ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook *First Quarter, 2018*

Benchmark Returns as of March 31, 2018

INDEX	Last 3 Mo.	Last 6 Mo.	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	(0.76)	5.83	14.00
Russell 2000 Index (small-cap stocks)	(0.09)	3.25	11.80
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	(1.69)	2.47	14.62
S&P Europe 350 Index Net Total Return Index (US$)	(4.32)	(3.84)	(0.65)
MSCI Japan Net Total Return Index (US$)	0.12	8.63	18.00
MSCI Emerging Markets Net Total Return Index (US$)	1.28	8.81	24.76
COMMODITIES			
US Dollar Index (DXY)	(2.14)	(3.14)	(10.16)
Gold	1.74	3.57	6.11
Oil (WTI)	7.48	25.68	28.34
Bitcoin	(50.40)	70.16	560.48
BONDS			
BloomBar* US Aggregate Bond (investment-grade bonds)	(1.46)	(1.08)	1.20
ICE US Treasury 20+ Year TR Index	(3.36)	(0.87)	3.86
BloomBar* US Treas. Inflation Protected Securities (TIPS)	0.88	0.42	0.88
Bloomberg Barclays Municipal Bond Index	(1.11)	(0.37)	2.66
BBG* US Corporate Total Return (corporate bonds)	(2.32)	(1.17)	2.70
BloomBar* US Corp. High Yield Tot. Rtn. (high yield bonds)	(0.86)	(0.39)	3.78
BloomBar* Global Aggregate Treasuries Total Return	2.90	4.02	8.14

**Bloomberg Barclays; Source: Bloomberg Finance LP*

One of the strongest themes of 2017 was a low volatility uptrend in stocks. From a volatility perspective 2018 has been nothing at all like 2017 (Chart 1).

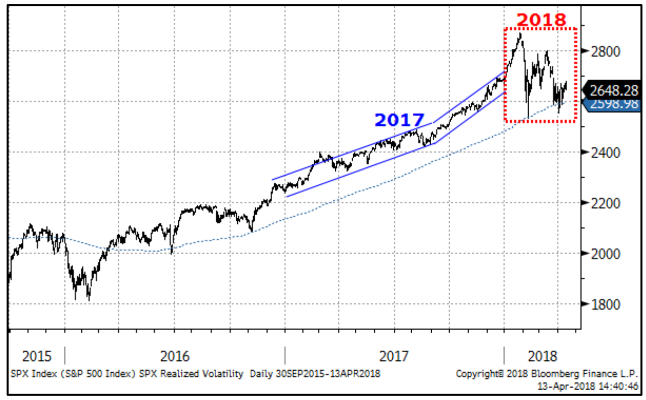
Volatility is an interesting concept. Some definitions of volatility include:

- Liability to change rapidly and unpredictably, especially for the worse. (Google Dictionary)
- A statistical measure of the dispersion of returns. (Investopia)
- A tendency to change quickly and unpredictably. (Merriam-Webster)
- The frequency and magnitude of price movements, both up and down, that a financial instrument experiences over a certain period of time. The more dramatic the price swings in that instrument, the higher the level of volatility. (Cboe Options Exchange)

Within financial markets, we usually to refer to two types of volatility: realized and implied.

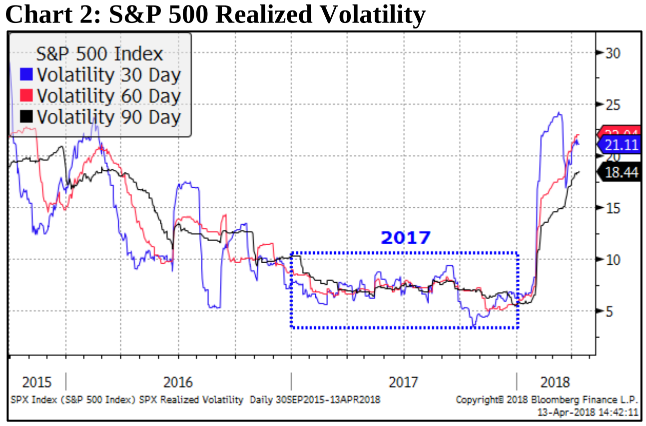
- Realized volatility measures the variations in the price (as measured by standard deviations) of a security or index over a given period (Chart 2).
- Implied volatility measures the market's expectation of future volatility (Chart 3).

Chart 1: S&P 500 Index



Source: Bloomberg Finance LP

Chart 2: S&P 500 Realized Volatility



Source: Bloomberg Finance LP

Chart 3: S&P 500 Implied Volatility

Source: Bloomberg Finance LP

No matter which definition one prefers, volatility in financial markets is back after lying relatively dormant for many years – especially in 2017 during which the maximum drawdown (peak to trough decline) was an incredibly low 2.8% for the S&P 500 Index. In fact, 2017 had the lowest annualized (one-year) standard deviation of returns (realized volatility) in the past 40 years of just 6.71%. The current one-year reading is 12.03%.

After posting strong returns during most of January (7.45% between December 31, 2017 and January 26, 2018), the S&P 500 declined 10.16% between January 26 and February 8.

As we discussed in last quarter's *letter*, betting on continued low volatility had become an increasingly crowded trade that had the potential to disrupt financial markets should it be unwound in a short period of time. Specifically, we said:

A stock market correction due to negative surprises could be quite painful to the extent that the VIX (implied volatility index) overshoots to the upside as the large volume of low-volatility trades are unwound. A 10% equity correction in the US this year would not be a surprise given the late stage of the bull market and current market positioning.

As fate would have it, we got our negative surprise. Interest rates (as measured by the 10-year Treasury note) rose sharply which triggered a rise in implied volatility (as measured by the VIX Index) (Chart 4). Once the VIX began rising and the bets that volatility would stay low well into the future began to lose money (which triggered massive demand for VIX options and futures), the rise in volatility rapidly began to feed on itself. This, in turn, drove stocks lower. It was a case of the tail wagging the dog. All of this happened very quickly and sooner than we anticipated.

Following the January 26 to February 8 decline, the S&P 500 gained 7.96% between February 8 and March 9. However, the S&P proceeded to decline again by 7.35% between March 9 and April 2 on fears of a trade war with China.

When President Trump had a pleasant first meeting with Chinese President Xi Jinping at the Mar-a-Lago resort early in his presidency, the market significantly reduced its expectation of a trade war. The market got it wrong.

"I'm not saying there won't be a little pain, but the market has gone up 40 percent, 42 percent so we might lose a little bit of it. But we're going to have a much stronger country when we're finished. So, we may take a hit and you know what, ultimately we're going to be much stronger for it."

President Donald Trump, April 6, 2018

There are times when conventional wisdom is wrong. Since Donald Trump became president, the "smart money" has believed that he is obsessed with the stock market. Therefore, the view went, none of his policies would threaten the bull market.

Not only have President Trump's tariff pronouncements produced stock market drawdowns, but his popularity appears to be unaffected. Actually, President Trump's approval rating declined as the stock market advanced in the second half of 2017 and recovered as the stock market went in reverse this year. So, the reality is that it's incorrect that President Trump is constrained by the stock market. His actions over the past month, as well as his approval ratings, suggest that he is comfortable with volatility. Eventually, however, stock market drawdowns will affect hard data and the real economy. This is when President Trump will care about the stock market.

Chart 4: 10-Yr. Treasury Bond Yield (interest rate), Volatility Index & S&P 500

Source: Bloomberg Finance LP

During the last five weeks, the Trump administration has moved quickly to begin implementing its protectionist platform. Trump's formal announcement of global tariffs on steel and aluminum products marked the shift, although we got a peek into the future with the January announcement of washing machine and solar panel tariffs.

President Trump did not announce that he would impose a 25% tariff on all imported steel and a 10% tariff on all imported aluminum because he was "unglued" or "angry". He did so because *he can*. President Trump faces very little in the way of political, constitutional, and economic constraints when it comes to pursuing protectionist policies – one of his campaign promises.

Following the March 23 US announcement of tariffs on around $50 billion worth of Chinese imports, President Trump again upset the markets on April 7 by suggesting that that he would impose another round of tariffs on a further $100 billion worth of Chinese imports, bringing the total under threat to $160 billion. The announcement came after the market closed up 0.89% on April 6. Maybe President Trump was upset that the market was so dismissive of his trade threats and decided to jolt it back to reality?

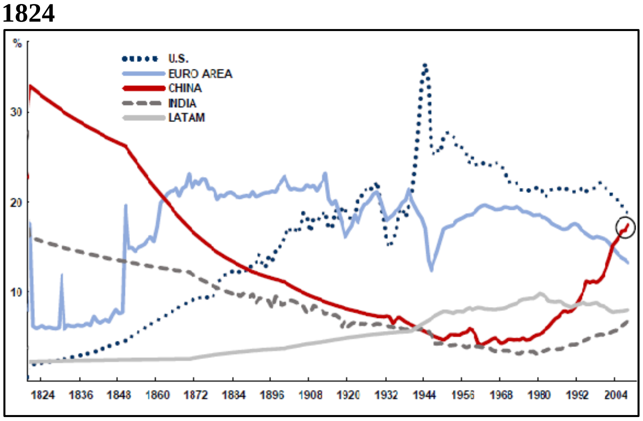
The markets are now focused on the economic impact of the announced tariffs (yet to be determined), constraints facing President Trump (minimal), and potential Chinese retaliation.

There's also a larger and more important picture to consider. The US announcement of tariffs on Chinese imports on March 23 and April 7 is not just the opening round of a trade war. Instead, the emerging trade war is most likely the opening round of a new cold war, a global superpower competition between the US and China that will define the twenty-first century.

Essentially, the US and China are now enemies, not rivals or competitors. It will take the market some time to come to terms with this idea and price it properly. Meanwhile, in the near term, we think fears of a full-born global trade war are overblown. The trade tensions are really only about two countries, with uncertain global implications. Investors are right to be cautious, but we believe risks to global corporate earnings are overstated *at this time.*

From China's perspective, its rapid economic ascent since 1980 is just the return of the long-term status quo (Chart 5) – the last 180 years were an aberration. During this period of Chinese weakness, the West – with Britain and then the US pulling the strings – conspired to restructure global rules and norms of geopolitical and economic behavior without input from China. The results were China's influence in important post-WWII economic institutions like the WTO and the IMF is limited and its military has second-class status.

Chart 5: GDP as a Percent of Global GDP Beginning in 1824



Source: Angus Maddison and BCA Research

On the other hand, the US perspective is that China's growth over the past two decades was made possible by US supremacy. The US secured the global rules and norms that enabled China to integrate easily into the global markets and then compete its way to the top. Not only did the US allow China to access its credit-fueled markets, but the US protected China's maritime trade, including energy supplies from the Middle East. To show its appreciation, China reneged on its WTO commitments, periodically suppressed its currency, stole American intellectual property, and withheld market access from US corporations.

Washington policymakers, and not only Trump's advisors, are turning against China. There is an emerging consensus among the US foreign policy, defense, intelligence, and economic policymakers that:

- Chinese-American economic cooperation and interdependence is over.
- The US can afford to confront China over trade because it is the least exposed major economy to global trade.
- The Chinese have acquired a huge share of global exports without an adequate opening of their domestic market.
- Ending Chinese technology transfer and intellectual property theft is a national security issue.
- The US can confront China because it has a strong history of winning its global confrontations in the past.

Fundamentally, American policymakers want to see China's rapid economic growth slow, they want to see China's capital markets and companies constrained by openness to global competition, and they want to contain China's catch-up in the technological and manufacturing value chain. This is not their stated objective as it would imply that the US wants to see China weakened and Chinese leadership miss its decade and century economic goals. But this is just what the US establishment wants. Therefore, the political and economic visions of American and Chinese policymakers are directly at odds with one another.

*"I won't rule out direct talks with Kim Jong Un. I just won't … **As far as the risk of dealing with a madman is concerned, that's his problem, not mine**."*

President Donald Trump, March 4, 2018

Both the US and China think they can win a trade war and are playing a game of chicken[1]. A game of chicken is the most unpredictable game because it can create an equilibrium where all *rational* actors have an incentive to keep driving head on – to stick to their guns – despite the risks. Continuing to drive carries the greatest risk, but also the greatest reward, provided the opponent swerves. Since the participants in a game of chicken assume the rationality of their opponents, they also expect them to eventually swerve. In the current context, this means that the US assumes that China is driven by economic rationality and will not dare face off against the US, which has far less to lose given its modest exposure to global trade.

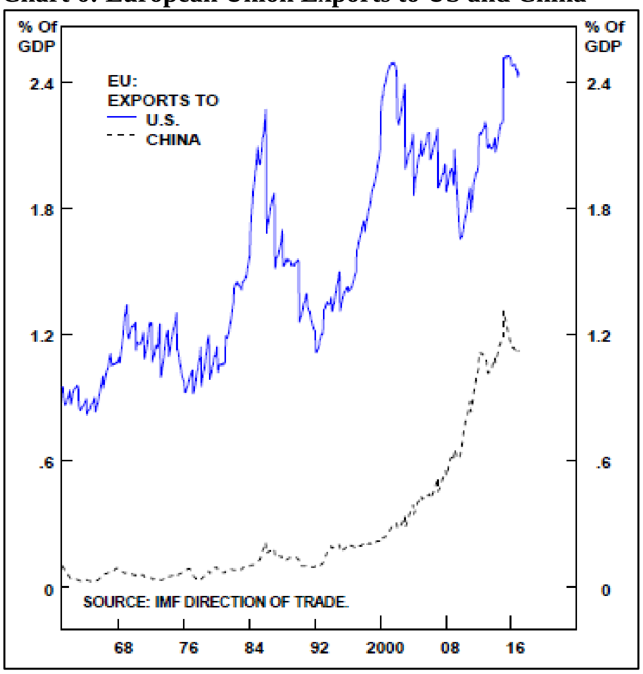
[1] The practice of racing hot rods head-on in order to prove one's manhood.

Chinese policymakers also think they can win. They look at America and see a country divided by political polarization. China, however, has just consolidated its political leadership and feels confident enough in its domestic stability to experiment with growth-limiting economic reforms and can use trade tensions with the US to further justify painful adjustments.

Who is right? We do not know.

An important factor, one that would alter China's risk assessment, is Europe. Despite being leveraged to China's growth, the European Union exports nearly double the value of goods to the US than to China (Chart 6). In addition, Europe's trade surplus with the US mostly pays for its deficit with China.

Chart 6: European Union Exports to US and China



Source: BCA Research

Therefore, an important question is whether Trump will embrace America's traditional alliance with Europe and capitalize on it during a trade war with China. If he embraces it, we think the combined forces of US and Europe will successfully force China to concede to the pressure.

The next (*known*) major geopolitical risk is the potential for renewed US-Iran tensions. On May 12, the White House will decide whether to end the current waiver of economic sanctions against Iran. If it does not, it is possible that the US will misapply its "maximum pressure" policy to Iran and threaten the complicated coordination with geopolitical allies on China. As noted above, the US-EU relationship is very important if the US wants a global economic alliance against China. The EU, however, does not want to renegotiate Iran sanctions.

The pessimistic view on trade protectionism risk, that there is more downside for ahead, is therefore still relevant. We need be careful not to overreact to positive developments, such as President Xi's recent speech at the Boao Forum where he largely reiterated previous Chinese promises to open up individual sectors to foreign investment.

In order to convince China that the threat of protectionism is credible, President Trump has to show that he is willing to incur pain at home. Going forward, it is actually in the interest of the Trump administration that investors take his threats seriously. President Trump will most likely welcome weakness in risk assets in order to show China that he is serious. A positive market reaction may actually result in a more aggressive policy from Washington. The summer months could be volatile as market confusion grows amidst the upcoming event risk.

We are concerned that the markets are mispricing constraints on President Trump. Geopolitical risks ahead of us are largely in the realm of foreign policy, where the US Constitution gives the president a lot of leeway. This includes trade policy. Therefore, it is much more difficult to have a high conviction view on how the Trump administration will act towards China (and Iran, and Russia). And, the success of the "maximum pressure" policy has emboldened President Trump to talk tough first and worry about consequences later.

We have to be aware that the US financial markets may be the target of President Trump's rhetoric. There are few better ways for the White House to show China, and others that it is serious and that its threats are credible than if it strongly counters the view that it will do nothing to harm US stocks. We therefore expect further volatility in the markets. We also expect a rise in the volatility of volatility.

In addition to geopolitical risks, headwinds for risk assets are growing:

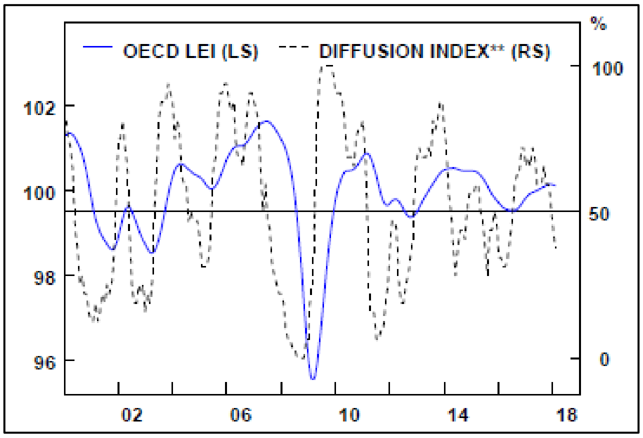
Global Growth

Global growth (outside the US), while still strong, is no longer accelerating. The Organization for Economic Co-operation and Development's (OECD) Global Leading Economic Indicator (LEI) has dipped slightly over the past two months and its diffusion index which measures the share of countries with rising LEIs has dropped below 50% (Chart 7). Consistent with the LEI diffusion index, economic surprise indices have also declined this year (Chart 8).

Interest Rates

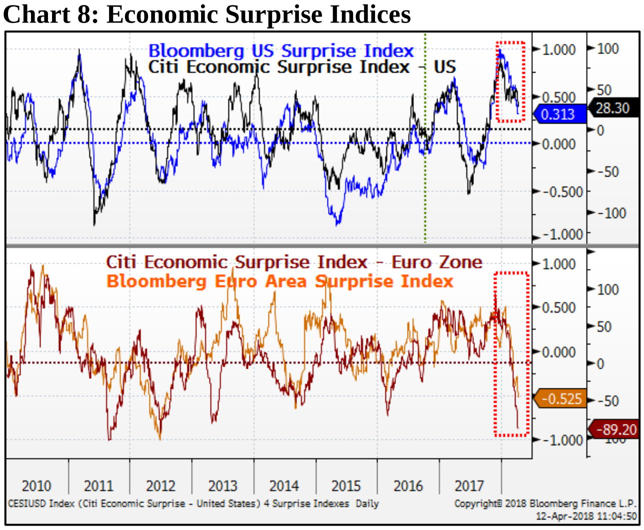
As noted earlier, interest rates have risen meaningfully this year, both at the short end where the Fed sets rates and the long end where bond market investors drive rates (Chart 9). As interest rates rise, the demand for credit (loans) declines. This leads to slower economic growth as the "credit impulse" retreats. Additionally, today's high stock market valuations (Chart 10) are justified only if bond yields (interest rates) stay low. 10-year Treasury note yields above 2% (the approximate current dividend yield of the S&P 500) gradually improve the attractiveness of bonds relative to stocks.

Chart 7



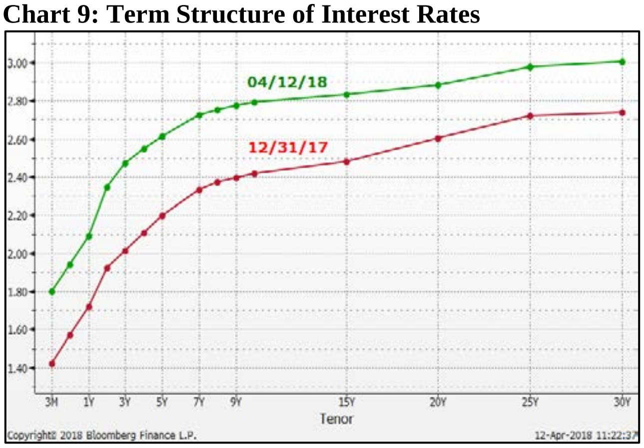
***Number of countries with rising LEIs as a percentage of total. Based on 32 OECD countries. Source: BCA Research*

Chart 8: Economic Surprise Indices



Source: Bloomberg Finance LP

Chart 9: Term Structure of Interest Rates



Source: Bloomberg Finance LP

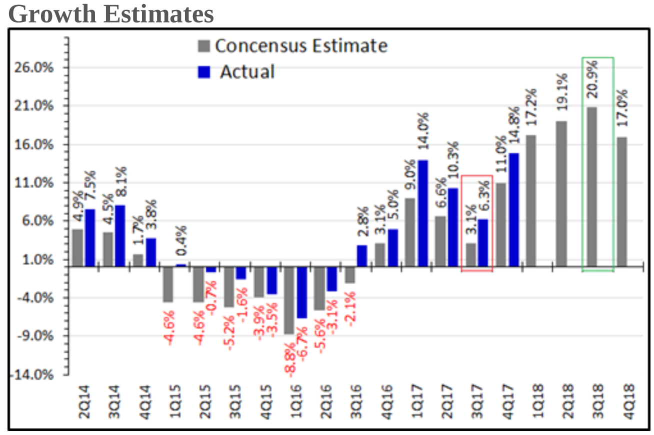
Chart 10: S&P 500 Price/Earnings Ratio

Source: Bloomberg Finance LP

Corporate Earnings

The bar is set high for 2018 corporate earnings growth with peak year-over-year growth estimates of almost 21% for the third-quarter (Chart 11). Given the recent tax cuts and third-quarter 2017 relative earnings weakness, 20%+ earnings growth can't be dismissed out of hand. However, the market will soon have to come to grips with calendar 2019 earnings per share growth of a more reasonable 10% (or less) with global earnings estimates being revised lower after five quarters of positive revisions (Chart 12).

Chart 11: S&P 500 Actual and Consensus Earnings Growth Estimates



Source: FactSet

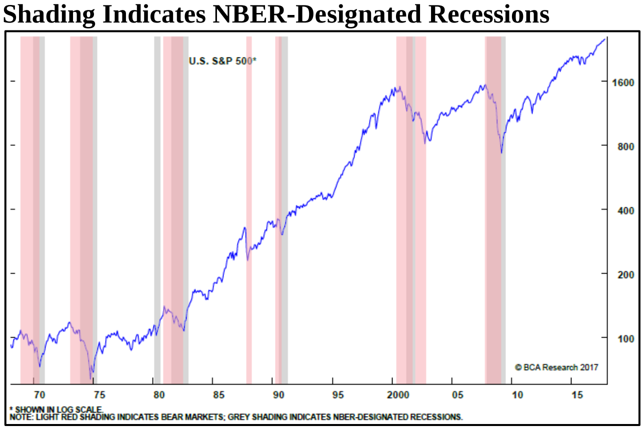
Chart 12: Global Earnings Revisions

Source: Bloomberg Finance LP

None of this is to say we believe we've come to the end of the bull market that started in 2009. For now though, fiscal policy, regulatory policy, and even Fed policy have taken a back seat to the new driver of daily swings in financial markets: trade policy. Ultimately, we think this round of credible threats from both the US and China will move each to a more cooperative resolution and expect the financial markets to respond favorably.

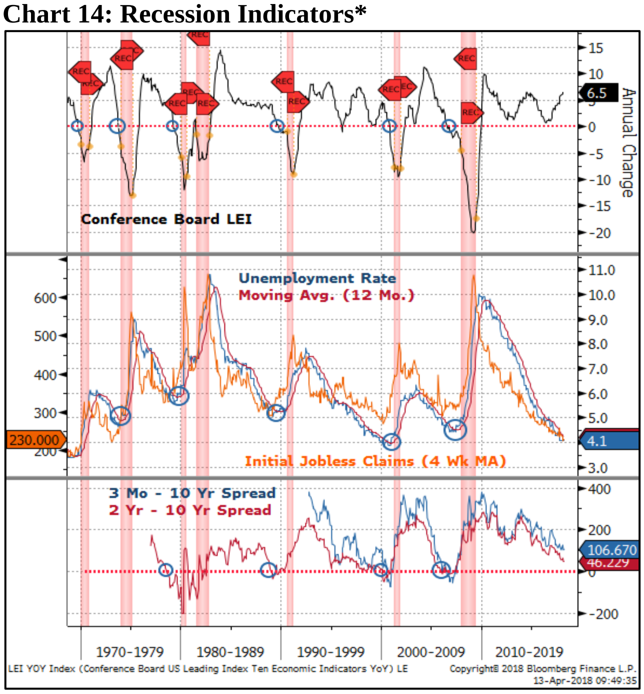
As noted in previous letters, recessions and bear markets usually overlap (Chart 13) and we don't expect a recession to develop over the next twelve-months. However, at some point it is likely that aggressive Fed interest rate policy will result in one. For now, some of the best recession leading indicators are still giving an all clear signal (Chart 14). However, many of the tailwinds pushing the stock market ever higher are fading and will turn into headwinds in the not too distant future.

Chart 13: Red Shading Indicates Bear Markets; Gray Shading Indicates NBER-Designated Recessions



Source: BCA Research

Chart 14: Recession Indicators*



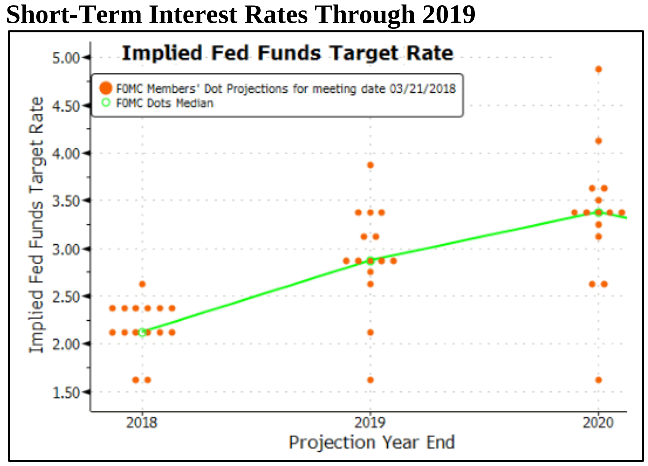
**Red shading indicates recession.*
Source: Bloomberg Finance LP

For now, we believe the setback in global stocks during the first-quarter was a rational reaction by investors given the events that transpired. While we expect higher (probably much higher) levels of volatility to become the new normal, we don't believe we've reached the end of this long bull market yet.

While most of this *letter* focused on the struggles the stock market has had to contend with since the end of January, the US economy remains strong by virtually all measures. This is mostly true for Japan and the European Union as well. We expect the impact of tax cuts, reduced regulation and stronger fiscal spending (along with reasonable negotiations with China) to provide enough support for the financial markets to generate positive returns in 2018. Beyond early 2019, the economic outlook begins to darken.

During the quarter we added additional floating-rate bond exposure to our clients' portfolios because we believe the Federal Open Market Committee (the "Fed") will continue on its projected path of higher short-term interest rates (Chart 15). Floating-rate securities pay interest at rates that are tied to short-term interest rates. This limits the negative price response of traditional bond to rising interest rate environments. In addition to our existing exposure to floating-rate securities via the Lord Abbott Floating Rate Fund, we added the Semper MBS Total Return Fund. The Fund's portfolio consists mainly of floating-rate mortgage and other asset-backed securities and has a 12-month trailing dividend yield of 5.56%. The Fund's current indicated yield is 6.47%.

Chart 15: Individual Fed Members' Projections for Short-Term Interest Rates Through 2019



Source: Bloomberg Finance LP

As always, please don't hesitate to contact me with questions.

-Brant Kairies
952-885-2732