2018 First Quarter Portfolio Review

Market Overview

Volatility came back with a vengeance in the first quarter of 2018, but despite the increase in noise, the result was basically flat performance. Global stocks, as measured by the MSCI ACWI, declined by -1.03% during the quarter led by weak performance in the U.S. and Europe with the S&P 500 Index declining -0.76% and the MSCI Europe Index declining -1.98%. The weakness in Europe was masked by the robust performance of the euro as the market declined by -4.61% in local currency. Japan was also buoyed by its currency as the MSCI Japan Index fell -4.80% in yen terms but gained 0.13% in U.S. dollar terms. The MSCI Emerging Markets Index increased by 1.28% with little help from the changes in local currencies. Asset classes with a sensitivity to interest rates represented some of the hardest hit segments of the U.S. market. The Dow Jones U.S. Real Estate Index fell -5.91% and the S&P 500 Utilities Index fell -3.30%.

The change in U.S. interest rates was the biggest news during the quarter. The Bloomberg Barclays Global Aggregate Index declined -1.46% with investment-grade credit, as measured by the Bloomberg Barclays U.S. Credit Bond Index, leading the decline at -2.32%. Bonds with a higher coupon fared better than core Treasurys and corporate bonds. The Bloomberg Barclays U.S. Corporate High-Yield Bond Index declined -0.86% while the Bloomberg Barclays U.S. Municipal High Yield Index increased 0.58%. Emerging market (EM) corporate bonds were also able to avoid the worst of the rate-driven drawdowns, with the Credit Suisse Emerging Market Corporate Bond Index declining by -0.52% in the quarter.

Portfolio Overview

Salient SmallMid Core Portfolio returned 5.24% (net performance) in the first quarter, outperforming the benchmark, the Russell 2500 Index, which returned -0.24%. Volatility returned in the first quarter with the VIX rising over 80%; it started the year at about 11 and then spiked to over 37 in early February, finishing the quarter at about 20, which is approximately its long-term average since inception. The January jobs report that came out in early February showed the average hourly earnings rate jumping more than expected. This increase meant that the U.S. Federal Reserve (Fed) might have to raise rates more than expected this year. This fear of a more aggressive rate-hiking Fed along with escalating trade fears were the dominant themes in the quarter. As noted in past commentaries, growth stocks have been outperforming value stocks, which continued this quarter. The Russell 2500 Growth Index returned 2.37% versus the Russell 2500 Value Index's -2.64%. This 5.01% difference follows the 2017 full-year difference of 14.11%. This continued outperformance, along with a flattening yield curve, may be indicating that the economy isn't accelerating much beyond what it has been over the last several years.

In the first quarter, the portfolio's top performing sector was financials. The portfolio's top performing stock for the quarter was Virtu Financial, a leading technology-enabled market maker and liquidity provider to the financial markets. Virtu directly benefits when volatility spikes and trading volumes increase. The portfolio's weakest sector in the quarter was industrials. Neenah Inc. was the portfolio's weakest stock in the quarter. Neenah's underperformance is directly related to higher input costs and start-up costs for new capacity at a plant. We remain positive on the company. At quarter end, the portfolio was more attractively valued than the benchmark with a price-earnings ratio of 28.5x versus the benchmark's 31.5x.

Investment Outlook

Global economic momentum continues as global gross domestic product estimates for 2018/2019 generally moved higher in early 2018. However, geopolitical intrigue possibly escalated to more protectionist trade policies and late quarter economic data that suggested at least some deceleration raised investor risk concerns. The business climate remains healthy. In the U.S., the tax cuts appear to be having the intended impact of lifting employment and increasing investment, and fiscal spend should be supportive with the new Bipartisan Budget Act. Europe remains on a positive trajectory with low inflation and good employment growth. Japan showed continued momentum with better-than-anticipated capital investment and a general uptrend in domestic demand. That said, the news may be as good as it gets for this part of the cycle. Purchasing managers' indices and other leading indicators have rolled over recently and the strong yen and euro may impact corporate profits in Japan and Europe. Consumer and business confidence suffered with tough trade talk dominating the headlines. Ergo, we note the mixed data coming from several emerging markets. Central and East Asia continue to be bright spots, but Brazil and Russia are not keeping up with the global economic performance averages. As noted in last quarter's commentary, China's economy should decelerate with less stimulus after last year's National Congress. Massive leverage and excess industrial capacity will continue to slowly drag on China's economic performance. Overall, however, the fundamentals remain solid. We believe the enacted U.S. trade tariffs, if not followed by more actions, will have limited impact. The 25% steel and 10% aluminum tariffs will result in an effective $11 billion tax on consumers of these metals—a potentially big pill for certain industries like aircraft and machinery, but negligible for the $19 trillion U.S. economy. The announced duties by China are even less impactful. Assuming a successful renegotiation of NAFTA and no full-blown global trade war, we look for very modest impact on the global business climate. We also highlight the very slow inflation burn with some wage price pressures offset by other more modest inflation data, which suggests that central banks can continue to be measured in accommodation removal.

Net returns are calculated using a highest management fee of 2.00%, applied monthly.

Investing involves risk, including a possible loss of principal. Past performance does not guarantee future results. Portfolio holdings are subject to change at any time.

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Bloomberg Barclays Global Aggregate Index represents a broad-based measure of the global investment-grade fixed income markets, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are U.S. domestic, taxable and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Corporate High Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Credit Index is an index composed of corporate and non-corporate debt issues that are rated investment grade (Baa3/BBB) or higher.

Bloomberg Barclays U.S. Municipal High Yield Index measures the noninvestment-grade and nonrated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington D.C., Puerto Rico, Guam and the Virgin Islands).

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Credit Suisse Emerging Market Corporate Bond Index consists of U.S. dollar-denominated fixed-income issues from Latin America, Eastern Europe and Asia.

MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Europe Index is a free float-adjusted market capitalization index designed to measure developed market equity performance in Europe.

MSCI Japan Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of the developed markets in Japan.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

Russell 2500 Growth Index measures the performance of those Russell 2500 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2500 Index measures the performance of the small- to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000 Index.

Russell 2000 Value Index is a large cap value index measuring the performance of the largest 2,000 U.S. companies with lower price-book ratios and lower forecasted growth values.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

VIX (the ticker symbol for the Chicago Board Options Exchange Volatility Index) is a popular measure of market risk and is constructed using the implied volatility of S&P 500 index options.

Yield is the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost or on the U.S. government's debt obligations.

Indexes shown for illustrative purposes only. It is not possible to invest directly in an index.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable.

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