ECONOMIC & MARKET REVIEW

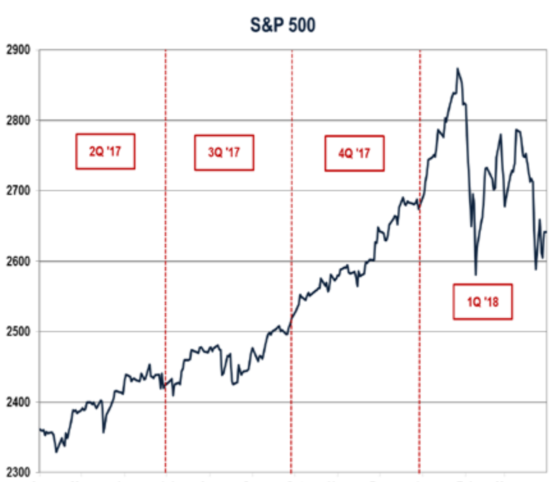
First Quarter 2018

It's a rollercoaster, not an escalator.

We made it all the way to the first quarter of 2018 before volatility arrived starting with a good January, followed by a poor February and a crazy March. After such a great 2017, it's not surprising the hill is steeper which naturally makes volatility greater. Markets are seldom a smooth escalator ride up, so the pleasant, comfortable last few years are over. I don't expect the equity markets to go straight down from this point, but I do expect more volatility.

First Quarter and Trailing 12 Months Performance

	First Quarter	Last Twelve Months
S&P 500	*-0.80%*	*14.00%*
Russell 2000	*-0.10%*	*11.80%*
Barclays Agg.	*-1.50%*	*1.20%*
MSCI EAFE	*-1.50%*	*14.80%*
MSCI EM	*1.40%*	*24.90%*



Source: FactSet, Cavanal Hill Investment Management. As of 03/31/2018

For the first time in nine straight quarters the equity market posted a negative return – a pretty amazing run. Q1 highlights – if you can call them that – included an inflation scare, trade war concerns, another rate hike by the Federal Reserve and serious privacy concerns raised about Facebook. Other than that, the first quarter was a walk in the park.

The Fed squares off with the market to WIN (whip inflation now)

The Fed is using short term interest rate hikes to tamp down the fire of inflation before it takes off. The Fed's preferred inflation gauge is core personal consumption expenditures (PCE), excluding food and energy. Core PCE increased 0.29% per month in January and 0.23% in February. If you annualize those two months – given, a small data set – you get an annual inflation rate of 3.10%. The growth rate for the past six months has been 2.30%, and the last 12 months only 1.60%. The trend is obvious: Inflation is quickly moving higher, hence the Fed's rate hike. I have concerns about how this might end, but at this point the Fed is addressing the issue appropriately with regular, small rate hikes.

Market Impact – We can expect higher yields on bonds and, at least for a while, not a negative for equities, although that impact will depend on the pace of inflation and interest rate increases.

Trade war concerns – Is the U.S. getting the short end of the stick in the global economy?

Donald Trump campaigned on an assertion that the U.S. had allowed our major trading partners to take advantage us, beginning with NAFTA, moving on to the steel and aluminum industries and ending with China. The markets were understandably roiled with what appeared to be an international trade war brewing at the behest of the President. I thought the President's original statements were a starting point for negotiations rather than a "best and final" offer. Negotiations require give and take, which is the route both NAFTA and the steel/aluminum discussions have taken, as some countries have agreed to a self-imposed limit on the amount of steel they will export to the U.S. No trade war…but no trade peace either.

The China Syndrome

China is a different issue and one that could prove much more challenging. With the largest population in the world – four times that of the U.S. – China is on its way to becoming the dominate economic and market power over the next decade. Their plan to become self-sufficient in a range of key industries by 2025 (their "Made in China 2025" initiative) creates a huge advantage for the Chinese – at a great cost to others. The Chinese government subsidizes many industries, which allows Chinese companies to make (and sell) their products cheaper than those in the U.S. The Chinese care most about job creation in China…regardless of ultimate global demand for a given product. That has created a negative pulse in the U.S. manufacturing sector and accompanying job losses. Then there are the limitations on the abilities of U.S. companies to operate in China, and highly credible allegations of rampant theft of intellectual property. It's clear that we have legitimate issues to work out with the Chinese and it would be in our interest as well as theirs to find workable solutions – but that is much easier said than done.

North Korea – The Odd Man Out

Staying with the Chinese theme, North Korea is deteriorating quickly. A combination of threats from President Trump and eventually US and UN imposed sanctions has North Korea not just to its knees but prone on the ground. China is the only country in the world that trades with North Korea. Now that the Chinese have finally joined the U.S and the United Nations to impose harsher sanctions, North Korea has cratered.

It's little wonder that Kim Jong-un is more flexible, but even with these harsh realities, getting the North Koreans to give up their nuclear weapons and convincing China to walk away from the only buffer between them and South Korea will be very difficult. Enough of geopolitics.

North Korea/Chinese Trade

-95% Exports from North Korea to China (February YOY)

-32% Imports to North Korea from China (February YOY)

Imports: January – February 2017 vs. Same Period 2018

Vehicle imports from China to Korea

Down from 1,900 to 138

Coal Exports to North Korea

Down from 13,300 tons to 0

Tech Stocks – All that glitters isn't gold, at least not anymore.

Facebook found itself in the spotlight for the amount and depth of information it has on users and how much of that information it shared with other companies. That drama quickly morphed into a problem for the other "FANG" stocks. FANG, the acronym for Facebook, Amazon, Netflix, and Google, was first coined by Jim Cramer on his CNBC show. These stocks have dominated the markets for many years, and their collective performance has been unbelievably powerful. But over the last year, you could feel the environment around these companies changing. Previously, they were admired, exalted, and incredibly successful and profitable. They were also off the radar screen of regulators. These companies will face potential regulatory overkill if they don't act quickly to proactively change their policies and practices regarding the storing and sharing of personal information.

Imagine if the federal government or local law enforcement readily had this type of information available about you: When you go to bed, who your friends are, what you said to them, what you bought at a store or online, what your personality traits are, where, when and how long it took you to travel to anyplace you've been, your photos, videos, music, search and browsing history, the radio stations you listen to…I'll stop there, but the list goes on and on. There would be people carrying torches and pitchforks in the streets of Washington, D.C.

Even so, I think we'll just have to get used to the idea that the privacy we used to have (or thought we had), is a thing of the past.

The privacy tech conundrum isn't just about privacy

While the loss of privacy and how the government regulates companies in what is supposed to be a free enterprise is a big concern, these issues are also creating some big picture economic problems with potentially serious consequences.

First, these stocks have been market leaders for a long time. If the performance of tech stocks like these as well as all the related startups and their venture capital investments alters, can there be adequate leadership from other sectors to make up the gap? Second, because of their huge market capitalization, FANG stocks make up a significant portion of the S&P 500 index. If they falter relative to the rest of the index, the "passive" index holders will find the index is not so passive. That could lead to selling, which would compound the downdraft.

Growth is still on the horizon

Despite these challenges, it's important to remember that U.S. and global economies continue to grow and fundamentals are good. Consumer spending is strong, corporate profits are very good, (first quarter earnings announcements will begin in April), capital expenditures are growing, employment is astounding and both business and consumer confidence are way up.

This will be a much more volatile year, I'm closely watching high yield spreads, and the yield curve, (flattest since 2007), for evidence the selloff is more than just a correction.

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Disclosures

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All data presented is as of last quarter, unless otherwise noted.