ACROPOLIS®
INVESTMENT MANAGEMENT

PORTFOLIO INSIGHTS

April 2018: Volume 16, Issue 2 // David Ott, Editor

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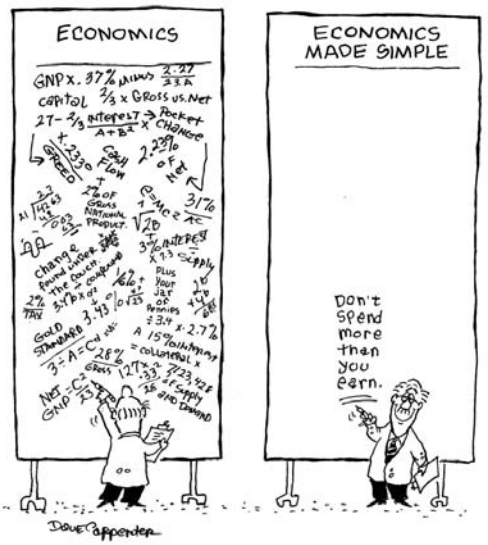
Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

Back to Volatility... Back to Reality



Volatility for the past two years was unusually low, a circumstance that nearly everyone understood was unsustainable. In January, the party got even hotter, as stocks rose by more than five percent and market darlings like Amazon and Netflix gained more than 20 and 40 percent, respectively.

While the market chatter around stocks was about how far stocks could 'melt-up,' the bond market was becoming increasingly concerned about inflation. While there is a lot of debate about the impact of low unemployment on low inflation, the substantial uptick in wage growth in recent years (and especially in January) spooked the bond market, which was already concerned about the weak US dollar (another source of inflation). The inflation concerns caused the Barclays Aggregate bond index to fall by -1.15 percent, the second worst month in four and a half years.

When stocks fell sharply in February, bond prices leveled off in a classic flight to quality. For the quarter, though, stocks and bonds both lost value, which is highly unusual. One of the benefits of a diversified portfolio that includes both stocks and bonds is that they are lowly correlated with each other, measuring 0.19 back to 1976, using quarterly data. In fact, since then, both asset classes simultaneously declined in only nine percent of the quarters.

Just as markets started to recover and calm down, the prospects of a trade war with China popped up almost out of nowhere. As a result, large multi-national companies that do substantial business overseas dropped again, proving that it's impossible to anticipate tomorrow's news.

In a quarter that was full of surprises, markets are getting back to normal in many ways. While it was enjoyable, the high returns and low volatility that we experienced in recent years is the exception, not the rule.

One thing we have lost, that we had in the past, is a sense of progress, that things are getting better. There is a sense of volatility, but not of progress.
- Daniel Kahneman, Nobel Prize Winner & Behavioral Economist

Stock Market Summary

By David Ott

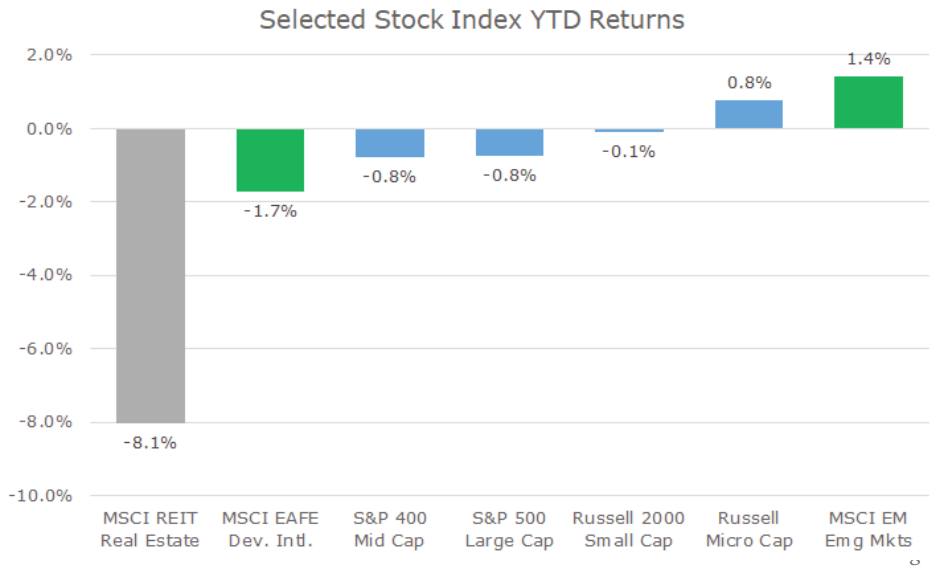
If investors only looked at the performance of the S&P 500 at quarter-end, they would be forgiven for thinking that nothing happened since the total return for the index was a modest loss of -0.8 percent.

In fact, the benchmark index hit a new all-time high on January 26th, only to suffer a 10-percent decline just 13 days later. During that brief period, the CBOE Volatility Index, or VIX, suffered the largest one day spike in its 24-year history. As a result, funds that relied on volatility-related strategies or leverage suffered substantial losses that carried over to the broad market.

Within the S&P 500, nine of the 11 sectors lost money, with consumer staples and telecom stocks suffering the most, falling -7.1 and -7.5 percent respectively. Technology stocks fared best, gaining 3.5 percent, followed by consumer discretionary stocks, which earned 3.1 percent. The gain in consumer discretionary stocks can mostly be explained by Amazon, which isn't classified as a technology company, as most people would expect. Technology stocks had run much hotter, up 10 percent at one point, but the scandal surrounding Facebook has caused investors to lose faith in some of the highly valued tech companies.

Overseas, developed stocks fell -1.7 percent, while emerging market stocks extended their gains from last year and produced the best returns among the major equity asset classes.

As the chart below shows, real estate investment trusts, or REITs, dramatically underperformed the other equity asset classes. REITs sold off dramatically in January, while stocks were booming because interest rates rose sharply and REITs are sensitive to interest rates. When stocks sold off, REITs did too because they are highly correlated with stocks. Unfortunately, REITs took it on the chin from all angles.



Bond Market Review

By Ryan Craft, CFA

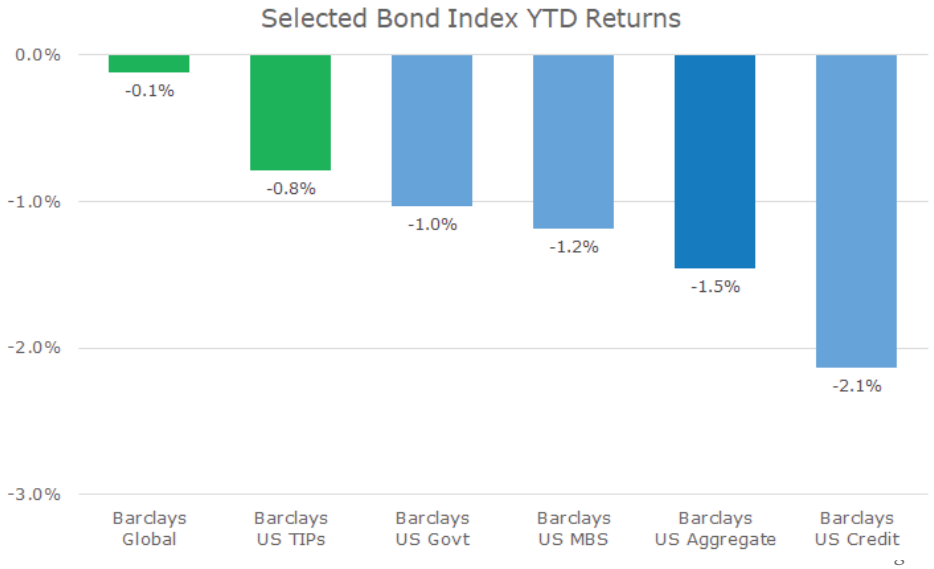
In a tumultuous first quarter, the bond market was not immune to pain. Throughout January, as the stock market soared on high expectations for growth, interest rates climbed 50 basis points to levels not seen in nearly a decade. Interest rates stabilized in the second half of the quarter as equity markets became more volatile and investors sought out safety in the Treasury market.

The Bloomberg Barclays Aggregate Bond Index was down 1.46 percent for the first quarter. Looking deeper into the different sectors of the bond market, it is clear that safer bonds performed much better than riskier bonds as short-term bonds outperformed long-term bonds and Treasury bonds outperformed corporate bonds.

Since the beginning of the year, Treasury rates have increased 30 to 45 basis points across the entire yield curve. This increase in yields was mainly driven by higher inflation expectations. Economic surveys and other forward-looking indicators point to a strong economy and a tighter labor market.

This leads many to expect inflation to increase in the future. It also leads many to anticipate the Federal Reserve becoming more aggressive in raising rates to ward off excessive inflation. Short-term rates are driven by Federal Reserve actions while longer-term rates are more influenced by inflation. Evidence of the safety trade for Treasury bonds was found in corporate bonds.

The Fed increased the overnight rate by 25 basis points in March. The current expectation is for another 2-3 hikes in 2018, bringing the overnight rate to 2.25-2.5 percent. Without an uptick in actual inflation, this will flatten the yield curve and may cause the Fed to begin talking about a pause. In almost any case, we expect the volatility to continue.



Don't confuse the lack of volatility with stability, ever.

- Nissim Taleb, Author & Investor

Tariffs and Trade Wars

By Tim Side

I am a tariff man, standing on a tariff platform.
- William McKinley, 25th US President

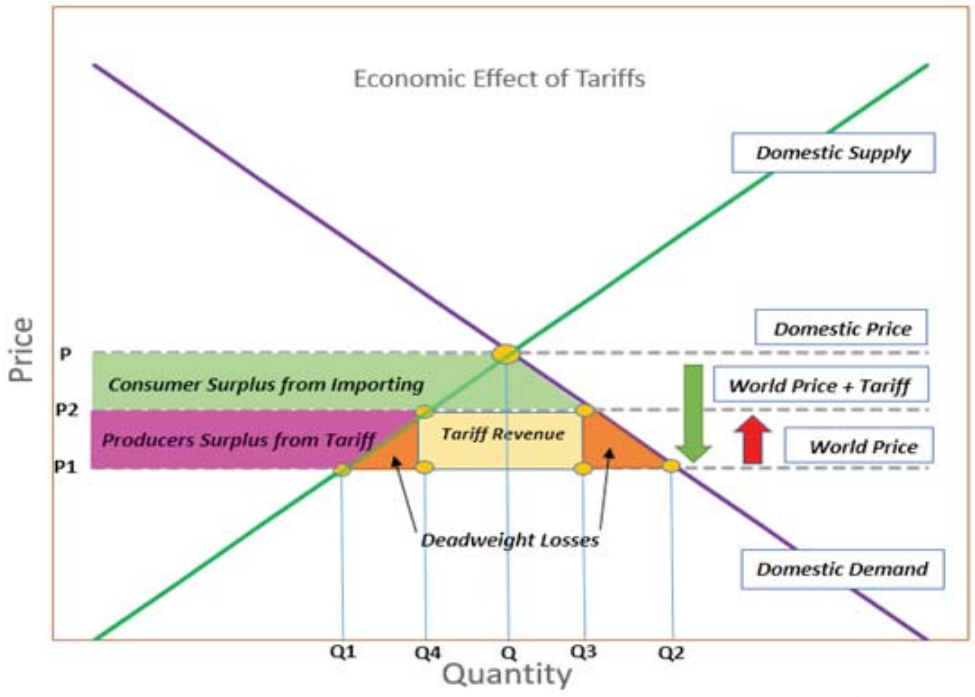
President Trump announced tariffs in March on Chinese imports, citing security concerns, a significant trade deficit, and estimated approximately $50-$60 billion in new tariffs. This was a follow up to his previous announcement of a 25 percent tariff on imported steel and a 10 percent tariff on imported aluminum. Following both announcements, stocks proceeded to sell off on fears of a trade war.

Since the simple act of increasing tariffs can touch an almost endless amount of factors, I thought I'd take a high level approach to get a better understanding of what's going on today, by seeing what economics and history says about tariffs and trade wars.

According to economic theory, tariffs hurt the overall economy because it benefits one specific group at the expense of multiple industries and the end consumer.

More technically speaking, it causes deviations from natural supply and demand and creates deadweight loss. The graph below shows the theoretical effect of tariffs on supply and demand.

Ignoring transaction costs, at Q you have the natural equilibrium for domestic supply and demand. When you open up to global trade, you have a lower price (P1) where domestic producers can only produce Q1 and domestic buyers can buy Q2 (the difference being made up by foreign producers). When you add tariffs, you increase the price to P2, raising the domestic



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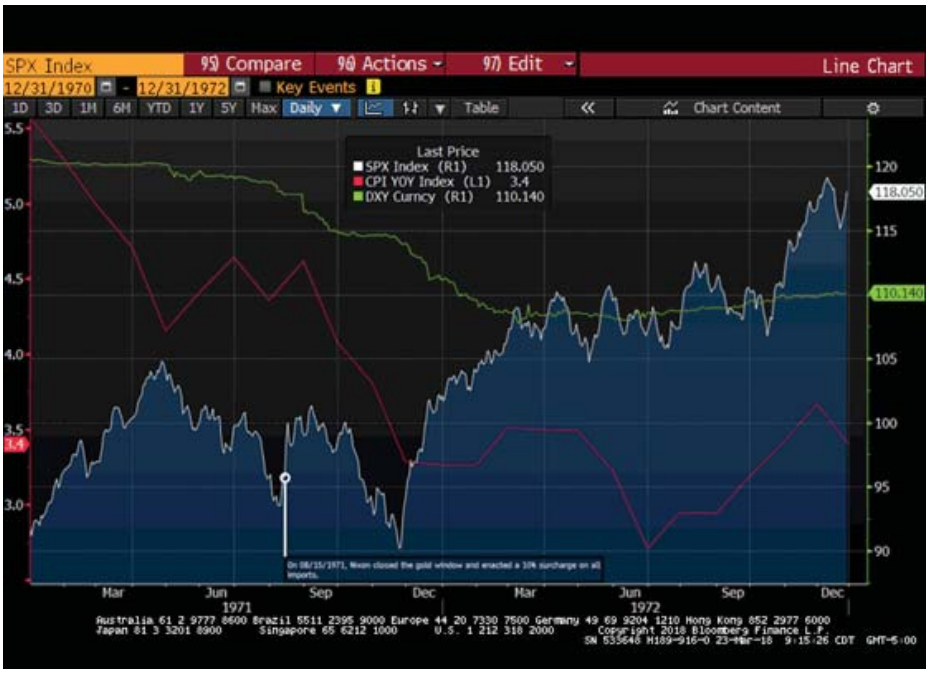


demand to Q3.

From the domestic producer's perspective, this works out well since they can create and sell more goods at a higher price. From the consumer's perspective, it is a negative since the price has gone up. For foreign producers, it's also negative since they are now selling less.

This first point is a part of why stocks would drop.

If you think of a sector like auto-makers in the context of a steel and aluminum tariff, auto-makers are a large consumer of these goods. According to basic economic theory, adding these tariffs will be a plus for steel and aluminum producers and a negative for auto-makers and end-consumers who will face higher car costs as an end result.

Unfortunately, in the real world, it's just not that simple. Foreign countries are (for good reason) not going to like tariffs. In the past, there have generally been two reactions: Increasing their own tariffs (creating a trade war) or appreciating their own currency to weaken the dollar which increases their purchasing power and helps negate the rising prices.

We have seen both of these effects within the past century.

Possibly the most famous (or infamous), is the 1930 Smoot-Hawley Tariff Act that raised tariffs to help protect American businesses and farmers during the Great Depression. This came eight years after a previous round of tariffs, known as the Fordney-McCumber Tariff of 1922, which led to a small

The curious task of economics is to demonstrate to men how little they really know about what they can imagine they can design.
- Friedrich August von Hayek, Austrian Economist

Tariffs and Trade Wars (continued)

I would never be 100 percent in stocks or 100 percent in bonds or cash. - Harry Markowitz, Nobel Prize Winning Economist & Father of Modern Portfolio Theory

trade war that hurt some individual sectors, but since the world was in a significant growth period, the effect was not as strong.

With the Smoot-Hawley tariff, like before, other countries raised their own tariffs. Because economies were already in recession, these tariffs helped contribute to a stagnation of global trade, causing the effects of the Great Depression to be prolonged.

Fast forward to the 1970's, we see Nixon introduce more tariffs when the US left the gold standard. We can see that in this case, the dollar depreciated, effectively negating the tariffs.

The callout on the previous page highlights August 15, 1971 when Nixon ended the ability to convert US dollars to gold and also enacted a 10 percent tariff on all imported goods. The green line shows the US dollar index and the pink line shows US inflation.

Moving forward to 2002, we can see a case that is similar to today, where President Bush enacted tariffs on steel imports:

The data callout highlights March 5, 2002, when Bush enacted the tariffs. Once again, we see the dollar depreciating, inflation falling, and the stock market falling as well. While the dollar continued to depreciate, inflation and stocks both rose after several months of decline.

Before going further, it is important to note that in each of the examples listed above, other factors were at play in the economy that also affected the value of the dollar, inflation,

New At Acropolis

By Michael Lissner, CEPA

We take pride in the professional designations that our team members continue to earn.

As of right now, we have three Chartered Financial Analysts (CFA) charter-holders, five Certified Financial Planners (CFP®), three ASPPA Qualified 401(k) Administrators (QKA) and two Certified Public Accountants (CPA) along with a variety of other designations.

We're pleased to announce that the list of designations is about to grow further because Dannelle Ward and Marie Tustin recently passed the CFP® exam. They don't carry the title just yet, but they'll be ordering new business cards soon enough. We're also crossing our fingers for two people taking the third and final level of the CFA exam this summer.

The CFP® designation is focused on financial planning issues like taxes, estate planning, and life insurance, while the CFA is focused on analyzing securities and markets.

All of the exams are challenging and require a lot of time and dedication, so we are very proud of our team!

Tariffs and Trade Wars (continued)

and stocks. Earlier we had the Great Depression, then the US leaving the gold standard, and finally the tech bubble.

You don't have to look very far to find something to be worried about today. The US is currently in the second longest bull market in recent history, the Fed is raising rates and unwinding its balance sheet, and volatility has seemingly returned to the market.

While economic principles and history both seem to show that raising tariffs and trade wars do not bode well for stocks, history has also shown that markets bounce back and that's why we invest for the long run, not the day-to-day.

While it also may seem like this could be the trigger and it may be time to pull out of stocks, it is important to remember that markets are pretty darn efficient and the fears of trade wars have been priced in based on what we currently know.

We are also seeing that as the details emerge, more and more allies seem to be excluded from the tariffs, with the exception of China. Now China is no small country and the US trade deficit to China runs in the hundreds of billions of dollars, but it is not the whole world and there are still many details that have yet to be ironed out.

We don't know how this will all play out, but we do know that these types of downturns have been factored into portfolio allocations and while market losses are painful and stressful in the short run, stock investing has paid off over the long run.

The real key to making money in stocks is not to get scared out of them.
- Peter Lynch, Investor

Data Center	2018
Dow Jones	-1.96%
S&P 500	-0.76%
S&P Midcap	-0.77%
Russell 2000	-0.08%
MSCI EAFE (Intl)	-1.53%
MSCI Emerging Mkt	1.42%

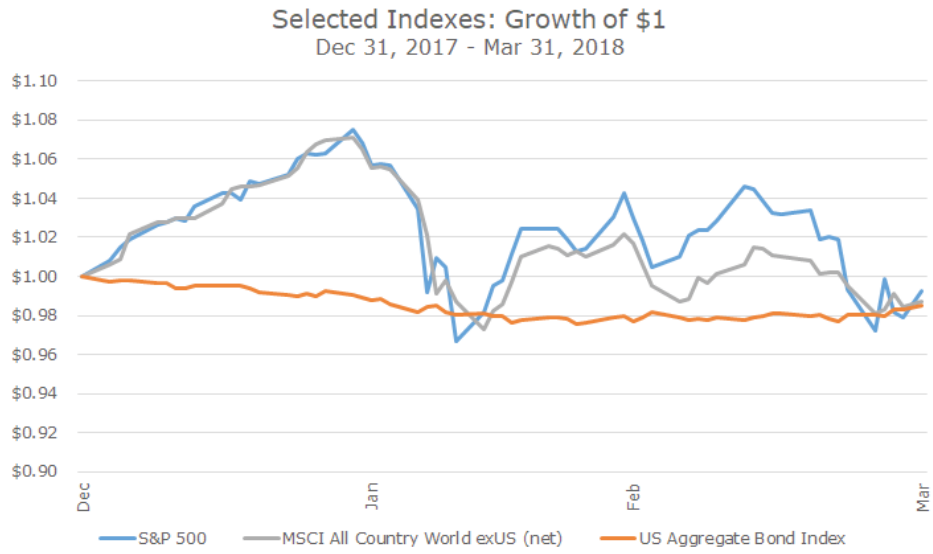
S&P Sectors	2018
Basic Materials	-5.52%
Consumer Discretion.	3.08%
Consumer Staples	-7.12%
Energy	-5.88%
Financials	-0.95%
Healthcare	-1.22%
Industrials	-1.56%
REITs	-5.02%
Technology	3.53%
Telecom	-7.48%
Utilities	-3.30%

Interest Rates	2018
Fed Funds	1.75%
Prime Rate	4.75%
3-mo. Treasuries	1.71%
2-yr. Treasuries	2.27%
5-yr. Treasuries	2.56%
10-yr. Treasuries	2.74%

Currencies	2018
Euro	1.2321
Japanese Yen	106.28
British Pound	1.4015

All Data as of 03/31/2018

The Big Picture



Fast Facts: Trade War Edition

1930 The year that Congress passed the Smoot-Hawley Tariff Act, which hiked tariffs by 20 percent on 20,000 goods, initially to protect farmers. The Act, along with retaliatory tariffs by other countries, cut global trade in half and is widely believed to have exacerbated the Great Depression.

$506 Billion The dollar value of the goods and services that China sold to the US last year. In contrast, the US sold $130 billion to the Chinese, suggesting that China has more to lose from a trade war than the US (although like true wars, no one really 'wins' a trade war).

$400,000 The estimated economic cost of George W. Bush's steel tariffs, per steel-industry jobs 'saved.' The US lost 200,000 jobs due to the tariff, about 13,000 of them from the steel industry.

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