protectionist trade policies was definitely on the table for the Trump administration.

And, on March 22nd, President Trump followed up with an even more dramatic announcement of penalties, directed solely at China, under the Office of the US Trade Representative (USTR) Section 301 of the Trade Act of 1974, for using unfair practices to acquire American technology. President Trump directed the Trade Representative to propose, within 15 days, a list of about $50 billion worth of Chinese imports on which tariffs would be imposed and to pursue a dispute settlement in the World Trade Organization (WTO) to address China's technology licensing practices. The Secretary of the Treasury was called upon to address concerns about investment in the US by China in industries or technologies deemed important to the US. These measures are a result of an investigation into Chinese trade practices by Robert Lighthizer (USTR) at the direction of President Trump.

On Sunday April 1st, China began its promised retaliation against the tariffs of 25% on steel and 10% on aluminum which had been announced on March 1st. The Chinese response includes penalties of 25% on American pork and eight other goods, and 15% tariffs on fruit and 120 different types of commodities.

The war of words between the US and China was escalated yet again on April 3rd when the USTR published the proposed list of products on which the tariffs under the

Section 301 Action would be imposed. The proposed list of $50 billion in tariffs covers about 1300 separate categories of products which are imported by China, including aircraft engines, industrial robots, semiconductor production equipment and electric vehicles. As would be expected, this latest threat was met immediately on April 4th by a commensurate retaliatory response from China who threatened to impose an additional 25% tariff on $50 billion of imports from the US, including soybeans, automobiles and chemicals.

Since that time we have had a lot of back and forth between the US and China and some of the news has certainly been more positive. It is important to recognize that the tariffs proposed by the USTR do not go into effect immediately. The US has at least 180 days after the comment period to decide whether to impose any tariffs, leaving time for negotiations with the Chinese to take place. While both sides in this dispute are acting tough, we assume that negotiations are going on behind the scenes. We are also sure that the Trump administration is hearing from leaders of US corporations who export to China and whose sales would be severely impacted by the imposition of the proposed tariffs.

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Global equities have already taken a hit based on fears of a trade war. Of course every other day the financial markets rally base on something positive in the headlines. We know investors fear a trade war because it could result in the cost of tariffs being passed on to consumers and corporate profit margins being cut. We don't know at this point in time whether we will see limited tariffs or more extended tariffs, so we are withholding judgement on whether there will be significant negative impact overall on the financial markets.

The impact of tariffs proposed to date will probably be mitigated by the fact that the global economy remains strong and growing, and the amount of the tariffs proposed to date is not that large in terms of the global economy. Also, global central banks are clearly watching this issue closely and would likely move to slow recent measures taken to tighten monetary policy if they were to become concerned about the economic impact of the tariffs.

We expect that markets will remain volatile while the issue is in the forefront of investors' minds. At this point it remains to be seen whether President Trump's tough stance on trade will lead to more, or less, free trade. A trade war, while possible, is not inevitable. Since a trade war would hurt both

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parties, it thus gives both sides a reason to compromise. We note that a recent WSJ/NBC News polling finds that Americans overwhelmingly think trade is more of an opportunity to boost the economy than it is a threat to it. We will continue to monitor this issue.

After the Facebook data breach was disclosed in mid- March investors became increasingly concerned about how management was handling the issue, and began to consider increased regulation of big tech companies like Facebook, Alphabet and Amazon more likely. While US technology stocks were in positive territory for the quarter, they were severely punished in the last two weeks of the quarter and continued to move to the downside in early April.

In the first quarter of 2018, we finally saw an unwinding of the exuberant embrace of equities that had carried global markets ever higher. Globally, most major market indexes ended the first quarter slightly in the red. The exception was the MSCI Emerging Markets Index as shown in the table below which uses total return, or appreciation plus dividend income.

MSCI Emerging Markets (EM) Index

	Q1	Calendar
MSCI EM Index	**1.5%**	**37.8%**
Brazil	**12.5%**	**24.5%**
Russia	**9.4%**	**6.1%**
China	**1.8%**	**54.3%**

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Finally, in the table below are returns in international developed markets, as measured by the MSCI EAFE Index reflecting total return, or appreciation plus dividend income.

MSCI EAFE Index

	Q1 2018	Calendar Year 2017
MSCI EAFE	-1.4%	25.6%
UK	-3.9%	22.4%
Germany	-3.5%	28.5%
Japan	1.0%	24.4%

Major global indexes are still up in double-digits over the past 12 months, and the global economy is expected to continue to grow throughout 2018 as the $1.5 trillion US tax-cut package will boost earn-

ings and prolong the nine-year US expansion.

After a slightly negative quarter and improving earnings estimates for 2018, US stocks are less expensive than they were. At yearend 2017, the S&P 500 was selling at a Price Earnings Ratio (P/E Ratio) of 18.2 times 2018 estimated earnings and yielding 2.0%. At the end of Q1 2018, the S&P 500 was selling at a P/E Ratio of 16.4 times next 12 months estimated earnings and yielding 2.1%. This P/E Ratio is slightly higher than the 25-year average of 16.1 times forward earnings. Q1 earnings season is set to begin and expectations are for earnings to rise by about 17%, which will boost the "E" in the P/E Ratio, thereby also improving valuations. Equities still look cheap relative to bonds, their major competitor among asset classes.

In spite of the headline news it is important to remember that there are positives in the market fundamentals.

That being said, international stocks look cheaper than US stocks, both in terms of their P/E Ratio and dividend yield. At quarter end, the MSCI All Country World ex-US index was selling at a P/E Ratio of 13.3 times next 12 months estimated earnings and yielding 3.3%, compared to a P/E Ratio of 16.4 times next 12 months estimated earnings and a 2.1% dividend yield on the S&P 500. US stocks have bested international stocks six out of the past eight years. International stocks have begun to catch up but still represent better value at these levels. Returns on international investments are boosted by a weak dollar and the US dollar declined 2.59% in Q1 2018. We expect the US dollar to remain weak due to increases in the budget deficit, the coming end of quantitative easing in the Eurozone and the overvaluation of the US dollar vs. other currencies.

Emerging Markets (EM) stocks and bonds look favorable in spite of their recent outperformance. EM equities will benefit from strong global growth, good emerging-market earnings, rising commodity prices and a falling US dollar. Current valuation is at the 25-year average of 1.8 times price-to-book value.

In spite of the headline news it is important to remember that there are positives in the market fundamentals. The US economy is in its 9th year of slow and steady expansion. Growth is expected to accelerate to 3% in 2018 before slowing to 2% in 2019 and after. US inflation is rising gradually due to a weaker US dollar, higher oil prices and tightening labor and housing markets. Inflation should remain contained as global use of information technology has empowered buyers of goods and services. The global economy is growing but growth remains slow and steady which adds stability to future

growth. Interest rates may rise further but the Federal Reserve has telegraphed that it will be gradual in its approach to raising rates and reversing quantitative easing. Finally, the best protection in difficult markets remains a well-diversified portfolio and consistent review and rebalancing to take profits when it makes sense. Understanding that short-term swings do not impact long-term investment, and we are long-term investors.

Here are a couple of great questions from some of our clients. Let us know if you have one you would like included.

Question: Should we be changing our target asset allocation based on the what's happening in Washington, D.C.?

Answer: The quick answer to this question is no, but it really depends on your specific situation. If your situation has not changed and you are still a long-term investor, the odds are that there really isn't a need to change your target asset allocation or your overall strategy. Given the volatility in the current market we do see a need to take profits when we have them and buy those asset classes that have underperformed. Sticking with that buy low and sell high philosophy works very well over the long term. Basically we believe in a long-term view keeping in mind any specific needs you may have in terms of cash flow. There may also be a need to make tactical adjustments within an asset class such as reducing longer duration bonds or adding to Treasury Inflation Indexed Bonds. We review all those factors over time and take them into consideration as we review investment portfolios.

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Question: What is a trade war and should I be worried about one?

Answer: We discussed some of this in the investment review earlier but here is more food for thought on the subject. This is an article that Bob Veres who is well known in the financial planning community and a long time friend just sent out. Thank you Bob.

The Trade War that Isn't—Yet

Bob Veres

When most of us hear talk about something described as a "war," we intuitively recognize that there could be very unpleasant outcomes on all sides. Wars have one thing in common: there is seldom a clear-cut "winner" amid the damage and destruction.

So when President Trump declares a "trade war" against the world's second-largest economy, it's natural that many people—including, apparently, a large number of investors—would feel spooked about what's to come in our collective future. This explains why every escalation of words, and new lists of things that will be taxed at U.S. and Chinese borders, has provoked sharp downturns in the markets.

But what, exactly, is a "trade war?" Beyond that, what is a "trade deficit" and why are we trying to "cure" America's trade deficit with China?

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To take the latter issue first, every bilateral trade deficit is simply a calculation, made monthly by government economists, that adds up the value of products manufactured in, say, China that are purchased in, say, the U.S. (Chinese exports or U.S. imports), and subtracts the value of products manufactured in the U.S. that are purchased by Chinese consumers (U.S. exports or Chinese imports). The first thing to understand is that this is not a very precise figure. To take a simple example, Apple manufactures its iPhones in southern China, ships them to the U.S. for sale, and the value of each of the millions of smart phones is counted as a Chinese export to the U.S. market. Apple reaps extraordinary profits, but this is considered a net negative in terms of U.S. trade.

Moreover, the full value of each iPhone is considered on the import ledger, without subtracting out the value of the "services" that Apple provides. The software and design were, after all, created in the U.S., and are a large part of the value of the phones that people become so addicted to. But these financially valuable aspects of the phone, made in America, are not reflected in the trade numbers.

Beyond that, many economists question whether a trade deficit is a bad thing in the first place. Chances are, you run a significant trade deficit with your local grocery store; that is, it brings to your neighborhood the food you put on the table, and you exchange money for it. You import food, but the grocery story doesn't import a comparable amount of things you make in your garage. Are you materially harmed by this economic opportunity that takes dollars out of your pocket and puts them in the hands of the grocery store? If you were, you might take your business to the grocery store further up the road, and run a trade deficit with a different establishment.

How does this relate to the U.S./China trade relations? Simple mathematics indicates that Chinese manufacturers are taking dollars from U.S. consumers, but they have to do something with those dollars to balance the ledger. That money finds its way into purchases of U.S. debt (Treasury bonds) or reinvestment in the U.S. economy, buying real estate or investing in domestic companies.

You fight trade wars with tariffs, which are simply a government tax on specific items when they cross the border. So when the Trump Administration announces the list of 1,300 different products that will become the targets of its tariff plan, that means that anyone buying those products will see their taxes go up—invisibly, in a higher cost of living.

The bigger potential damage comes when China retaliates in kind, and certain sectors of the U.S. economy have to pay the Chinese government a tariff for the privilege of selling their products to the Chinese market. China represents 15-20 percent of Boeing's commercial airline sales, so a proposed 25% tariff could sting. More directly impacted are U.S. farmers. Soybeans represent the largest agricultural export from the U.S. to China ($14.2 billion worth of shipments in 2016, about one-third of the U.S. crop), and the Chinese consume a lot of U.S.-raised pork. When the tariffs were announced, pork futures dropped to a 16-month low, and soybean futures fell 5% overnight.

The larger concern is that China is preparing to shift its sourcing of agricultural products from the U.S. to Brazil and Argentina, and the retaliatory tariff makes this economically attractive for Chinese consumers. Will that business ever come back again?

If this has you worried, or searching China's latest list to see which stock might be impacted as the rhetorical trade war escalates, it might be helpful to take a step back. So far, none of these tariffs have been levied; no actual shots have been fired in the trade war, which means it is not yet a "war" at all. The U.S. and China are trading retaliatory lists of potential targets, and there is some escalation in the value and extent of those lists. But when it comes time to actually fire those shots, the most likely scenario is a generous compromise that leaves us with the status quo.

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minum imports? It turned out to be mostly bluster. A full 50% of all U.S. steel imports, from Brazil, South Korea, Mexico, Canada and others, were exempted from those tariffs. Larry Kudlow, the White House's new economic advisor, said several times last week that there would be, in fact, no new tariffs, and no trade war with China. It will be months before any of the proposed tariffs could be put into place, which is plenty of time for Kudlow's prediction to come true—and make all the panic sellers who drove down stock prices look a little bit silly.

On March 26th Lassus Wherley was recognized as a 2018 Best Places to Work for Financial Advisers as announced by InvestmentNews.

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Lassus Wherley News

On March 26th Lassus Wherley was recognized as a 2018 Best Places to Work for Financial Advisers as announced by *InvestmentNews*. *InvestmentNews* is the leading source for news, analysis and information essential to the financial advisory community. Lassus Wherley was chosen as one of this year's top-50 based on employer and employee surveys delving into everything from company culture, benefits, career paths and more. *InvestmentNews* partnered with Best Companies Group, an independent research firm specializing in identifying great places to work, to compile the inaugural survey and recognition program. *The list is a first of its kind for the financial advice industry*. Lassus Wherley will be recognized on May 15th at the first annual **Best Places to Work for Financial Advisers Awards** Luncheon in Chicago at the University Club.

Lassus Wherley was also named in 2018 for the eighth consecutive year one of the **Best Places to Work in New Jersey**. This program identifies, recognizes and honors the top places of employment in New Jersey that benefit the state's economy, its workforce and businesses. The winning companies will be recognized and honored during the NJBIZ Best Places to Work in New Jersey awards reception and ceremony on Tuesday May 1, 2018 at iPlay America, Event Center in Freehold, NJ.

I was honored to serve on the CFP Commission on Standards over the last two years. I enjoyed working with an amazing group of professionals with a passion and dedication to continuing to build our profession.

CFP Board unanimously approved a new Code of Ethics and Standards of Conduct ("Code and Standards"), which sets forth ethical standards for CFP® professionals. The new Code and Standards replaces CFP Board's current Code of Ethics, Rules of Conduct, Financial Planning Practice Standards and Terminology, effective October 1, 2019.

The new Code and Standards includes a range of important changes, including expanding the scope of the fiduciary standard, requiring CFP® professionals to act in the best interest of the client at all times when providing financial advice. This is a bold step CFP Board is taking that we believe will benefit the public, firms, and CFP® professionals alike.

Keep in touch and remember that you are a long-term investor regardless of what happens in the financial markets in the short term.

We recognize the uncertainty surrounding us today, and we know that the world is changing very quickly. Please let us know if you have any questions. And remember to practice that deep breathing when the world starts to get to you.

Stay warm and try to enjoy this crazy spring!

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