MONTHLY UPDATE AND COMMENTARY
MAY 2018

Dear Investor,

The market's reaction over the past four weeks to some of the best earnings in years was lackluster at best. With about 95% of the S&P 500 finished reporting calendar Q1 results, earnings were up over 25% year-to-year. The poor performance in stocks may lead us to believe one of several things. First, that all this good news was priced in and that expectations will come down from here. This is the so-called "peak earnings" theory. The second prominent assessment is that the poor reaction in stocks is forecasting a decelerating economy ahead. This argument has gained some credence because semiconductors, materials, and industrials bore the brunt of the post-earnings meltdown. However, there exists a third explanation that we subscribe to, which is simply that stocks are taking a break before moving higher.

The forward P/E amidst the January euphoria neared 19x, but now sits at roughly 16.5x, right on its 30-year average. While these valuations look attractive, there are four main areas of worry keeping a ceiling on stocks:

- The primary fear is the flattening yield curve, which is causing "inversion anxiety." An inverted yield curve is historically predictive of a recession on the horizon. We believe immediate concern about the curve is overblown for three reasons. First, rising short-term rates are causing the flattening, not falling long-term rates. This is the result of the Fed raising rates, as opposed to a flight to quality driving the long end down. Second, markets can do very well in a flat curve environment, as they did in the late '90s. Third, even if the curve does invert, it takes an average of 17 months until we see a recession.
- Another current fear is a serious trade war, which again in our opinion is overblown. We have witnessed the first salvo in what will be protracted negotiations between the U.S. and China, but both sides have too much to lose to allow an all-out economic war.
- A third area of worry is the rising tide of inflation. We are starting to see the signs of price increases across many components in the core CPI, but wages seem to be relatively sticky despite the historic low unemployment rate of 3.9%. We do not envision a significant rise above the Fed's 2% inflation target this year.
- Finally, many are speculating that the Fed will overshoot with its current tightening stance. Keep in mind they are trying to increase short term rates while at the same time unwinding part of a $5 trillion balance sheet. We agree that this will take some deft maneuvering, but Powell is a market guy and will be watching closely for signals that the tightening is a threat to the economy. We believe he will be likely to back off quickly in that event.

Sometimes there are so many cross currents within the markets that paralysis prevails for a period of time. We are caught in one of those periods. The economy is leading the market and at some point will need to reach equilibrium. We believe for the balance of the year the market will catch up with the economy and end the year on a positive note. Warning signs exist but it's too early to ring the bell.

Please contact me with any questions.

Jesse T. Ellington III
Chief Investment Officer
Union Bank & Trust
3900 Westerre Pkwy, Ste 201
Richmond, VA 23233
T 804.774.2087
C 843.412.1420
F 804.967.8821
jesse.ellington@bankatunion.com