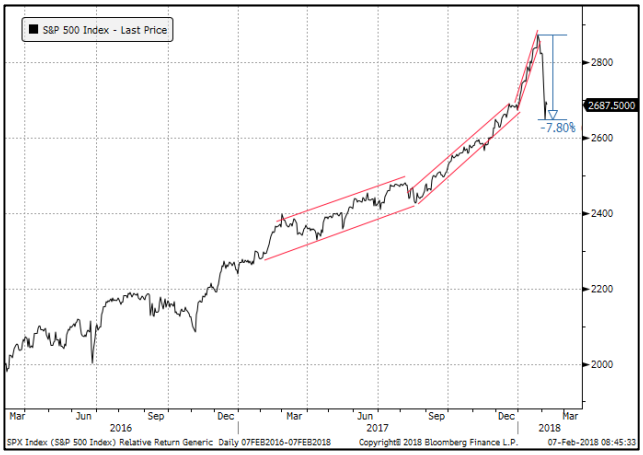
ACCESS FINANCIAL SERVICES, INC.

Market Update February 7, 2018

Global stocks suffered a sizable setback on Friday, February 2 and Monday, February 5. The S&P 500 Index of US large company stocks declined 6.13% during those two days. Between January 26 (the all-time high for the S&P 500 Index) and February 5, the Index declined 7.79%.

From our perspective, this setback is long overdue. However, we don't believe we're in for a drawn out bear market (at least at this point). While these are significant declines over short periods of time, they should be viewed in the context of the unsustainable, low volatility advance since early 2017 (chart 1). The closing value of the S&P 500 Index declined to levels last seen as of the close on December 14 (less than two-months ago).

Chart 1: S&P 500



Source: Bloomberg Finance LP

During January, stocks had become dangerously "overbought" (S&P 500 Index: +7.45% between 12/31/17 and 01/26/18) and were vulnerable to a correction. Volatility had also declined to extremely low levels. The strong advance in global stock markets accompanied by very low levels of volatility led to wide spread complacency. As we wrote in our last *Quarterly Review and Outlook* (http://accessafs.com/useful-info/newsletter):

> *"…time and again, stability breeds complacency – and complacency usually ends badly. That's all the more so when volatility is at record lows and there are potential risks to many of the drivers of last year's rally in just about everything."*

We also noted that betting on continued low volatility had become an increasingly crowded trade in recent years:

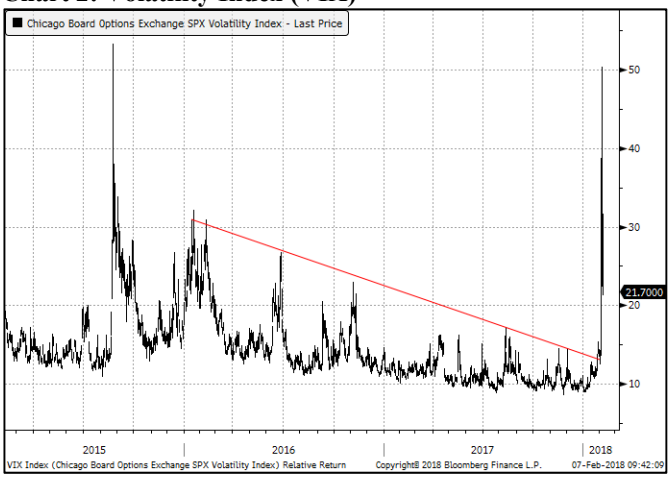
> *"More concerning than elevated bullish investor sentiment as measured by investor surveys are the signals being sent by financial instruments that reflect investors' views about expected future volatility.*
>
> *The most common measure is the Chicago Board Options Exchange Volatility Index known as the VIX Index. The Index measures the market's view of expected future volatility. Conceptually, it can be thought of as the price of buying protection against a decline in the S&P 500. Since 1990, the median value of the VIX has been 17.3. It is currently trading around 9.*
>
> *The implication is that market participants are so confident that volatility will stay low that they're willing to sell protection against a decline in stocks at very low rates. This is similar to an insurance company reducing premiums on hurricane insurance to unsustainable low levels because an insurable event hasn't occurred for a longer than normal time frame.*
>
> *While low VIX readings are another indicator of increased complacency, a larger issue is that betting on volatility remaining depressed has become an investment strategy at the institutional level. Basically, these investors are selling VIX options (protection against a decline in the market) on a leveraged basis in order to collect the premium. Implied volatility (as measured by the VIX Index) is another mean-reverting series. However, it can remain at low levels for extended periods, especially when global growth is robust and synchronized. Ironically, many VIX trading models encourage additional selling as volatility declines, such that lower volatility enters a self-reinforcing feedback loop. The danger is that this virtuous circle turns vicious when volatility returns with leveraged low-volatility trades going deeply into the red causing market-wide stress."*

Precisely such a vicious cycle erupted on Monday (chart 2), causing the S&P 500 Index to suffer its worst daily loss since August 18, 2011.

The question is where do we go from here? So far, the sell-off in stocks looks largely technical in nature. Chart 3 (X-axis: 1-day S&P 500 return; Y-axis: 1-day change in the volatility index) shows that the VIX soared by roughly four times more on Monday than one would have expected based solely on the decline in equity prices. This suggests that the spike in volatility caused the stock market plunge, rather than the other way around. The relatively muted

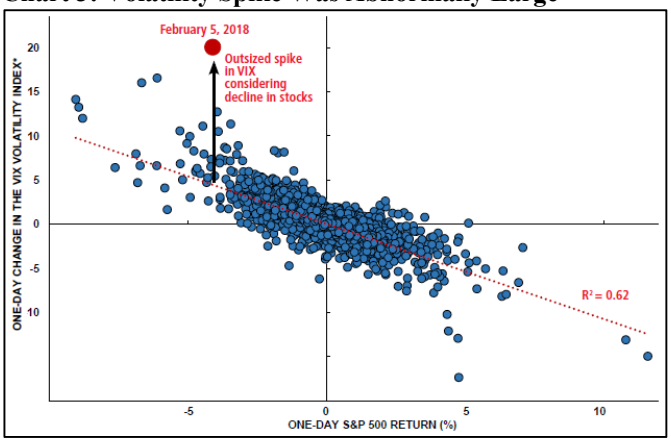
reaction of other "risk gauges" such as junk bonds, emerging markets stocks, and gold prices over the past few days is consistent with this notion.

Chart 2: Volatility Index (VIX)



Source: Bloomberg Finance LP

Chart 3: Volatility Spike Was Abnormally Large



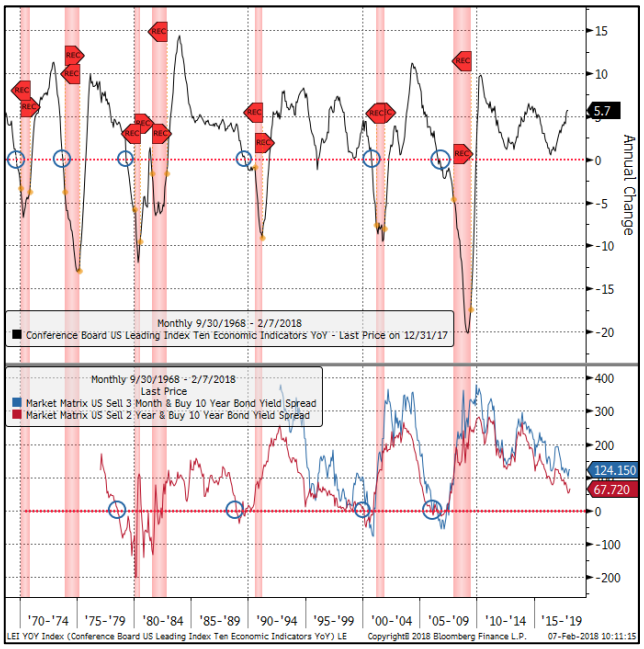
Source: BCA Research

It is impossible to know if Tuesday's rebound (S&P 500 Index: +1.74%) will persist or if the correction still has further to run. What we can confidently say is that the cyclical underpinnings for the bull market haven't changed…yet. Leading economic data remain resilient and corporate earnings continue to come in above expectations.

None of our recession-timing indicators are flashing red. The Conference Board's Leading Economic Indicator (LEI) is rising at a healthy 5.5% year-over-year pace (chart 4 top panel). Historically, a decisive break below zero in the year-over-year change in the LEI has been a reliable recession indicator. Likewise, while the US 2/10-year Treasury curve (the difference between 10-year treasury interest rates/yields and 2-year rates/yields) has flattened, it has not inverted yet (chart 4 bottom panel red line). Moreover, even once the yield curve inverts, the lags can be quite long before the recession begins. For example, in the last cycle, the yield curve inverted in early 2006, but the recession did not begin until December 2007.

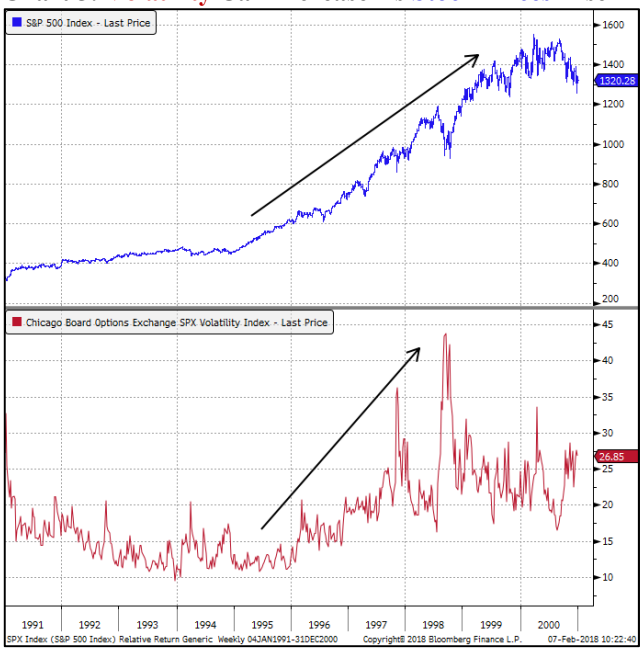
This does not mean that everything will be smooth sailing from here. Monday's sell-off marked an inflection point in the low-volatility world that has prevailed over the past few years. Going forward, volatility will remain elevated relative to what investors have come to expect. However, as the experience of the 1990s shows, stocks can still go up when volatility is trending higher (chart 5), but this is going to make for a much more challenging investment environment.

Chart 4: Recession Watch



Source: Bloomberg Finance LP

Chart 5: Volatility Can Increase As Stock Prices Rise



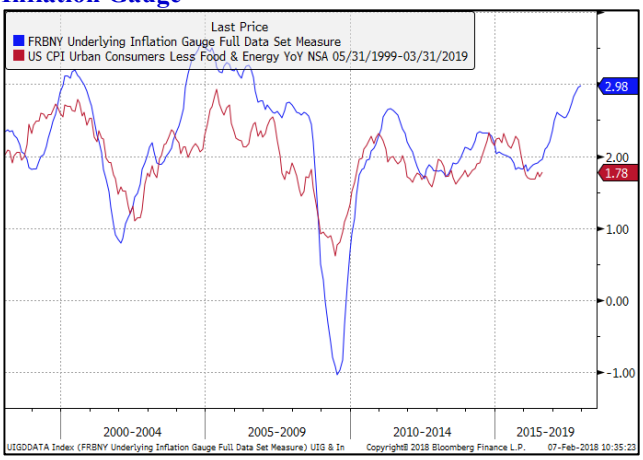
Source: Bloomberg Finance LP

As we've discussed in our recent *Letters* (http://accessafs.com/useful-info/newsletter), the Fed is in the process of winding down the extraordinary stimulus that investors have gotten used to. Whether this

undermines the case for owning risky assets depends to a large degree on how quickly the process unfolds.

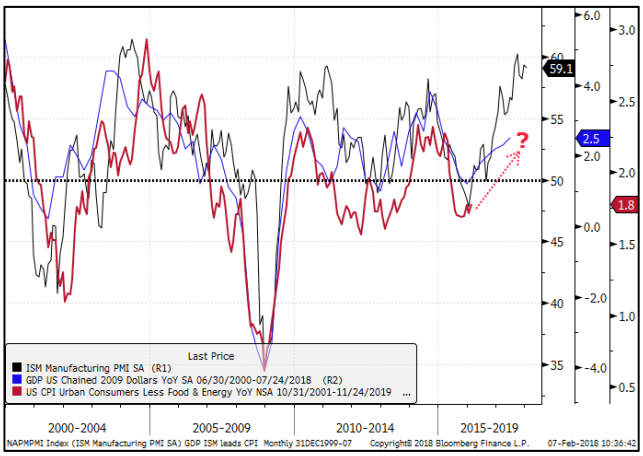
At this point, we think the process will be fairly gradual. However, there are a growing number of indicators pointing to accelerating inflation (charts 6 and 7). Higher inflation and low unemployment are what the Fed needs to continue raising short-term interest rates.

Chart 6: Core CPI Inflation and NY Fed's Underlying Inflation Gauge



Source: Bloomberg Finance LP

Chart 7: ISM Manufacturing Index leads GDP and Core CPI Inflation



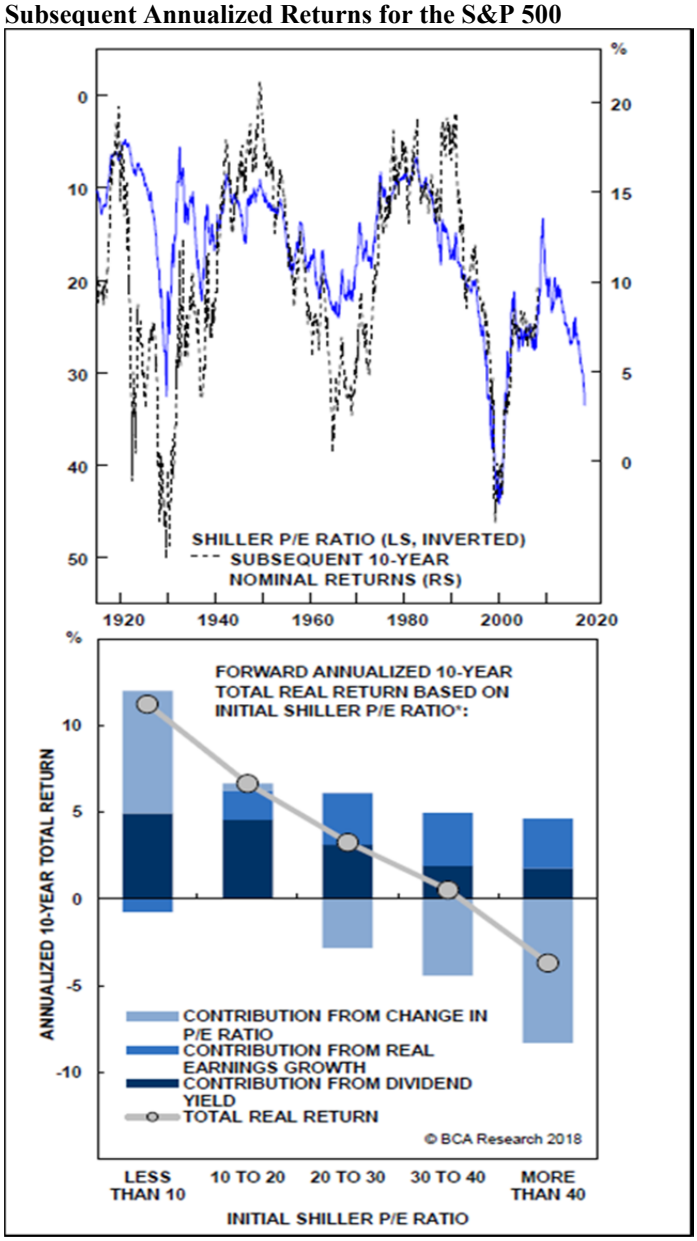
Source: Bloomberg Finance LP

Ultimately, we do expect core inflation to move above 2%, forcing the Fed to lift interest rates into restrictive territory which will negatively impact risky assets. However, this is likely to be a story for 2019 rather than 2018. Stocks tend to peak about six months before the start of recessions. If the next recession occurs in mid- to late-2019, as we expect, the equity bull market should last a while longer.

The bottom line is that we believe that the market turmoil since last week reflects a technical correction from overbought and over-complacent levels, but the cyclical bull run is not over yet. With that said, the bull market is entering its late stages. The low inflation and low volatility era is coming to end as the US economy begins to face late cycle supply-side constraints, especially in the labor market. Therefore, the equity advance will be associated with higher volatility than the last few years.

Additionally, stock valuations remain very high. While valuations are not much use for timing the stock market, they are the most important driver of returns over the long haul. There is a close correlation between valuations and the subsequent 10-year total return for stocks (chart 8). Today's high market valuations portent subpar returns over the next decade.

Chart 8: Shiller P/E Ratio (currently 34!) and Subsequent Annualized Returns for the S&P 500



Source: BCA Research

-Brant Kairies
952-885-2732

The views expressed are those of Access Financial Services, Inc., and should not be construed directly or indirectly, as an offer to buy or sell any securities mentioned herein. Due to volatility within the markets mentioned, opinions are subject to change without notice.

Information throughout this letter is obtained from sources which we believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Nothing on this publication should be interpreted to state or imply that past results are an indication of future performance. Neither we nor our information providers shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or for any delay or interruption in the transmission thereof to the user. There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information written in this letter.

Investing is subject to risks including loss of principal invested. Past performance does not guarantee future results.