Sterling Advisors

REVIEW & OUTLOOK - 1Q2018

This Review & Outlook includes commentary on Sterling Advisors' three investment Strategies: Large Cap Value, Large Cap Core and Intermediate Fixed Income. As a valued client, we want you to be aware of and updated on all investment options available to you from Sterling Advisors. Going forward, this is the format you will see in this quarterly piece.

Closing Prices 3/31/2018	
DJIA	24,103.11
S&P 500 Index	2,640.87
Barclays Intermediate U.S. Govt.	2,054.95
Russell 1000 Value	1,464.87
NASDAQ	7,063.45
U.S. Treasury Bond	
Current Yield 10-year Bond	2.740%
Current Yield 30-year Bond	2.974%

Source: Bloomberg

The Market Environment

U.S. stock indices posted modest losses in the first quarter, breaking their quarterly winning streak dating back to October of 2015. Volatility in financial markets increased sharply after an unusually long period of uninterrupted calmness. As is usually the case, the bouts of volatility were triggered by increased uncertainties, including fears of a more aggressive Federal Reserve, mixed economic data and a rapidly changing foreign trade policy. Large Cap U.S. stocks, measured by the S&P 500 Index, declined by 0.8%* in the first quarter.

On March 21, we heard from new Federal Reserve Chairman Jerome Powell for the first time. Those looking for surprises were disappointed, as the Chairman announced a widely anticipated 0.25%* increase in the Fed Funds rate and reiterated the Fed's previously stated commitments to a continued normalization of interest rates and further reductions in the size of its balance sheet. While his comments on data-dependency fell in line with the sentiments of outgoing Chair Janet Yellen, the door remains open to as many as three additional rate hikes in 2018, along with substantially less liquid market conditions due to the Fed's lack of new asset purchases.

The U.S. economy remains on an upward trajectory with strong GDP growth, tame inflation, lower corporate tax rates, stable commodity prices and full employment. However, we are beginning to notice more mixed data under the surface. For example, housing metrics such as new home sales have softened lately, perhaps in response to an uptick in mortgage rates, which impact affordability. Auto sales have also been weaker than what we would expect to see in an economic expansion. On the other hand, we are seeing the lowest unemployment rate in decades, which has yet to translate into meaningful wage pressure on employers. The recently announced foreign trade tariffs will begin to impact economic data in the coming quarters. While it is all but certain that proposals will vary significantly from what is written into law, history tells us a more protectionist global stance on trade is likely to be inflationary.

Turning to the internals of the stock market, the return of volatility has been a prominent theme lately. Equity securities offering stability with high dividend-income, such as utilities, REITs and consumer staples, have been under pressure as rising interest rates have created alternatives for risk-averse investors. Several of the most loved technology stocks of the current bull market have begun to falter under the weight of regulatory threats and privacy concerns regarding the data collection practices of social-media companies, for instance. We believe the market internals observed in the first quarter are a harbinger of a longer-term rotation away from growth and momentum strategies, and toward companies displaying traditional value-oriented characteristics.

Large Cap Value Strategy

The Large Cap Value Strategy had a successful start to 2018, in a generally turbulent market environment. Our idea generation process is alive and well, resulting in several new equity positions in the first quarter. Our quantitative screening method continued to present new purchase ideas in every market sector, which the investment team then thoroughly evaluated using our qualitative decision-making process. Portfolio managers also acted upon our risk management discipline, reducing and eliminating holdings based on our anticipation of increased risks due to changing economic conditions and fundamental underpinnings.

Drilling down to sector weightings, we continue to favor Technology and Industrials as areas where we have an overweight allocation vs. the Russell 1000 Value Index. Consumer Staples, Telecom and Utilities are three sectors we have avoided additions to based upon unattractive relative valuation and our expectation of gradually rising interest rates. These three higher dividend-yielding sectors are likely to be at a comparative disadvantage as investors are able to achieve a more competitive return in other asset classes, especially as interest rates move higher. Although these sectors can provide stability and protection in bear markets, we continue to favor equities with superior earnings and dividend growth expectations as the most attractive long-term source of relative outperformance for our clients.

Average cash levels were slightly higher than past quarters based on our expectation of continued volatility. We see this as a trend that will increasingly allow for opportunistic stock-picking, which we will be prepared for with the necessary cash reserves to act on your behalf.

Finally, there have been changes to several prominent investment themes within the strategy. We have meaningfully reduced our exposure to the U.S. housing market through the elimination or trimming of positions. Our view is that although the normalization of home ownership rates and longer-term housing recovery is intact, it will be increasingly difficult to achieve relative outperformance by investing in this area due to the impact higher mortgage rates have on home affordability. We do maintain some exposure to housing through companies with outstanding relative-value characteristics, but our aggressively bullish view was tempered during the first quarter. Additionally, we have trimmed our Technology exposure, specifically in the semiconductor and networking areas where we harvested gains in long-term holdings. In this case, we continue to be optimistic about earnings prospects but chose to follow our discipline of selling at our estimate of full-valuation and redeploying to companies showing more compelling risk vs. reward ratios.

Large Cap Core Strategy

In the first quarter, higher amounts of volatility have caused investors to refocus on the importance of risk management. This continues to be the most important objective for our team. Investors are watching how a possible central bank or policy mistake, geopolitical event or a credit contraction might affect their portfolios. For years, advancements in social media technology have far outrun regulatory supervision and oversight, and for the first time, that trend could be reversing. It is clear funding costs have increased substantially, as we witness the sudden increase in LIBOR or the London Interbank Offering Rate and the sharp yield increases on the short end of the interest rate curve. Our team continues to monitor closely.

Understanding the correlations of what drives earnings across various sectors, industry groups within sectors and individual companies within industry groups is paramount for maintaining a high quality portfolio to navigate the changing market landscape. Over the past couple of years, our strategy has taken advantage of growth in stocks that do better in an environment of a rebounding global growth and a pickup in interest rates. Our top sector weights have been Financials, Technology, Industrials and Healthcare and continue to believe exposure should be limited in Utilities, Consumer Discretionary, and Materials. The U.S. consumer is poised to have a good 2018, aided by rising incomes, solid balance sheets and elevated confidence about future employment and incomes. GDP growth will continue to move higher but will more than likely peak later this year.

The global economy has changed during these last nine years. As would be with any economic cycle, investors witness early-, mid- and late-cycle periods. We continue to believe we are in the fundamental backdrop of a late-cycle economic landscape. Dividends become an especially important component of an investors' total return late in the cycle. Correlating this to the current stock market, bull markets do not end of old age, rather, they end from unintended consequences from monetary policy, interest rates or high energy prices. The latter we certainly do not have now. The former two are concerns. It is becoming a market of stocks and not a stock market. We look to take advantage of the dislocation between the two.

Intermediate Fixed Income Strategy

The Federal Reserve continued its measured rise of interest rate hikes with the first of 2018 coming at the March meeting. This was the sixth rate hike since late 2015. The Fed Funds rate now stands at the range of 1.50% to 1.75%* with the market is expecting two to three more rate hikes in 2018. At the March meeting, the Fed also steepened its guidance for 2019 and 2020 as well. The March meeting was also the first meeting for incoming Fed Chairman Jerome Powell. The Fed is in a precarious situation. If it hikes rates too quickly it can choke demand for borrowing and spending but if it moves too slowly it can cause the economy to overheat.

Monetary policy remains accommodative supporting strong labor market conditions and a return to 2%* inflation. The yield curve, which flattened significantly in the fourth quarter of 2017, continued to flatten in the first quarter. The short end of the curve continued its march up on the back of the Fed's rate hikes. The long end of the curve has been kept low by the policies of foreign central banks as they have fueled low to negative interest rates overseas. Historically, the short end of the interest rate curve responds much more directly to the Fed's rate hikes than the long end. The long end is mostly a reflection of the potential growth of the U.S. economy and is not affected much by Fed hikes.

Generally, a flattening yield curve is seen as an indicator of slowing economic growth, which points to an increased possibility of recession. We do not see that as the most likely outcome this time because of these artificial influences. Corporate spreads have begun to widen. This dynamic in the bond market can lead to asset mispricing, price negotiations, opportunities to increase or decrease weightings among sectors, and move up or down the yield curve to capture relative value. We continue to look for high quality issues unwillingly unloaded by mutual funds and exchange-traded funds at attractive prices.

Outlook

It is difficult to forecast how 2018 will unfold in light the increased uncertainties we see developing on a daily basis. Although it would be quite simple to frame a negative outlook for stock prices in the balance of the year, we do think it is important to point out we have experienced a long-awaited 10% stock market correction. This has helped purge speculative excesses from certain areas of the equity markets. Also, changes to our tax code, normalizing interest rates, foreign trade policy changes, infrastructure spending and other policy changes may be causing short-term consternation, but could result in long-term gains for our economy and corporate earnings. Our view is that although the bar is set high, most domestic companies will meet or exceed analysts' earnings expectations and provide optimistic guidance for the year ahead.

With stock valuations closer to the high end of their historical range and robust corporate earnings growth expected by analysts this year, we see the primary risk to stocks being a shortfall in meeting those heightened earnings expectations. Although the absolute level of interest rates remains accommodative, further increases, particularly if they happen rapidly, is a scenario that would cause us to become more defensive. The importance of investing in individual equity and fixed-income securities offering reasonable risk vs. reward opportunities, and avoiding those with elevated risks, cannot be overstated at this mature point in the business cycle.

Sources: * Bloomberg

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Dow Jones Industrial Average: The most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. **NASDAQ Composite Index:** Measures all NASDAQ domestic and international based common type stocks listed on The Nasdaq Stock Market. The NASDAQ Composite is calculated under a market capitalization weighted methodology index. **Standard and Poor's 500 Index:** Capitalization-weighted index of 500 stocks, including the reinvestment of dividends and other distributions, designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Russell 1000 Value** Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.