# MIDDLETON & COMPANY, INC.

# Investment Update

April, 2018

## 2018 First Quarter Update

**Review:** After a strong finish in 2017, global equity markets began 2018 with a robust rally but closed the quarter with modest losses across most asset classes. Volatility, which had been exceptionally low, rose noticeably in the quarter due in part to higher interest rates and the potential for escalating trade wars. The Federal Reserve, as expected, raised the target Federal funds from 1.25%-1.50% to 1.50%-1.75%.

| Period | 1Q18 | 4Q17 | 2017 |
|---|---|---|---|
| S&P 500 | -0.80% | 6.6% | 21.8% |
| MSCI EAFE* ** | -1.41% | 4.3% | 25.6% |
| MSCI Emerging Markets** | 1.47% | 7.5% | 37.8% |
| Barclays U.S. Aggregate Bond | -1.46% | 0.4% | 3.5% |
| Barclays Muncipal Bond | -1.11% | 0.8% | 5.5% |

*Europe, Australia, Far East
**MSCI returns are in U.S. Dollars

**Economy:** After growing 2.9% in the fourth quarter, it is estimated that the U.S. economy grew 2.3% in the first quarter according to the Atlanta Federal Reserve's GDPNow model. The Federal Reserve is projecting 2.7% growth for 2018 versus 2.3% in 2017. Consumer spending continued to rise during the first quarter, but at a slower pace versus the fourth quarter of 2017, which is not atypical following the holiday season. Wages are growing at an annual rate of 2.3%; however, inflation, at 1.6% as measured by the PCE Deflator, remains below the Federal Reserve's 2% target.

Globally, growth is still rising with the potential to decelerate as the year progresses. The European Union grew 2.4% in 2017 and the European Commission is forecasting somewhat slower 2.3% growth for 2018. In Japan, real GDP grew 1.5% in 2017 and the Japan Center for Economic Research is assuming deceleration to 1.3% for 2018. Emerging Markets continued to show the fastest growth in 2017, rising 4.3%, with the World Bank forecasting a slightly higher 4.5% in 2018. China achieved 6.9% growth in 2017, but is expected to decelerate to 6.5% this year as the government continues to emphasize the quality of growth over quantity.

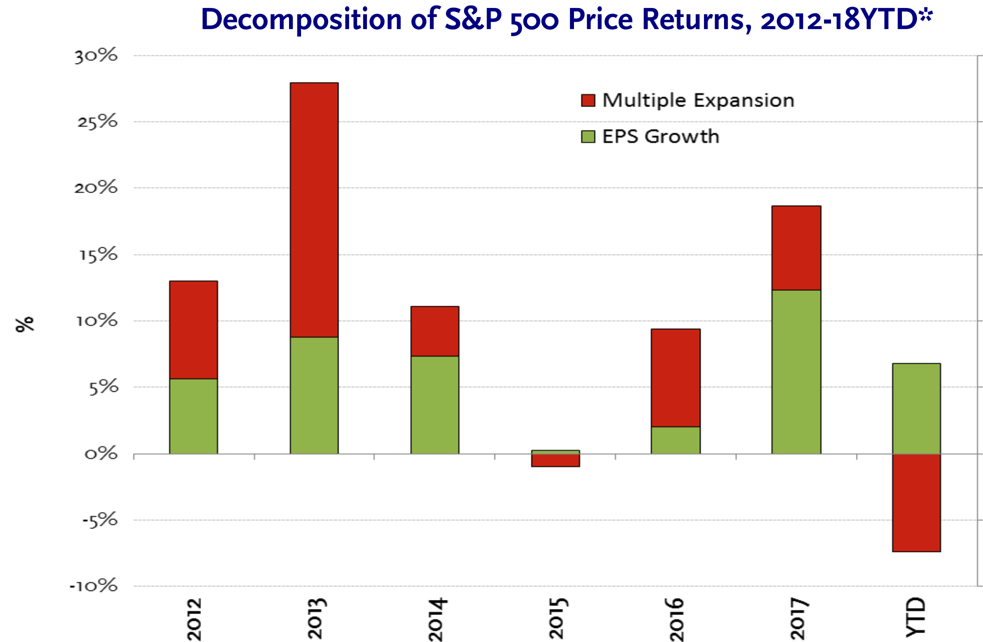
Removal of monetary stimulus remains a key focus for the markets, affecting both fixed income and equity valuations. We expect the Federal Reserve to continue raising interest rates and reducing its balance sheet in 2018, leading to tighter financial conditions. The European Central Bank is expected to stop its bond buying program sometime in the fall. Only the Bank of Japan currently has no explicit plans to reduce monetary support.

600 Atlantic Avenue
18th Floor
Boston, MA 02210-2211

Phone: 617-357-5101
Toll-free: 800-357-5101
Fax: 617-357-7199

info@middletonco.com
www.middletonco.com

The effects of higher interest rates and the withdrawal of monetary stimulus on the U.S. equity market can be seen in the chart below. The combination of both earnings growth and multiple expansion have driven market returns in recent years. However, so far in 2018 we have seen multiple compression despite continued growth in earnings:




*Source: FactSet*
**YTD through 3/22/18*

**Strategy:** We are closely monitoring non-discretionary versus discretionary spending patterns. Business capital expenditures should improve given corporate incentives built into the tax plan. An important variable in equity returns will be how high interest rates rise and how quickly. This could affect equities both fundamentally due to increased financing pressure, like higher consumer borrowing costs, as well as generating further multiple compression through higher discounting of future earnings. European equities may be subject to the same valuation pressures, but they will be less important to Japanese equities given continued low interest rate management by the Bank of Japan. Whether the Euro and the Yen will remain strong will also be important considerations for these markets.

We expect S&P 500 earnings to increase this year boosted by the impact of tax reform. In fixed income, we remain defensively positioned in shorter maturities as the Federal Reserve withdraws monetary stimulus. Although equities continue to offer better risk-adjusted returns versus fixed income, rising interest rates are beginning to offer selectively attractive alternatives in shorter maturity bonds.