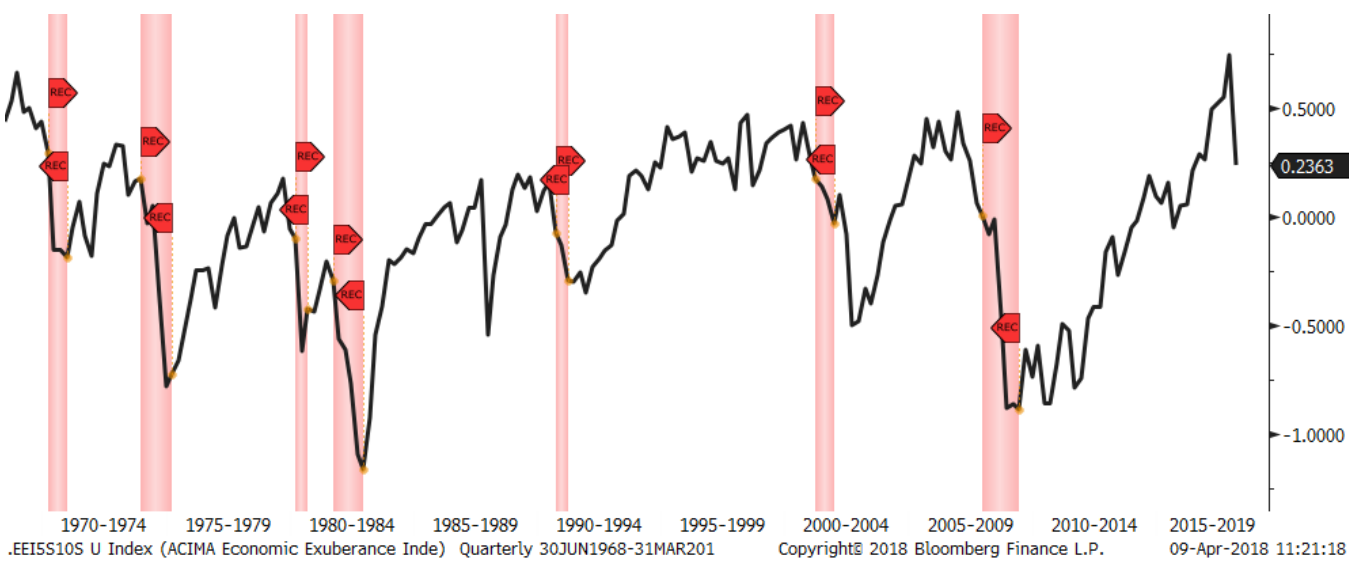
"Markets love volatility." **- Christine Lagarde, IMF**

After going through an extraordinary period of seven quarters of record low volatility, that all important characteristic of the markets came alive during the first quarter, but did so in a concerning manner.

The markets started January right where they left off December, and rallied roughly 7.5% before peaking in the last week of the month amidst concerns over inflation and the deficit[1]. The rally into January 26th was steady, and included 14 up days. Volatility as measured by the CBOE VIX Index reached multi-year lows in early January.

Then began a period of adjustment that twice brought the markets into correction territory (defined as a 10% drop from the peak), twice testing the all-important 200 day moving average for the S&P 500 index. More importantly and concerning from a pure technical perspective was the fact that the S&P 500 closed the quarter at a lower level than where it started. In technical jargon, what we experienced was a "quarterly reversal" – an event that does not happen very often. When combining the above price action with an intra-quarter market move (the difference between the market high and low during the quarter) exceeding 10%, and when the intra-quarter high was also a four-year high (representing a cyclical bull market), we have only had 14 such events since the end of WWII. The last such occurrence was December 2007 during the peak of the bull market of '02-'07.

ACIMA Economic Exuberance Index



Why is this important to us? Because such reversals extending as long as a quarter usually occur due to a change in sentiment beyond short term technicals. In other words, something other than trading factors and likely fundamental is at work creating this de-risking phase.

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[1] ACIMA Private Wealth – Feb. 6, 2018 Market Update

It wasn't a surprise to us that during this same period our Economic Exuberance Index (EEI)[2] not only reached an all-time high, but actually reversed itself, and ended with its biggest drop dating back to 1968. Almost every component that makes up the index deteriorated during the quarter and increased our probability of recession for the coming 24 months significantly.

We discussed the negative impacts on equity valuations from the significant rise in the budget deficit—and resulting higher interest rates—back in January. We also raised concerns regarding the potential impacts on trade arising from nationalism / protectionism coming out of Washington in our annual outlook[3]. With the events of the past several weeks, we can add the strong possibility of a trade war with China to our high probability for a breakdown in NAFTA discussions. Uncertainty and downside risks for trade are not likely to end with China, NAFTA, and a recently scaled back free trade agreement with Korea. Whether it was during the presidential campaign or after the inauguration, the President has raised his concerns over trade with a considerably larger number of parties including the E.U. (and Germany specifically), the ASEAN countries, and India as it relates to work visas. Many of these issues are likely to be publicized in the coming months and quarters. In addition, electioneering ahead of the midterms, as well as the Mexican presidential election in July (and its potential impacts on NAFTA negotiations), are all factors than add to the uncertainty already priced into the markets.

Whether the reversal of the markets in Q1 are a harbinger of greater downside volatility or just a healthy stop in the bull market is obviously a wait and see story. But given the historical precedent, the still very high valuations for U.S. equities, continued deterioration in the fiscal balances, Federal Reserve's unwinding of its balance sheet, and rising nationalism out of Washington give us pause. With the business cycle now 106 months old (tied for the second longest cycle since the end of WWII), the addition of the above constraints to the nine-year-old bull market raises our cautionary stance on risky assets one level higher.

As always, stay tuned.

Ardavan Mobasheri
Chief Investment Officer
April 13th, 2018

[2] *Mobasheri, Ardavan, Oct 10, 2017. "Exuberance near a 40-year high, but no telling how long it will last" CNBC.com*
[3] *ACIMA Private Wealth 2018 Outlook*

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