CLEARWATER CAPITAL

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THINK18

March 2018

Private Client Letter

Corrections Are Normal

U.S. equity markets ended a 10 month winning streak in February, the longest such streak since 1959. Following an unusually peaceful year (2017 saw the lowest level of market volatility since 1964), stocks moved into correction territory ending a number of notable periods of upward movement. We had gone 715 days without a 10% decline, 578 days without a 5% decline, and 448 days without a 3% decline (the longest span on record).

While we have enjoyed an extended period of rising equity prices without much turmoil, we must remember that corrections are an expected and healthy part of the investment process. Since 1920, there have been 628 separate times when the market has declined by 3% or more. This works out to about seven 3% corrections **every year**!

Investors are often tempted to ascribe deep meaning to market corrections and this time is no different. The trajectory of inflation is suddenly a great concern to some, and the related pace of interest rate increases from the Fed is feared to threaten the bull market.

The narrative now appears to be that the economy may be too healthy. Just a year ago the narrative said the economy had entered a "new normal" wherein growth of 3% or more was no longer attainable. We find it odd that the better level of economic activity we had hoped for would now become the thing we should be most troubled about.

The reality is a healthy economy with durable growth and strong corporate earnings is good for investors. Stronger economic growth will lead to a pick-up in monetary velocity, which in turn will put upward pressure on inflation. This is a normal economic relationship and does not suggest that runaway inflation will emerge overnight. In time, investors will come to realize that a stronger economy, moderately rising inflation, higher interest rates, and a continuing bull market can coexist at the same time.

A quick review of economic fundamentals during periods of market stress is usually quite helpful to maintaining one's perspective. The U.S. employment rate remains at a 17 year low, U.S. manufacturing in January expanded at its fastest pace since March of 2015, small business optimism remains near record levels, and consumer confidence in January was at its highest level since 2004.

Individual earnings are now increasing and personal disposable income reached an all-time high in December. Not surprisingly, U.S. consumer spending also reach an all-time high is the fourth quarter of 2017. We should remember that the U.S. consumer accounts for nearly two-thirds of all economic activity, and the U.S. consumer is feeling pretty good right now.

John E. Chapman

John is the Chief Executive Officer at Clearwater Capital Partners and serves as the firm's Managing Partner. With thirty four years of Wall Street experience, John directs all wealth management and advisory services for the firm. He also serves as the firm's Chief Investment Strategist and chairs the firm's Investment Policy Committee.

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Key Takeaways

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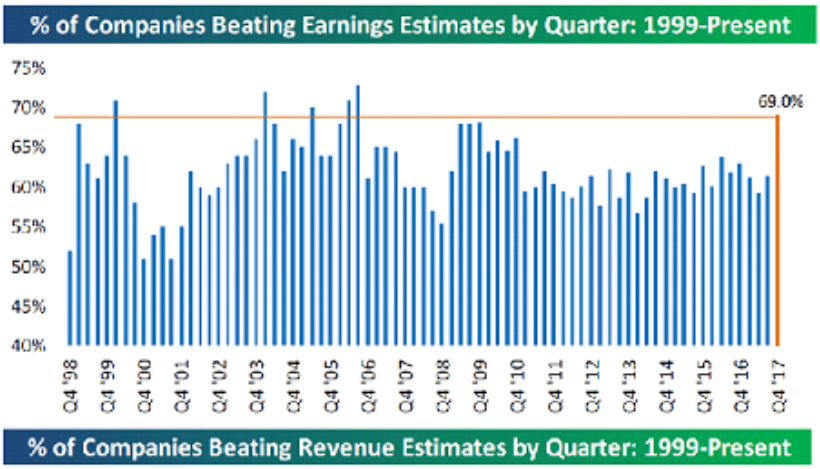
- U.S. equity markets ended a 10 month winning streak in February, the longest such streak since 1959.
- We must remember that corrections are an expected and healthy part of the investment process.
- We find it odd that the better level of economic activity we had hoped for would now become the thing we should be most troubled about.
- In time, investors will come to realize that a stronger economy, moderately rising inflation, higher interest rates, and a continuing bull market can coexist at the same time.
- The U.S. consumer accounts for nearly two-thirds of all economic activity, and the U.S. consumer is feeling pretty good right now.
- We are as committed to our full-year targets as when we published them only a couple months ago.

Corporate earnings remain at the heart of all bull markets and ultimately support equity prices. Fourth quarter earnings season just wrapped up with 69% of companies beating earnings estimate. This was the highest reading since the third quarter of 2006 and the sixth best quarter over the past 20 years. Forward guidance was just as impressive and we now have the fourth consecutive quarter with a strong positive guidance spread.



Source: Bespoke

Still, the recovery from the February correction will likely be somewhat choppy in the near-term. Our view is that over the short-term (weeks and months) equity prices will be dominated by technical factors and investor sentiment. Moving averages, support levels and emotion will produce a level of volatility we admittedly have not had to contend with over the past couple of years.

Over the medium-term (one to three years) we believe equity prices will be determined by fundamentals and facts. Economic and business cycle developments will dictate corporate earnings and market movements. Over the long-term (three or more years) we see the landscape shifting in important ways and believe fiscal policy will emerge as a dominant issue for investors (more on this later).

For now we believe investors are best served by maintaining a constructive view of the economy and the markets. Yes, inflation and interest rates are heading higher. No, these developments do not mark the end of the secular bull market cycle. We are in the midst of a very favorable uptick in economic activity world-wide, and we are as committed to our full-year targets as when we published them only a couple months ago.

As offered in our ***Outlook 2018***, we expect real GDP to grow by 3% or more in 2018, which would be the first year that's happened since 2005. We see three, possibly four, Fed rate hikes in 2018 with the yield on the 10-year Treasury bond rising to between 2.75% and 3.25%. We expect corporate earnings to top $150 per share on the S&P 500 and our year-end target for the index is 3,115.

Stay focused, stay invested. Our best days are still ahead.

Thank you for your continued trust and confidence.

John E. Chapman
March 2018

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