JMS CAPITAL GROUP
WEALTH SERVICES • REAL ESTATE • DEVELOPMENT

Quarterly Market Commentary

First Quarter 2018 Key Takeaways

Volatility returned to the financial markets in the first quarter, for the first time in a while. Stocks surged out of the gates in January, then corrected sharply, before rebounding into mid-March, clawing back much of their losses. They then dipped again into quarter-end, buffeted by a potential trade war and a Facebook data scandal. When the dust settled, large cap stocks ended down 0.76% for the quarter.

Developed international stocks also got off to a strong start to the year, before suffering similar losses to U.S. stocks during the sharp correction in early February. They made up ground relative to U.S. stocks in March but still ended the quarter down 1%. This could be due to a variety of reasons from European politics to a lower exposure to technology. Our views have not changed and we are maintaining our overweight to developed international stocks..

Emerging-market stocks held true to their higher-volatility reputation. They shot up 11% to start the year, fell 12% during the mid-quarter correction, and then once again outgained U.S. and international stocks to finish the quarter with a 2.5% return. Our portfolios' overweight to emerging-market stocks added to returns as they outperformed U.S. stocks for the period.

Overall, our active U.S. equity managers in aggregate added value relative to the benchmark, led by our active growth managers, who beat the large-cap growth index by a meaningful margin. Foreign stock funds did not fare as well in the first quarter. Active developed international equity managers outperformed, but active global and emerging-market stock funds failed to match the returns of their strategic benchmarks during the first three months of the year.

Core bonds didn't play their typical "safe-haven" role in the first quarter. They posted losses during the sharp stock market correction in February and delivered a 1.5% loss for the quarter overall, as Treasury yields rose across the maturity curve.

Our absolute-return-oriented and actively managed fixed-income funds, in addition to floating-rate loan funds, outperformed the core bond index for the period. We continue to expect these positions to outperform over the next several years, particularly if interest rates continue to rise.

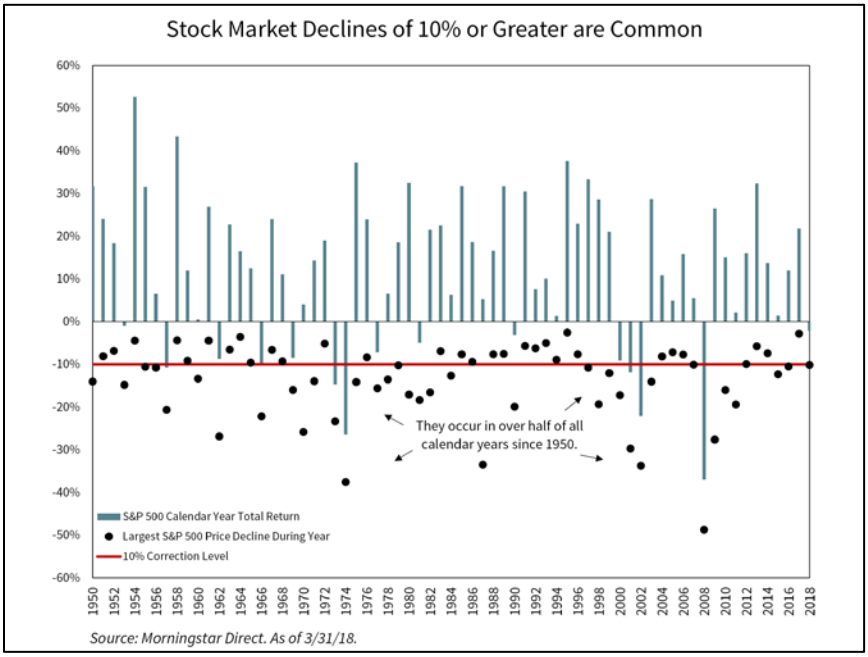
Finally, the performance of our liquid alternative strategies was mixed. Most of our absolute return funds were roughly flat for the quarter. On the positive side of the ledger, our liquid alternative sleeve outperformed core bonds, and helped limit losses during the sharp down days in February and March. However, managed futures, after a fantastic January, fell sharply in February and March, as it was whipsawed by the sharp trend reversal in equities. Should the 1st quarter market correction turn into an extended drawdown, we would expect managed futures to benefit from the sustained trend.

At the end of last year, by some measures, U.S. stock market volatility was the lowest it had ever been in *90 years* of market history. 2017 marked the first year since 1995 without a correction of more than 3%. While the 10% market correction this year was short-lived, it provided a reality check for equity investors. However, the global economy still looks solid in the near term. And looking ahead, we have positioned our portfolios for further volatility and likely lower equity returns as the markets ride out what is already a longer-than-usual economic cycle.

First Quarter 2018 Investment Commentary

Market and Portfolio Recap

Needless to say, it was a bumpy start to the year for financial markets—something we'd suggest getting used to in the months and years ahead. After years of record-low volatility, the 10% market correction this quarter was a reality check for investors: Stocks can go down as well as up.



Equity investors should understand that stock market declines of 10% or more are *normal*. They've happened in over half of all calendar years since 1950. In exchange for their higher long-term expected returns, you must be willing and able to ride through these inevitable periods of decline.

Portfolio Attribution

In what was a difficult quarter for most asset classes, our portfolios notably included a handful of positive-returning investments. Domestic growth-oriented equity managers were among the top contributors, with gains in the low- to mid single digits. Our investments in emerging-market stocks also benefited portfolio returns.

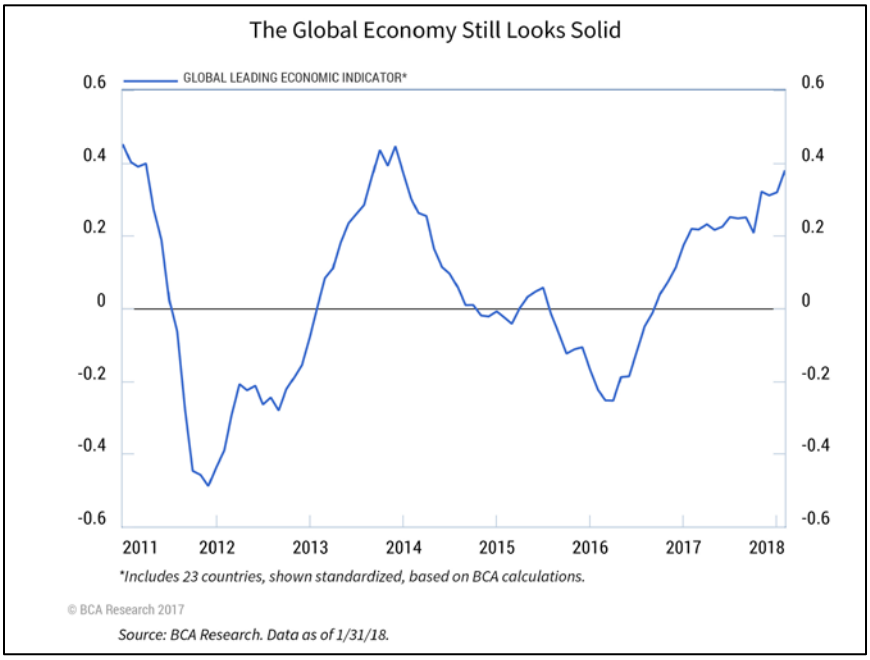
Our active fixed-income positioning also helped to support portfolios, on a relative basis, during a period when core bonds failed to play their typical "safe-haven" role. Absolute-return-oriented and flexible bond funds were in positive territory overall for the quarter, and our floating-rate loan funds gained around 1%.

Among the portfolio detractors for the quarter were our trend-following managed futures funds, which started the year with very strong returns but gave them back and then some during the February market correction. Though performance will be volatile at market inflection points, we still believe in the value of trend-following strategies over a full market cycle.

Market and Portfolio Outlook

We have two primary observations about the quarter's rocky ride. First, the declines witnessed serve as a good reminder that markets do not exclusively go up. Until the recent drop, the S&P 500 had rallied for more than 400 days without registering even a 3% decline from its high. That was the longest streak in 90 years of market history. So, from that perspective, the return of market volatility is a return to "normal" market form. We believe investors should be prepared for continued volatility rather than expect things will revert back to the unnaturally smooth markets we experienced in 2017.

The second observation is that despite the dramatic news headlines and market volatility that might suggest otherwise, the global macroeconomic and corporate earnings growth outlook has not materially changed or deteriorated from what it was at the start of the year. In fact, the economic news that triggered the recent selloff was not a report of economic weakness but one that suggested the economy might be getting a bit too *strong*, with a tight labor market finally translating into higher wage growth and broader inflationary pressures. Fundamentally, even after the correction, the U.S. and global economies still look solid. Global growth may no longer be accelerating, but it remains at above-trend levels and the likelihood of a recession over the next year or so still appears low (absent a macro/geopolitical shock).



The U.S. economy is getting later, if not late, in its cycle. We are experiencing the unwinding of an unprecedented period of global monetary policy influence, and geopolitical tensions fill the headlines—the latest being the potential for a trade war between the United States and China.

It is not in our nature to speculate on whether any of these factors will trigger more market volatility, and what their impact will be if and when markets react. However, it *is* in our nature to ensure we've properly assessed and managed risk in our client portfolios across a wide range of shorter-term outcomes, while positioning them to capture longer-term returns. With very little portfolio protection offered by core bonds in this flat to rising interest rate environment (i.e., returns more in line with this quarter's losses), we continue to look to our positions in alternative strategies to behave more favorably during sustained equity market declines and generate returns independent of stock and bond markets.

We also remain defensively positioned in our equity risk allocation and tilted in favor of more attractive foreign market valuations. While not table-pounding in an absolute-return sense, the outcomes we see for developed international and emerging-market stocks continue to be more relatively attractive than U.S. stocks.

Our analysis suggests the positive economic outlook has already been discounted to a meaningful degree in current U.S. stock market prices. So while the economy is strong, the stock market has been reflecting this for a while. The valuation of the S&P 500 is well above our estimate of its fair-value range on a normalized (longer-term) basis. As the valuation multiple comes down, it will be a significant drag on the total return of the market index over our five-year investment horizon, regardless of the earnings outlook.

The Best Defense

As we reflect on the volatility levels we have witnessed so far this year, it's worth reiterating why we emphasize a five-year or longer time horizon as the basis for our expected-returns analysis. It is over those longer-term periods that valuation (i.e., what you pay for an investment relative to its future cash flows) is the most important predictor of returns. Over the shorter term, markets are driven by innumerable and

often random factors (i.e., noise) that are impossible to *consistently* predict (although that doesn't stop lots of pundits from trying).

There are a lot of paths financial markets and the economy can take to reach our base case scenario destination. And there is a wide range of reasonably likely outcomes around that base case. Simply put: markets and economies are unpredictable. But when it comes to the investment world, we are often our own worst enemy. We can fall prey to performance-chasing, our natural inclination to "do something," and other behaviors that may have helped our ancestors, but hurt us as investors. The best defense is a sound, fundamentally grounded investment process like ours that you can have the confidence in to be able to stick with for the long term.

Thank you for your continued confidence and trust.

—JMS Team

JMS Capital Group Wealth Services LLC
417 Thorn Street, Suite 300 | Sewickley, PA | 15143
412-415-1177 | jmscapitalgroup.com

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With the exception of historical matters, the items discussed are forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from projected results. We have based these projections on our current expectations and assumptions about current and future events - as of the time of this writing. While we consider these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, competitive, regulatory and other risks, contingencies and uncertainties, most of which are difficult to predict and many of which are beyond our control. There can be no assurances that any returns presented will be achieved.