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Investor *Letter*

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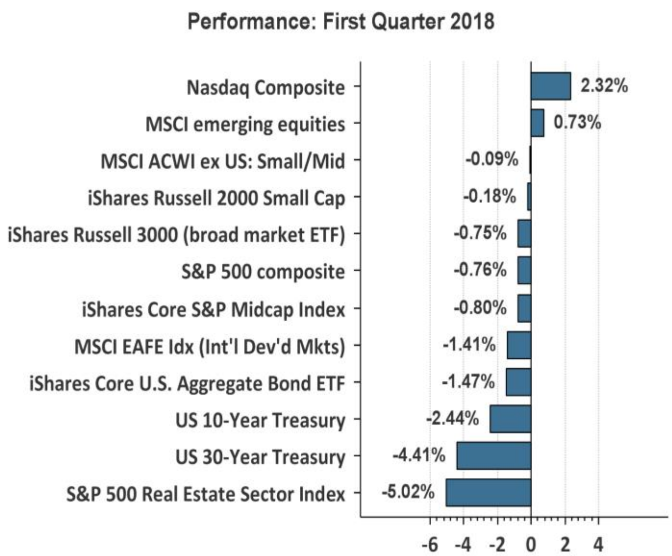
"The stock market is a wonderfully efficient mechanism for transferring wealth from the impatient to the patient." – Warren Buffet

It has been written that patience is more than a virtue – it is a state of one's being. As Warren Buffet acknowledges, successful investing takes a great deal of patience and the first quarter of 2018 certainly required a calm and patient approach.



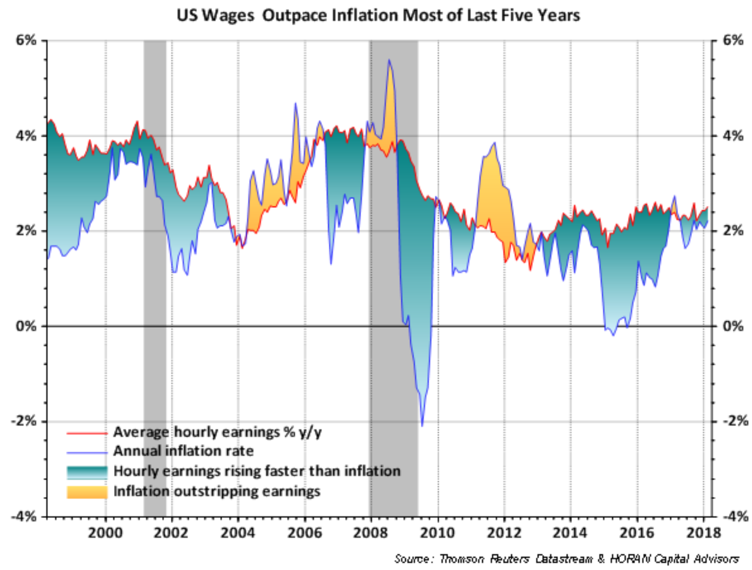
Source: Thomson Reuters Datastream & HORAN Capital Advisors

The S&P 500 Index began the year by rising nearly 8% before reversing course on January 26 and giving back the quarter's gain. The S&P finished the quarter down 0.76% with nine of the eleven S&P sectors in the red. Sectors traditionally known for higher paying dividends experienced the most pain: Telecommunications -7.48%, Consumer Staples -7.12%, Energy -5.88%, Real Estate -5.02%, and Utilities -3.30%. This was driven in part by higher interest rates. Stocks with high dividends tend to replace bond allocations in low interest rate environments. As rates rose, investors rotated from high dividend payers back into bonds.

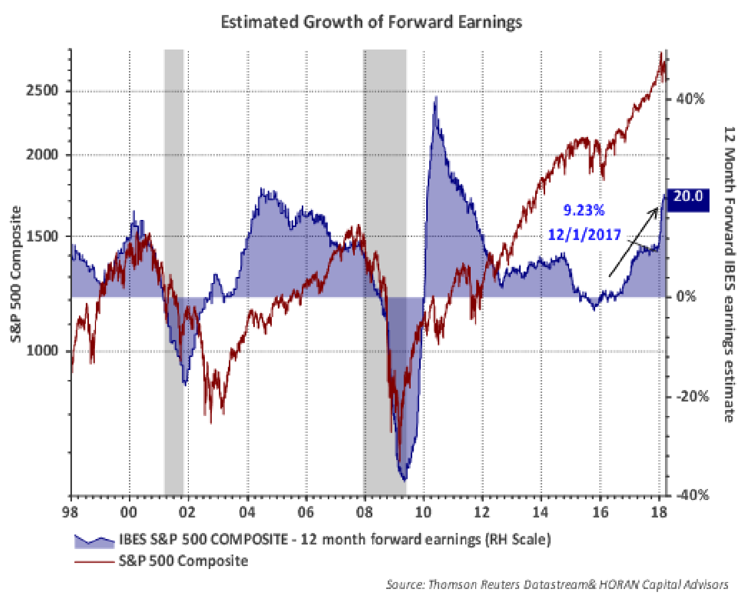
Many investors are grappling with the threat of rising inflation and higher interest rates; others find solace in a strong economic backdrop with better than expected corporate earnings. This dichotomy brought an environment of volatile price action and a significantly different experience from that of 2017. Last year was a bit abnormal as the U.S. stock market experienced very little volatility. It was the year of consistent returns and minimal drawdowns. In fact, the largest drawdown was just 3%. The market has already experienced a 10% drawdown for 2018.

The first quarter broke a string of nine consecutive positive quarters for the S&P 500 Index. Investors have been fortunate by the length of this positive cycle, however recent experience can often lead one to expect "more of the same." Charles Schwab & Co. recently highlighted this behavior, as it is known as recency bias: "our tendency to believe that something is more likely to happen again because it occurred in the recent past. The inverse is also true: the longer it has been since an event took place, the less likely we are to believe it will happen in the near future." What this implies about today's market is the negative return in the first quarter seems unusual in the context of the nine previous positive quarters. In reality, down quarters tend to occur more frequently than our recent experience.

Inflation, Fundamentals & Tariffs



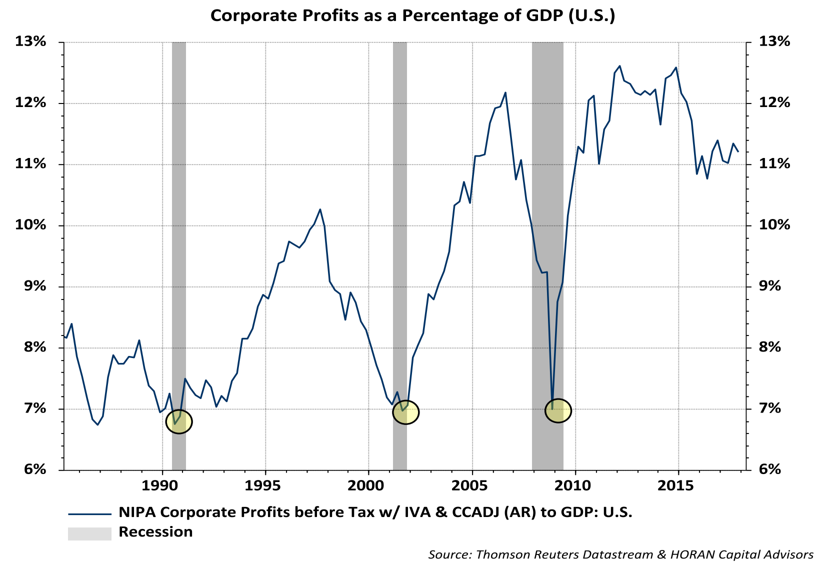
The markets' heightened volatility began with reports of higher inflation, most notably the wage growth measure in the January Employment Report. This report led some to fear the Federal Reserve (Fed) may need to raise interest rates faster than anticipated. The Fed raised rates on March 21 and signaled they intend to increase rates two to three more times in 2018. The Fed's outlook sees continued strength within the U.S. economy and labor market. Despite recent concerns, inflation overall continues to run below the Fed's targeted rate of 2%, and we agree with statements made by the new Fed Chairman, Jerome Powell, "there's no sense in the data that we're on the cusp of a sudden acceleration in inflation." We are likely to experience some inflation, but few are worried about runaway inflation.



The fundamentals of the global economy remain solid despite increased equity market volatility. For the first time since the financial crisis, every major economy around the world experienced growth in 2017 and a number of economists forecast continued strength this year. U.S. corporate earnings, which were previously projected to increase 10% this year, are now expected to grow by a robust 20%. This is due to recent tax reform benefiting corporate tax payers and rising company sales. Furthering the strong fundamental backdrop, the first quarter was the strongest start for mergers and acquisitions (M&A) in a calendar year. In total, $1.2 trillion of value exchanged hands as companies seized the potential last gasp of low interest rates and the first hints of tax reform. The size of many of these transactions was significant as companies look for broad synergies, cost-cutting and new strategic shifts.

Although consumer and business confidence remains high, the regulatory environment is loosening, and M&A may be accelerating, investor confidence has been shaken recently by concerns of a global trade war. After first proposing tariffs on the imports of solar panels and washing machines, President Trump signed an order in early March to impose tariffs of 25% on steel and 10% on aluminum. The latest action was met by retaliatory threats from China and several of the U.S.'s largest trade partners. Mexico and Canada have been granted an exemption to the initial tariffs, but this is contingent upon amending the North American Free Trade Agreement (NAFTA). The major worry for industry professionals and investors relates to where tariffs begin and end and ultimately who will be impacted most. Fed

Chairman, Jerome Powell stated, “There’s no thought that changes in trade policy should have an effect on the current outlook.” But he also clarified, as reported by the New York Times, “Officials could grow more concerned if the dispute escalates and other countries retaliate with tariffs of their own.” The markets will closely watch how these trade policies develop to assess the potential impact on global economic growth. We believe some form of an even playing field with reciprocal trade is sensible.



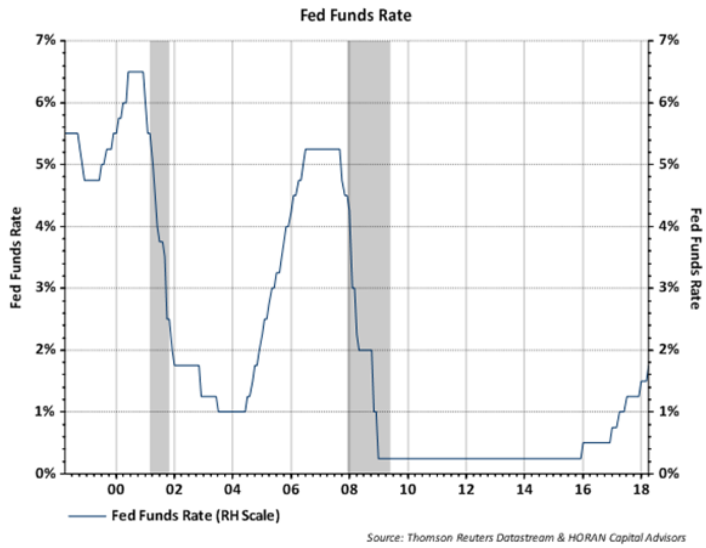
Although the economy is not the market, it is important to evaluate the business cycle. The current economic expansion is approaching the longest on record and recessions follow expansions. However, the slow growth and shallow recovery aspects of the economy following the financial crisis have influenced many economists to project expansion for years to come and even beyond the next presidential election in 2020. A recent Wall Street Journal article also noted, “If [the expansion] continues into the second half of 2019, it will exceed the 10-year record set by the 1990s economic boom.”

Recent economic releases continue to support the narrative of an expanding economy. GDP grew at an annual rate of 2.9% in the fourth quarter and appears to be mildly accelerating. Survey data from the manufacturing sector indicates healthy demand for goods. A broader profit picture looks at the corporate profits number that goes into the calculation of GDP. This profit figure includes all company profit results, public and private. As the above chart shows, corporate profits as a percentage of GDP are running above the 11% level. Prior recessionary periods would show a declining trend in this ratio with profits falling to near 7% of GDP. The profit picture does not suggest a recession occurring near-term.

Market Trends

There may be a sizable bond market change facing investors; one not seen for more than 35 years. Many are calling for the end of the bond bull market as interest rates continue to trend higher. Since the early 1980s, interest rates broadly declined into the lows of the Great Recession of 2008 and the economic recovery through 2015. In fact, the Fed Funds Rate bottomed at 0.25% in December of 2008 and stayed at that level until 2015. The Fed has now increased that rate six times since December 2015, as noted by the chart on the next page, and is forecasting 2-3 more increases this year followed by additional increases in 2019.

Since bond prices move inversely to interest rates, investors are beginning to experience the negative impact rising rates have on bond portfolios. The Bloomberg Barclays Core U.S. Aggregate Bond Index, a widely accepted barometer for U.S. corporate and government bonds, was -1.46% in the quarter and is now only +1.20% on a three-year annualized basis. Long-dated government bonds fared worse for the quarter as the ICE U.S. Treasury 20+ Bond Index was -3.36%, underperforming the stock market. All else being equal, the trend of higher interest rates is likely to continue with sustained strength in the U.S. economy and the Fed’s desire to move short-term interest rates to a higher and more normalized level. While short-term rates have increased, longer-term rates have been slower to move higher in part due to nascent inflation. The most recent release of the Consumer Price Index showed overall CPI increasing 2.2% on an annual basis with core CPI (Less Food and Energy) increasing 1.8%; below the Fed's 2.0% target.



Conclusion

The equity markets over the past few years have been abnormal due to very little downside volatility. Looking ahead, we expect the stock market to experience more normal patterns of volatility, which means larger swings, up and down, as has occurred thus far this year. On the positive side of the equation, company fundamentals and the economic backdrop continue to appear sound. As JPMorgan's highly respected CEO Jamie Dimon recently stated in his annual letter, "The global economy across Asia and Japan, Latin America and Europe, and the United States has been doing well – better than most would have expected a year ago. The United States in particular may be strengthening as we speak. The competitive tax system, a more constructive regulatory environment, and very high consumer and business confidence are increasing indications that the economy will likely expand."

What is important for investors today is not to place outsized weight on the 'noise' at the expense of underlying fundamentals. While headlines can have an impact on investor sentiment and market moves in the short-term, company and economic fundamentals are ultimately where markets derive their long-term direction. Importantly, policies being pursued today have similarities to policies implemented in earlier decades which were bullish for stocks. We continue to believe fundamentals support stock gains in the coming years.

We are always available to answer your questions and discuss our outlook further. Thank you for your continued confidence.

Respectfully,

HORAN Capital Advisors

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