Peter Sorrentino, Chief Investment Officer, Comerica Asset Management First Quarter 2018

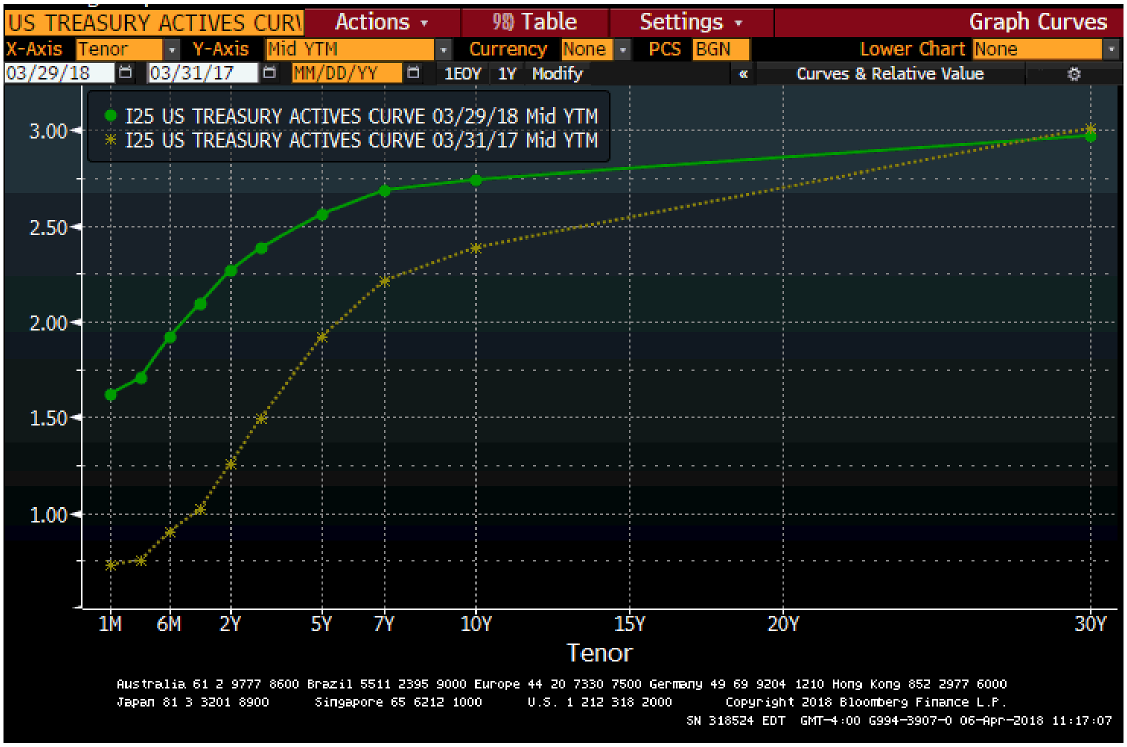
Quarterly Commentary

First Quarter 2018 Recap

The first quarter of 2018 witnessed a return to normalcy, as the major indices posted the first decline in ten quarters and the lingering effects of monetary intervention faded. Investors were forced to cope with the uncertainties of trade tariffs and confusing economic data without the backdrop of inflation-adjusted negative short-term interest rates. The modest declines posted by the major indices is deceiving, for underneath the surface, returns were radically different – not merely among economic sectors, but by size and location as well. In a major change, technology shares were not collectively the best performers, as that distinction belongs to shares within the consumer discretion sector, which generated a positive 2.6% return. That stands in stark contrast to the largest decline of the quarter among shares of the consumer staples, which collectively surrendered 7.5%. The former is enjoying the prospect of better sales owing to strong wage and employment growth, while the latter is suffering the prospect of limited pricing power and relentless competitive pressures as automation rolls into the industry.

During the post-crisis recovery, investors have exhibited a habit of buying any dips in the market with the backdrop of easy monetary policy. It made sense as a means of escaping the financial repression being imposed on what investors typically view as safe assets, money market and passbook accounts, along with Treasury Bills and certificates of deposit. All of which had offered what were negative returns on investment when adjusted for inflation. As the central banks have wound down their extraordinary measures, short-term interest rates have responded as evidenced in Exhibit 1. Since the Federal Reserve began raising short-term interest rates just over a year ago, the change in rates has been most dramatic for shorter maturity obligations – now triple what they were 12 months earlier. Therefore, investors are no longer compelled to buy the dips, as there are now legitimate investment alternatives to risk assets.

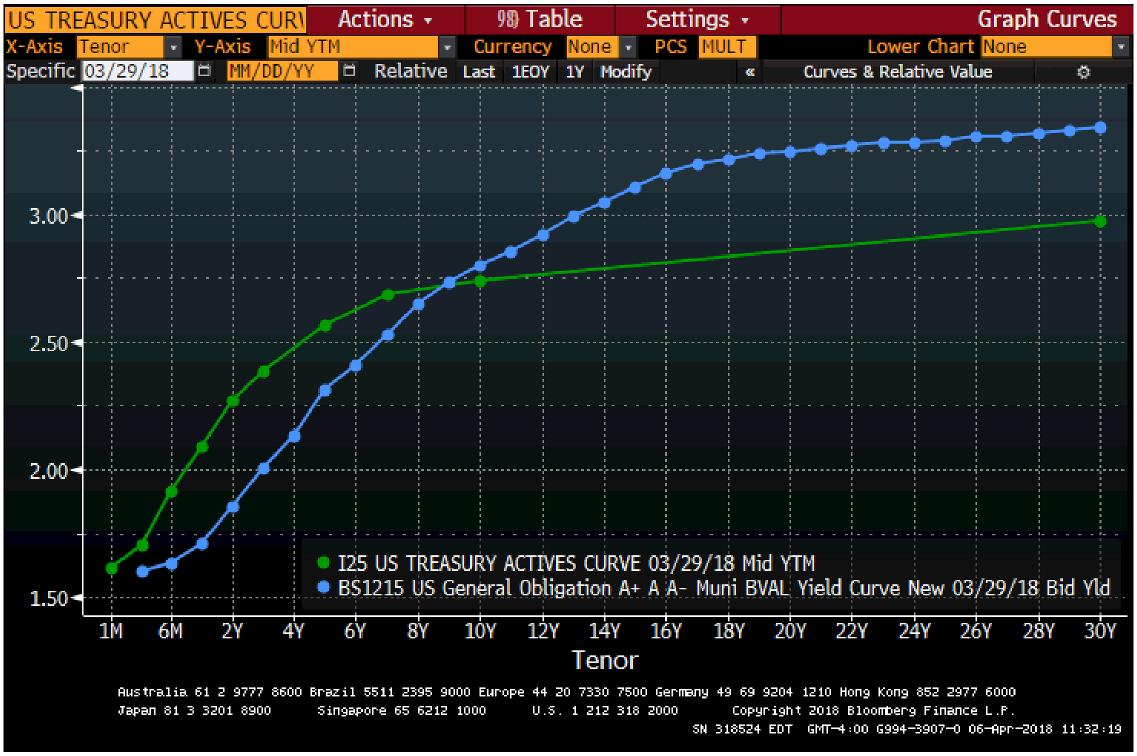
Exhibit 1



Source: Bloomberg

The bond market struggled as well, where the continued rise in short-term interest rates had little impact on longer maturity interest rates. Inflation, despite rising wage and commodity prices, continues to be offset by the deflationary impact of technological innovation increasing efficiency and, thereby, creating downward price pressure. In the end, markets loathe uncertainty, and in the opening months of 2018, uncertainty was the order of the day with new leadership at the Federal Reserve Bank, the prospect of trade tariffs, and a political impasse. But this is how the world is supposed to be – not the numbed and coddled environment that was the hallmark of the post-crisis period. On a positive note however, it must be noted that following the passage of the tax legislation, investors stepped up and absorbed one of the largest new-issue calendars the municipal bond market has ever experienced. Even after the recent changes to individual income tax rate, municipals (Exhibit 2) may offer a meaningful return advantage to retail investors.

Exhibit 2



Source: Bloomberg

2018 Outlook

Our outlook for both the economy and the market remains unchanged. We view this as a late cycle expansion characterized by increased business spending to improve efficiency and enhance profitability. The principal beneficiaries are smaller, domestically-focused enterprises with limited exposure to the global uncertainties of trade tariffs and currency fluctuations. We experienced the investors embracing this viewpoint during the first quarter, in what looked like a tug-of-war in the performance of the shares of large versus small company stocks. That interplay can easily be seen in the price graph below for the S&P 100 Index, the largest of the large, and the S&P 600® Index, the smallest of the 1500 S&P stock universe.

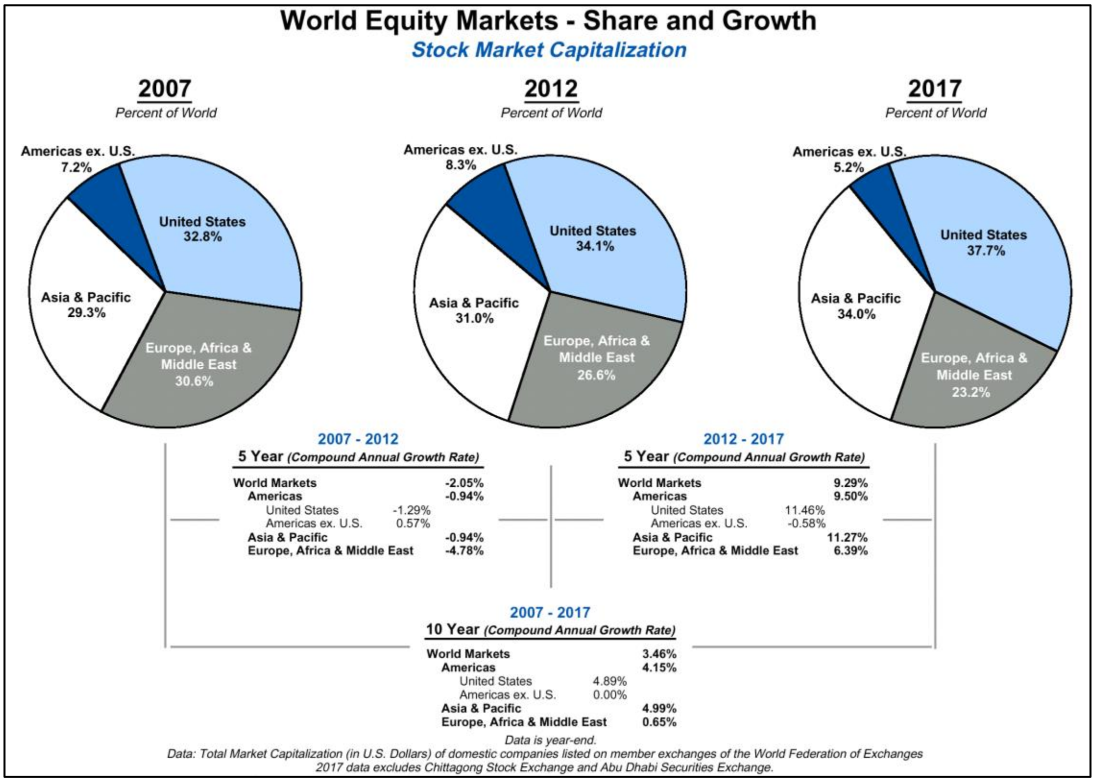
Exhibit 3

Source: Bloomberg

The duration of this economic recovery has reached the point where it is likely to be reinforced by a modest replacement cycle for passenger and commercial vehicles of all types. Infrastructure replacement, beyond just bridges and roads, is expected to experience increased spending, for example, as pipelines replace rail tankers for moving fuel, and autonomous vehicles rescue us from a national driver shortage.

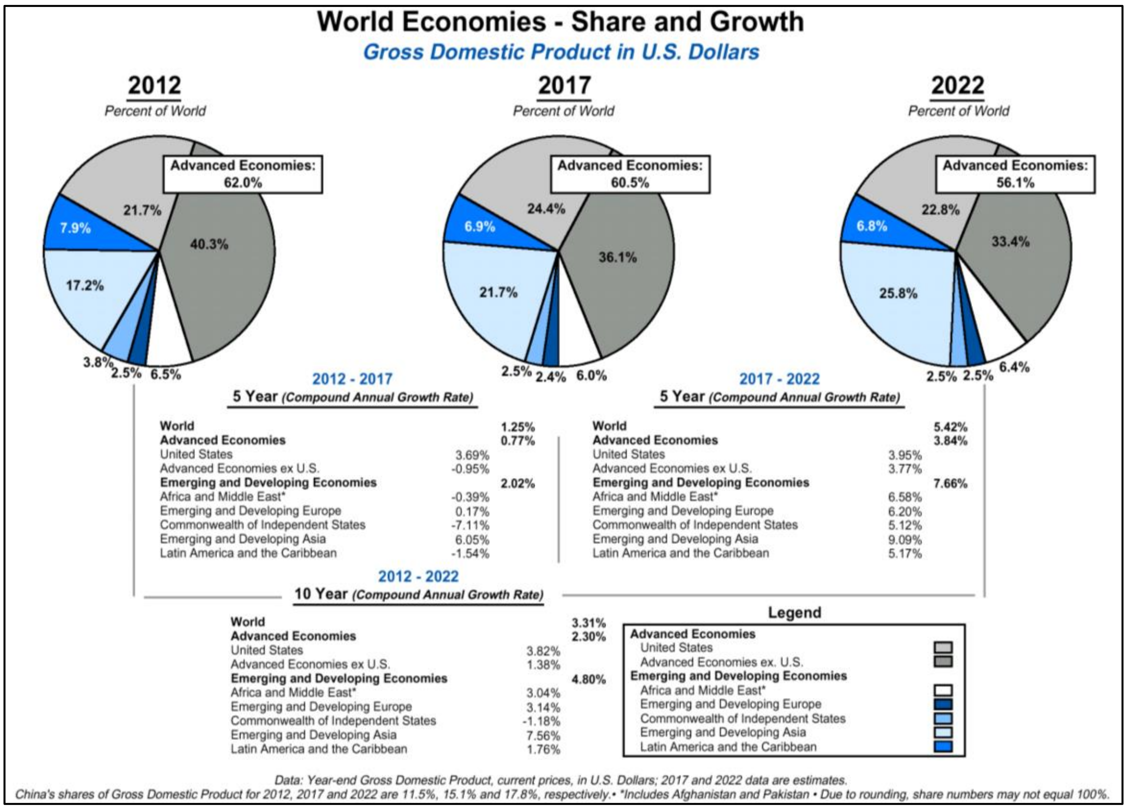
Our inward emphasis is not to imply that we eschew investment opportunities elsewhere around the globe, but quite the contrary. In the developed markets of Western Europe and Asia, we see accelerating economic growth as an opportunity for enhancing investment returns. Emerging markets, too, offer attractive risk and reward propositions for investors with valuations that have only just broken levels achieved prior to the global financial crisis. As illustrated below, the U.S. equity market capitalization is currently well beyond the U.S. portion of global GDP. This does not portend collapse of U.S. equity prices, but rather that other markets are likely undervalued and, as such, present attractive return opportunities.

Exhibit 4



Source: Crandall, Pierce & Company

Exhibit 5



Source: Crandall, Pierce & Company

Commodity prices have enjoyed a significant advance in recent months, and considering uncertainties regarding trade will likely experience significant volatility for the immediate future. In light of considerable idle capacity among industrial metals and miners, any sustained price advance will be countered by a return of production to the marketplace. As such, we see limited upside potential in this category. The trend towards higher interest rates will be a gradual, halting one as the countervailing inflationary and deflationary forces ebb and flow. Demand for income assets has not gone away and, with an aging population, will likely persist well into the future. The magnitude of that demand will be tested later in the second half of this year as the U.S. Treasury comes to market with a record volume of new issuance.

The return of price volatility enables us to put idle funds to work at more attractive valuations – an opportunity ten quarters in the making. While painful by any measure, the ongoing correction is very healthy for the market. Corrections, like recessions, are a way of dealing with excess and imbalances that have been building. Were this not to have occurred, the market would continue to build up distortions that, as we witnessed in 1987 and 1999, end in what can best be termed as unfavorable events.

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NOTE: IMPORTANT INFORMATION
Source: Unless otherwise noted, all statistics herein obtained from Bloomberg.

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