CLEARWATER CAPITAL

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May 2018

Private Client Letter

Markets Treading Water

Equity markets in the U.S. are currently trading at levels very near where they finished calendar year 2017. Following a big rally in January, equity prices dropped by more than 10% in February, marking the first such correction in over 700 days. Since then stocks have traded back and forth and are now just fractionally below where we started the year.

Investors are currently focused on first quarter earnings reports. Overall, the earnings data has been quite good with profits expected to surge by 23% or more this quarter for the S&P 500, on revenue growth of about 7%. Close to 80% of companies are ahead of earnings-per-share expectations by an average of 9%, the best results since 2010. And, 74% have beaten revenue expectations by an average of 2%, the strongest results since 2008 (JP Morgan Research). The forward price-earnings multiple on the S&P 500 now stands at 16.4 and is only slightly above the five year average of 16.1.

The U.S. economy is doing well and geo-political tensions seem to be easing, yet the impressive spike in corporate profits has yet to produce a corresponding move higher in equity prices. The S&P 500 remains stuck in a downtrend from its January highs, with well-defined lower highs and lower lows. So far, the 200 day moving average (DMA) has provided decent support level with two successful tests, however the subsequent rally attempts have been lackluster.

This has understandably frustrated many investors. Some observers point to first quarter GDP results as sign of a slowing economy. Real gross domestic product rose a modest 2.3% during the first quarter, but was up 2.9% year-over-year. The first quarter GDP number has been consistently weak over the past several years (perhaps due to faulty seasonal adjustments), but we believe growth should rebound to close to 3% for the year. As we have previously observed, it is even possible that we could see a 4% quarter sometime this year.

Interest rates have begun to edge higher with the 10-year Treasury yield recently rising above 3% for the first time in four years. This particular development has become a concern to some, however higher interest rates should be expected in an economy that is experiencing a patch of positive momentum. Our forecast calls for the 10-year Treasury to trade between 2.75% and 3.25% in 2018. We would not consider higher rates to be a potential problem until the yield on the 10-year Treasury approached 4% or more.

Just three months after sentiment towards the stock market in the monthly Consumer Confidence report hit record high levels, that same measure of sentiment has come crashing down. Expectations for higher stock prices

John E. Chapman

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Key Takeaways

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- Overall, the earnings data has been quite good with profits expected to surge by 23% or more this quarter for the S&P 500 on revenue growth of about 7%.
- The forward price-earnings multiple on the S&P 500 now stands at 16.4 and is only slightly above the five year average of 16.1.
- The impressive spike in corporate profits has yet to produce a corresponding move higher in equity prices.
- Interest rates have begun to edge higher with the 10-year Treasury yield recently rising above 3% for the first time in four years.
- The economic indicators we monitor indicate that a recession remain unlikely at least through 2018 and 2019.
- We have a host of positives factors that we believe will produce a tailwind to our full year outlook.
- We believe patient investors will be rewarded later this year.

dropped from 36.0% down to 32.7%. Bearishness towards the equity market has shot up from a multi-year low of 19.9% in November to 33.0% today and for the first time since the 2016 election, more consumers expect stocks to go down than up. The last three months have seen bullish sentiment drop at the fastest pace since at least 1987.

Fortunately, this particular indicator has been a pretty reliable contrarian signal over time. As illustrated in the table below, equity prices have been generally higher three, six, and twelve months following such a dramatic reversal in sentiment.

Month Ending	Two Month Decline in Positive Sentiment	S&P 500 Performance (%)			
		One Month	Three Month	Six Month	One Year
4/30/97	-15.0	5.86	19.09	14.14	38.74
10/31/98	-14.6	5.91	16.47	21.53	24.05
7/31/02	-16.1	0.49	-2.84	-6.13	8.63
8/31/11	-14.2	-7.18	2.30	12.04	15.40
4/30/18	-18.3				
Average		**1.27**	**8.76**	**10.39**	**21.70**
Median		**3.17**	**9.39**	**13.09**	**19.73**

We believe that the greatest risk to equity prices would be a recession that triggered a decline in economic activity and corporate profits. This said, most of the economic indicators we monitor indicate that a recession remain unlikely at least through 2018 and 2019. While we are expecting interest rates to rise from current levels, as the Fed normalizes its balance sheet, we do not see an inversion of the yield curve. Spreads will likely remain positive for many months to come.

While our outlook for the economy and the equity markets is generally positive at this time, we do have concerns longer-term. We see recession risks rising in 2020 or 2021, driven by fiscal policies and higher government spending. The one development that could threaten the near-term scenario would be the emergence of protectionist policies that lead our country into a trade war. While this is something we will closely monitor, the policy risks here seem to be receding.

Along with reasons to worry, we have a host of positive factors that we believe will produce a tailwind to our full year outlook. Among these positives are continuing regulatory reform and a more competitive tax code. Corporate investment is surging and employment data has been very strong. Easing tensions on the Korean peninsula also represent a favorable development, even as the specific path forward remains tentative.

Crosscurrents and conflicting data points will always present challenges as we attempt to chart effective wealth strategies into an uncertain future. The market's recent performance continues to dictate a degree of short-term caution and until the equity markets break out of this period of consolidation, investors will likely face more volatility. It is important to note that strong earnings are working to improve equity valuations and we believe patient investors will be rewarded later this year.

Thank you for your continued trust and confidence.

John E. Chapman
May 2018

Seats are still available for our remaining annual strategy discussion. You may register for any of the venues by clicking the link below:

Clearwater Capital's 2018 Strategy Symposium

MAY 2ND - BOULDER RIDGE / Breakfast - Wednesday, May 2nd at 8:00 AM

MAY 3RD - CHICAGO The Peninsula Hotel / Lunch - Thursday, May 3rd at 11:30 AM

MAY 8TH - HOFFMAN ESTATES Stonegate Convention Center / Breakfast - Tuesday, May 8th at 8 AM

MAY 9TH - INVERNESS Inverness Country Club / Breakfast - Wednesday, May 9th at 8 AM

MAY 10TH - ELGIN Elgin Country Club / Breakfast - Thursday, May 10th at 8 AM

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