Summit Financial Resources, Inc.

Investment Newsletter
First Quarter 2018

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EXECUTIVE SUMMARY

After experiencing the euphoria of the best year in recent memory, investors were jolted back to reality in the first quarter of 2018. Inflationary signals, rising interest rates, trade tensions and other geopolitical risks added to idiosyncratic events related to privacy concerns and crypto currencies in provoking investor anxiety. Despite sharp moves up and down, most investing markets only moderately declined for the quarter. The U.S. dollar continued to weaken, boosting the returns of international investments.

While the global economy is expanding at a healthy pace, the momentum has slowed. Gains in manufacturing and trade, particularly in Europe and parts of Asia, are less robust and are threatened by new tariffs and a possible trade war between the U.S. and China. Both consumers and businesses have failed to bump up spending despite high confidence levels. The recovery in select emerging markets is reaching a more mature stage as the economies in countries such as Brazil and Russia stabilize.

In the U.S. stock market, growth stocks once again sharply outperformed value stocks, as fast-growing consumer and technology companies, despite short-term swings, were favored. Real estate companies and other high dividend stocks were rebuffed by investors as rising interest rates made fixed income relatively more attractive. Energy stocks, which have yet to benefit from the upswing in oil prices, also underperformed. The valuation of stocks from developed countries has become more attractive as price levels have fallen. Emerging markets, led by Brazil and China, sharply outperformed their more developed counterparts which show signs that earnings momentum is weakening.

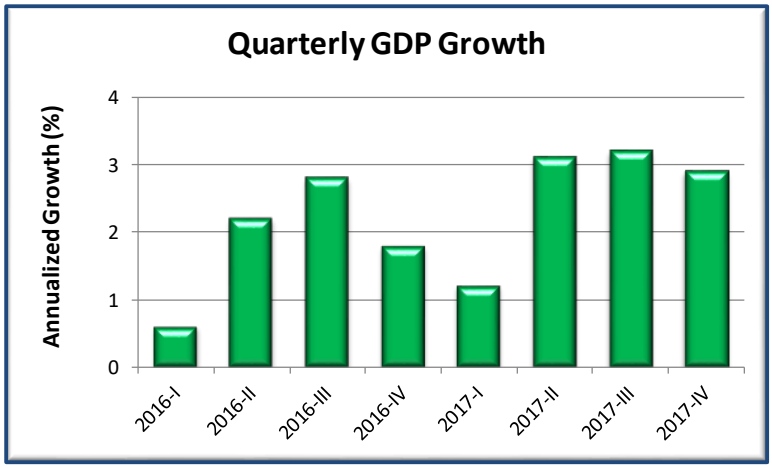
The “re-inflation” theme that was a popular talking point amongst investors in 2016 has morphed into fears that inflation will rise too quickly and by too much, forcing central banks to take aggressive action. U.S. inflation appears to be trending upward on the back of wage gains and tight capacity. Dollar weakness, trade tariffs and tax cuts suggest rising pressures ahead. However, other than in China, inflation remains fairly modest in most parts of the world.

Most bond markets had a negative quarter due to both higher interest rates and tighter credit conditions. High quality short-term and international bonds were the only major markets to post gains. In the U.S., corporate debt is now 70% of GDP and leverage is historically high. Rising interest rates threaten to drive up the rate of defaults and downgrades when companies that are dependent on cheap credit find their profit margins squeezed.

The sudden reversals in the stock markets have once again highlighted the benefits of a diversified portfolio. High level macro decisions made by governments and investor sentiment, two factors that are very difficult to forecast, are driving relative investment performance. As always, maintaining a longer-term focus is the best way to achieve investment goals and objectives.

ECONOMIC REVIEW AND OUTLOOK

Key Economic Fundamentals



Data Source: U.S. Department of Commerce

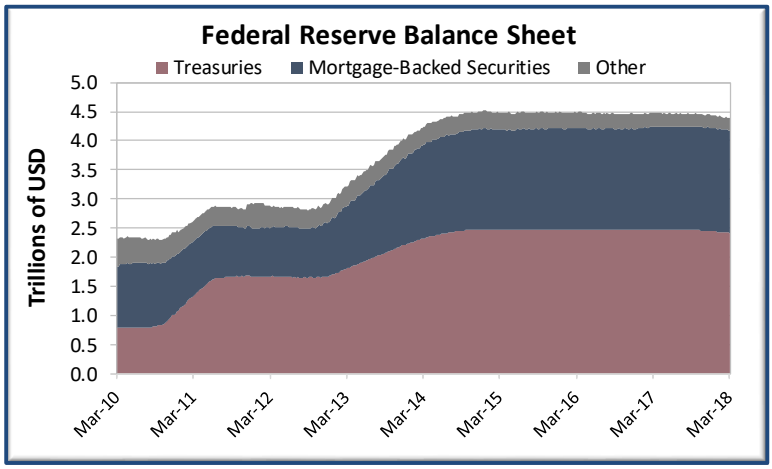
The U.S. registered economic growth of 2.9% in Q4 of 2017. For the full year, real GDP increased 2.3%. Expectations for near-term economic growth in the U.S. remain tepid, but have increased recently as a direct result of fiscal stimulus. In fact, in January, the IMF increased their U.S. GDP forecast by 0.4% for 2018 and 0.6% for 2019.

Global Growth Rates[1] (%)

	Q4 2017	Q1 2018	Q2 2018	2017	2018	2019
Advanced	**2.4**	**1.7**	**2.5**	**2.3**	**2.3**	**2.1**
Euro[2]	2.4	1.5	3.0	2.5	2.4	2.3
U.S.[2]	2.9	2.0	2.3	2.3	2.5	2.2
Japan[2]	1.6	0.2	2.0	1.7	1.4	1.4
U.K.[2]	1.6	1.4	2.3	1.8	1.8	1.9
Canada[2]	1.7	1.8	2.0	3.0	1.9	1.7
Emerging	**4.6**	**5.6**	**5.2**	**5.1**	**5.2**	**4.9**
China	6.6	7.4	6.6	6.9	6.8	6.4
India	8.0	7.0	7.2	6.7	7.1	7.3
Russia	-1.5	3.5	2.8	1.5	1.7	1.6
Brazil	0.2	3.2	5.1	1.0	3.0	2.5
World	**3.3**	**3.2**	**3.5**	**3.4**	**3.4**	**3.2**

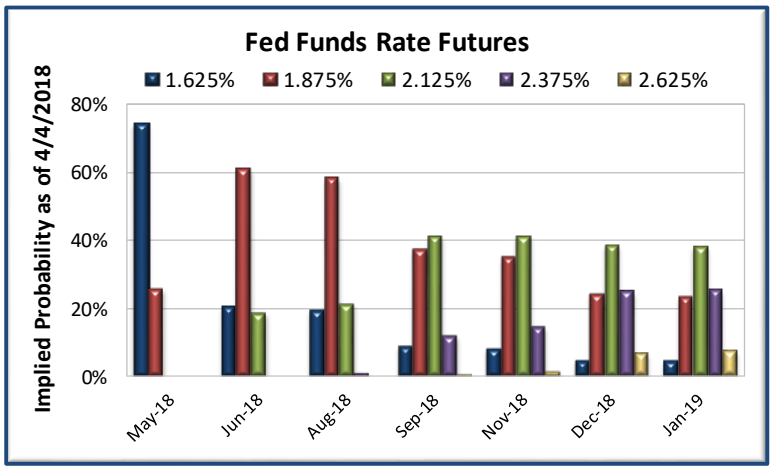
Data Source: J.P. Morgan, International Monetary Fund, World Bank
[1]Q4 2017 and 2017 are actual, all others are forecasts
[2]Quarterly numbers are sequential annualized, others are year-over-year

2017 growth came in ahead of expectations for most advanced economies, while results were mixed relative to expectations for large emerging economies. Current estimates call for stable growth in the near-term for most major countries and regions. Canada is expected to soften, while a rebound is expected in Brazil. India and China are expected to continue to expand at a relatively rapid pace.



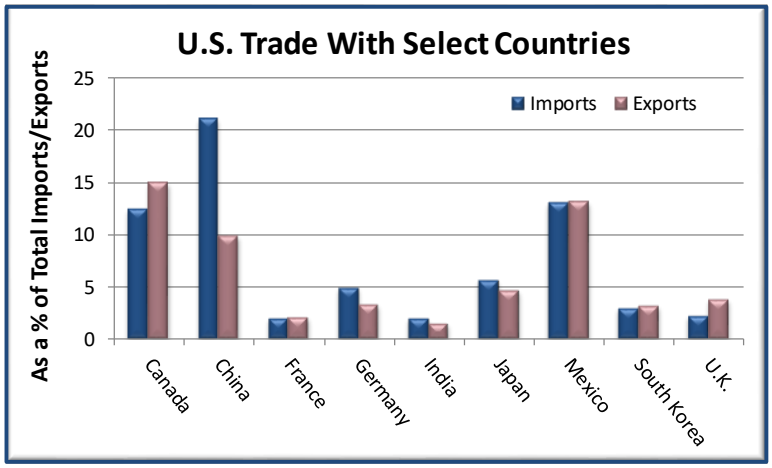
Data Source: U.S. Federal Reserve

In October 2017, the Fed began unwinding its balance sheet, which ballooned to a high of $4.52T in Jan 2015. After nearly 6 months of "quantitative tightening," Fed assets are down 2.7% from the high. The Fed has telegraphed its plan for balance sheet normalization to the markets. The process will increase the supply of bonds, which may put upward pressure on rates.



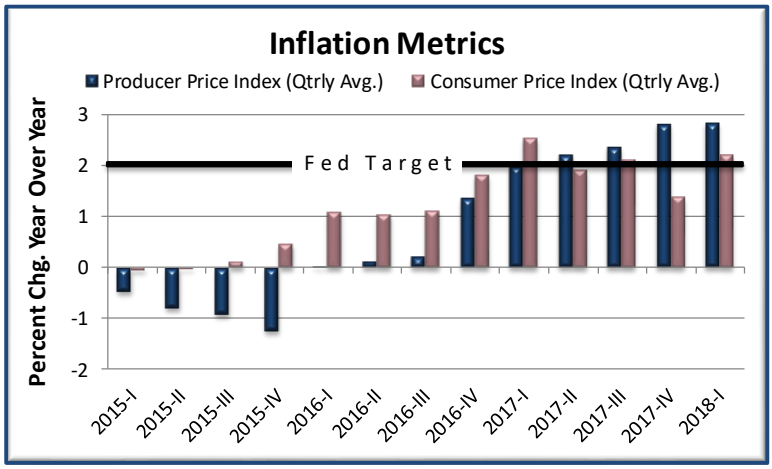
Data Source: Bloomberg

As the Fed unwinds its balance sheet, it also continues to hike the Fed Funds target rate, thus tightening monetary policy from two angles. The current target rate stands at 1.625% (1.50%-1.75%). As shown to the left, markets indicate the most probable outcome is an additional two hikes this year to 2.125%, though Fed members are somewhat more hawkish.



Data Source: Bloomberg

Trade conflicts dominated headlines in Q1. China, in an act of one-upmanship, answered Trump's initial proposed tariffs with the threat of tariffs on over 100 U.S. products. The aggressive back-and-forth posturing between the two nations has continued. Tensions with Mexico have abated, as a NAFTA agreement seems increasingly likely. Nonetheless, prospects for trade wars have stoked inflation fears.

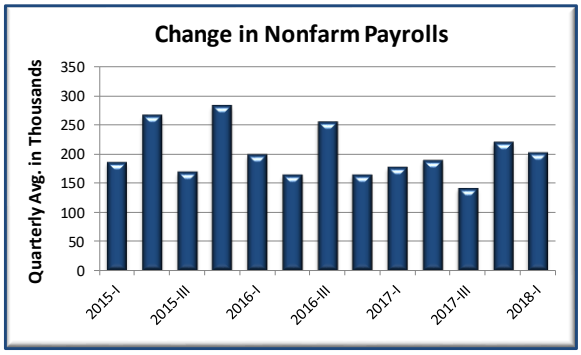


Data Source: U.S. Department of Labor

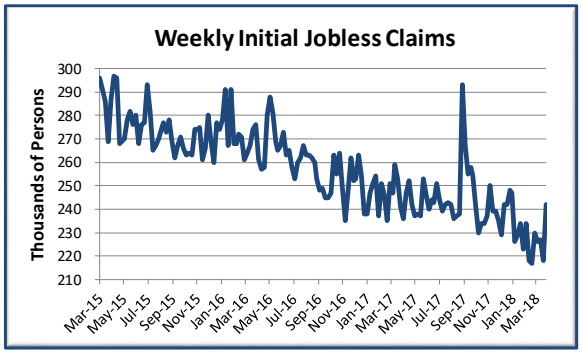
Inflation metrics have generally been accelerating. CPI and PPI both came in above 2% in Q1. Although the Fed's preferred inflation gauge (the PCE deflator) has also been heading upward, the trend is less stark, and the most recent reading was *below* 2%. Recent Fed minutes revealed a growing consensus that inflation will be above the 2% target in 2018.

Employment

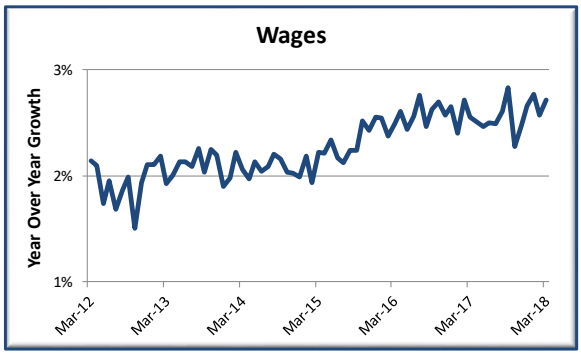
Labor market momentum from 2017 carried over into the first quarter of 2018, as payroll growth averaged a bit above 200,000 in Q1. Weekly jobless claims came in below 300,000 for the 161st consecutive week, the longest streak since this metric first started being tracked in 1967! Wage growth has generally hovered around 2.5% for over a year, but a modest upward trend is observable in the longer term. Notably, the January wage number that fueled concerns of accelerating wage inflation and roiled markets when it was first reported at 2.9% was later revised lower, thus allaying fears that the Fed may need to be much more aggressive than anticipated in tightening monetary policy. An unemployment rate of 4.1% has become old hat, as March was the sixth month at this historically very low level.



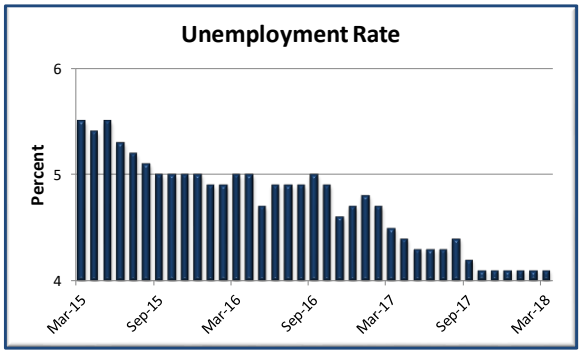
Data Source: U.S. Department of Labor



Data Source: U.S. Department of Labor



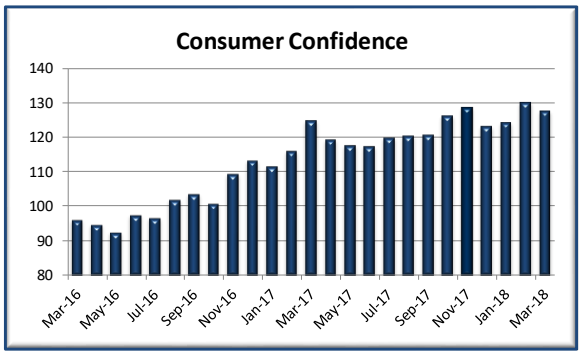
Data Source: U.S. Department of Labor



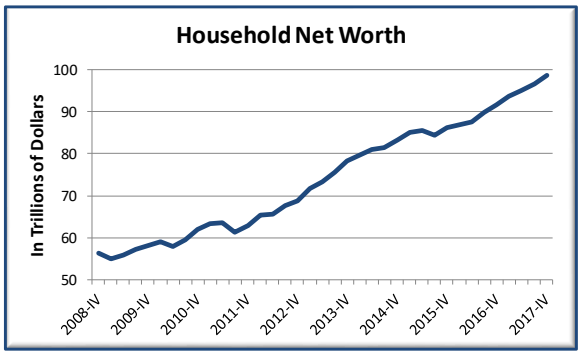
Data Source: U.S. Department of Labor

Consumer

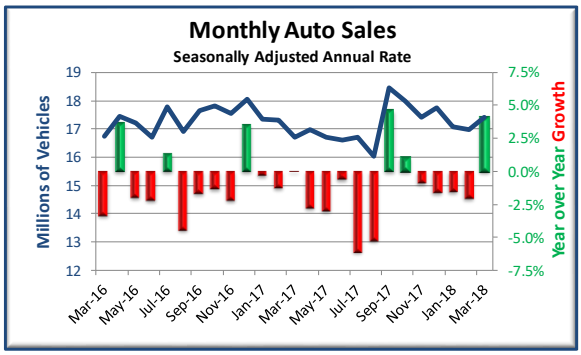
Despite a turbulent stock market and rising interest rates, consumer sentiment remains buoyed by continued strength in the housing market and favorable labor market dynamics. Also serving to buttress confidence is a 7.8% year over year increase in household net worth; households are richer than ever. Auto sales, which make up about 3% of the country's GDP, were unexpectedly strong in March, after experiencing negative year over year growth for much of last year and in January and February of 2018. Expectations for a sustained rebound in autos should be tempered, however, as March's strength was potentially attributable to large incentives and anticipation of higher borrowing costs. While the savings rate edged higher in Q1, it remains very low by historical standards. Investors are no longer "saving for a rainy day," which *could* be a threat to future consumer spending.



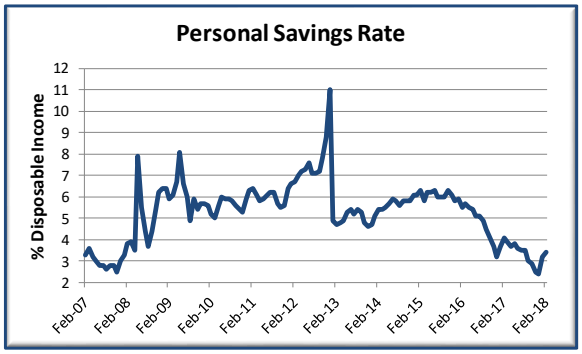
Data Source: The Conference Board



Data Source: U.S. Federal Reserve



Data Sources: Bloomberg

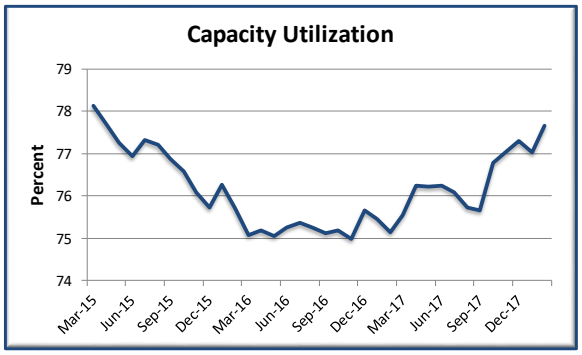


Data Sources: U.S. Bureau of Economic Analysis

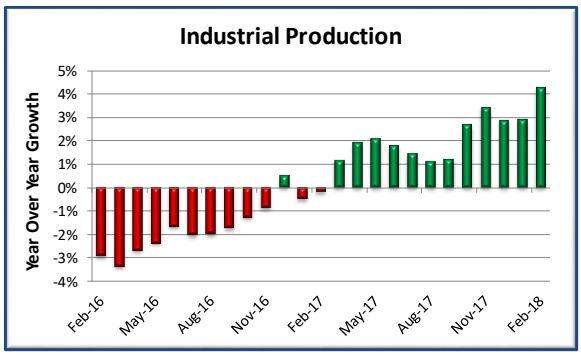
Business Activity

Business activity remains strong, particularly in the manufacturing sector, as illustrated by the ISM graph below. Capacity utilization has established a clear uptrend, ascending to a 3-year high. More capital that was sitting idle is being put to work to meet rising demand. If the pace of increase in utilization continues, the metric could reach 80 in 2018, the level which has historically been associated with inflationary bottlenecks. Industrial production has accelerated in recent months, indicating healthy growth in the manufacturing, mining, and utilities industries. While early analyst estimates typically overshoot, S&P 500 company earnings are anticipated to grow at a robust 25% clip in 2018 and 11% in 2019. However, strength could be transitory as many of the benefits to corporations from the tax legislation phase out over time.

Data Source: Institute for Supply Management



Data Source: U.S. Federal Reserve



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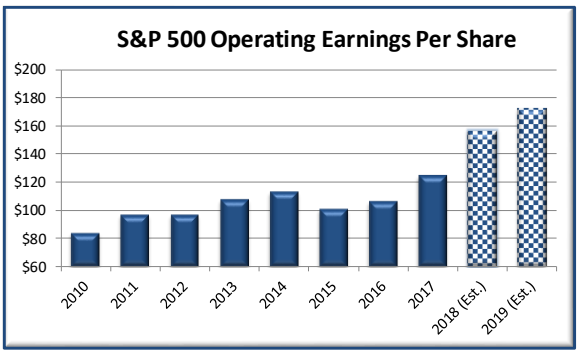
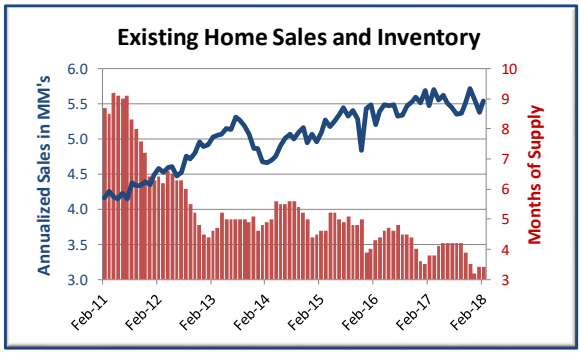


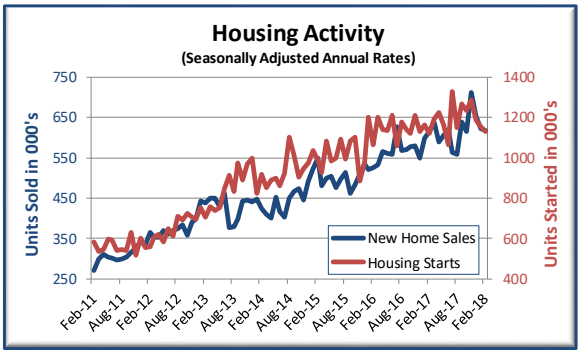
Data Source: S&P Dow Jones Indices LLC

Real Estate

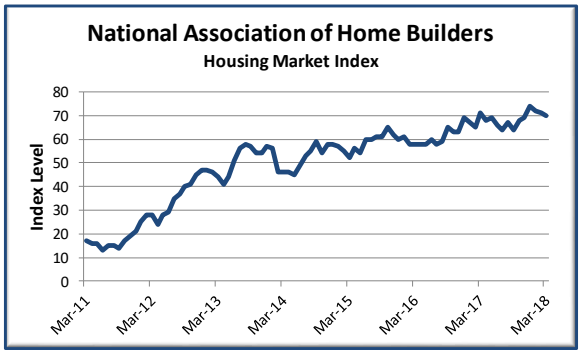
The housing market has been a pillar of economic strength of late. Existing home sales remain near decade highs, despite the constraint of low supply and accelerating price growth. Housing starts and new home sales paint a similar strong picture. Home builders are feeling confident, particularly in the West, where activity is very robust. Additionally, home prices have accelerated almost in a straight line since mid-2016. It is noteworthy, however, that most housing data that has been released is somewhat delayed, reflecting activity in February, a month during which the interest rate on a conventional 30-year mortgage rose materially. Mortgage rates ended the quarter around 4.45%, an increase of roughly one half of one percent as compared to year-end. It will be interesting to see how housing metrics respond in the coming months, as the specter of higher rates begins to sink in.



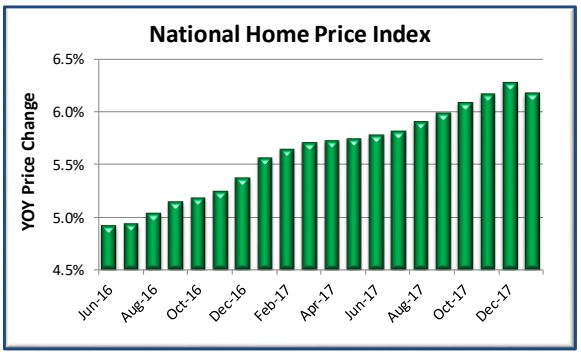
Data Source: National Association of Realtors



Data Source: U.S. Bureau of the Census



Data Source: National Association of Homebuilders



Data Source: S&P/Case-Shiller

CAPITAL MARKETS REVIEW

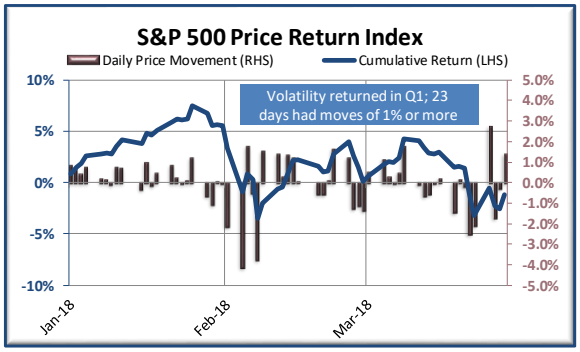
Returns

	1st Quarter 2018
Cash and Fixed Income	
U.S. Treasury Bills	0.3%
Barclays U.S. Aggregate Bond	-1.5%
Barclays Municipal Bond	-1.1%
Barclays Global Agg. ex. U.S.	3.6%
Hedge Funds and Alternatives	
Bloomberg Commodity	-0.4%
DJ US Real Estate	-5.9%
HFRI FOF Composite	0.9%

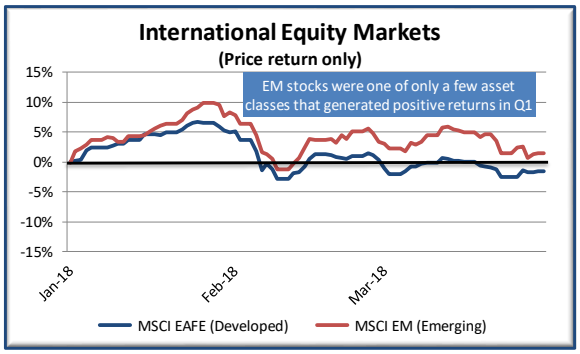
Data Sources: Morningstar & Hedge Fund Research, Inc.

	1st Quarter 2018
Domestic Equities	
Wilshire 5000	-0.8%
S&P 500	-0.8%
Russell 2000	-0.1%
International Equities	
MSCI ACWI ex. U.S.	-1.1%
MSCI EAFE (Developed)	-1.5%
MSCI EM (Emerging)	1.4%

Equity Markets

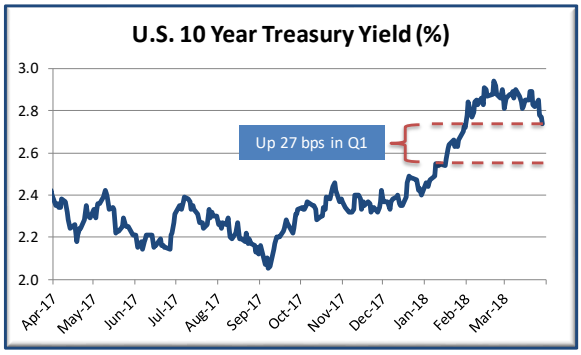


Data Source: S&P Dow Jones Indices LLC

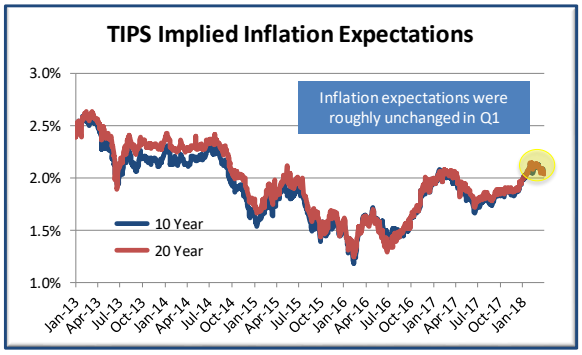


Data Source: Morningstar

Fixed Income Markets



Data Source: U.S. Department of the Treasury



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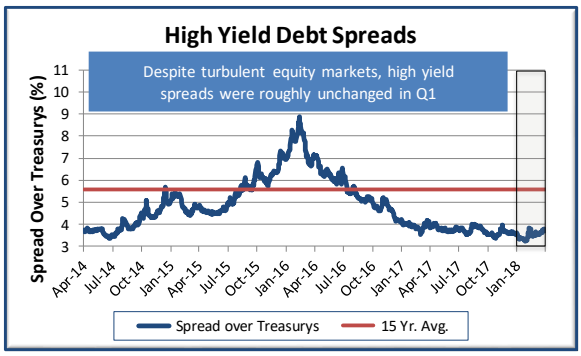
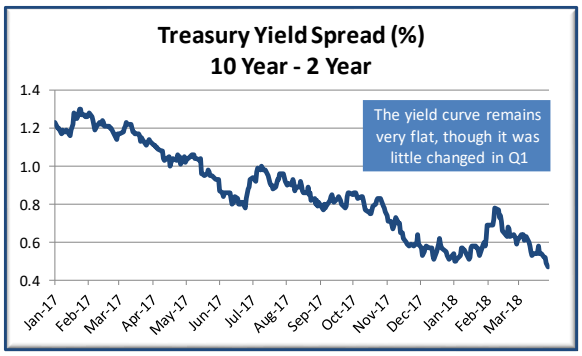
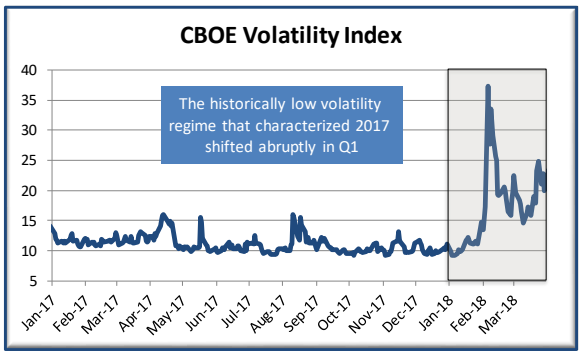


Data Source: BofA Merrill Lynch

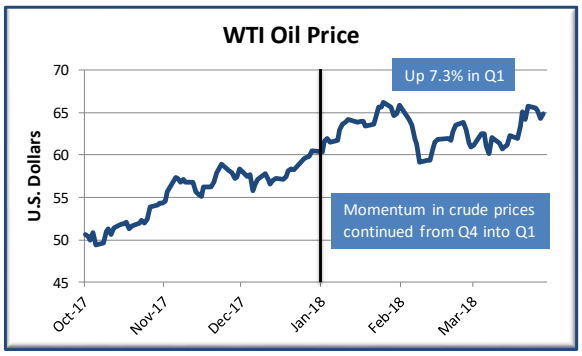


Data Source: U.S. Department of the Treasury

Other



Data Source: Chicago Board Options Exchange



Data Source: U.S. Energy Information Administration

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