Redhawk Quarterly Commentary

March 31, 2018

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic topics designed to help make decisions affecting your long-term financial strategy.

Market Commentary

U.S. Market

US equities started the year strongly, supported by ongoing strength in economic data, robust earnings, and the confirmation of a major tax reform package. US business confidence reached an unexpected, multi-decade high in March. Gross Domestic Product (GDP) for Q4 2017 was revised upwards to show growth of 2.9% and industrial activity slowed, but continued to indicate expansion.

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for March 31, 2018. Average P/E and standard deviations are calculated using 25 years of FactSet history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of March 31, 2018.

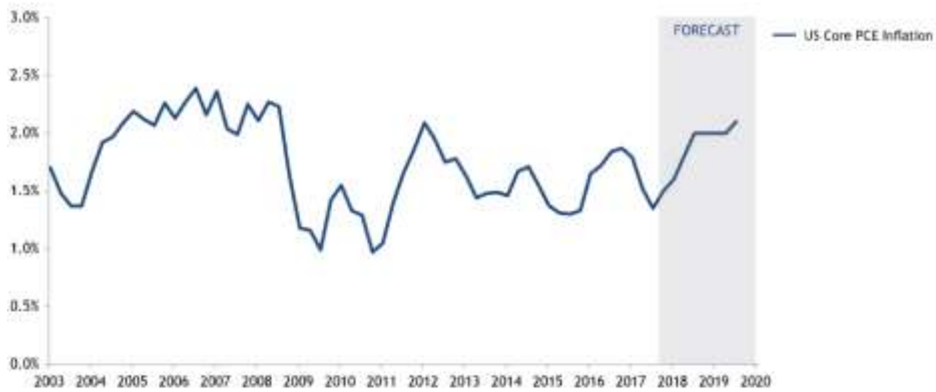
However, the latter part of the quarter saw a marked increase in volatility. Investors first digested the potential of an elevated US inflation reading and the possibility that the Federal Reserve (Fed) may need to become more proactive in raising interest rates in order to keep upward price pressures under control. The Fed did raise rates by 0.25% in March to a range of 1.5% to 1.75%. However, the Fed did not alter its overall rate projection of three hikes for 2018 and the announcement calmed some concerns.

For the first time in three years, the S&P 500 posted a negative return of -0.8% for the quarter. The market got off to a strong start in January, but volatility became the theme for the rest of the period. Market selloffs were sparked by increased expectations of tightening by the Fed, fears of an imminent trade war particularly between the US and China, and company-specific issues with some of the "FANG" (Facebook, Amazon, Netflix, and Google) stocks sent markets lower.

Cyclical sectors performed more strongly in January and February, when the market was focused on faster rate hikes. In March, the broader decline in risk appetites saw more defensive areas outperform. During the quarter, the weakest performance was in telecoms and consumer staples. Although most sectors fell, technology and consumer discretionary stocks were the only positive sectors over the quarter.

Manufacturing activity has been recovering since 2016, when a low in oil prices coincided with the end of a corporate profit recession. Looking forward, economic indicators are expected to continue to strengthen. GDP growth estimates are rising and consumer confidence has continued to improve. In addition, US core Personal Consumption Expenditures (PCE) inflation is expected to trend up steadily toward the Fed's 2.0% target. So far, better domestic economic activity has been met with rate hikes. The US has some of the highest interest rates among developed economies and they are expected to rise further at a slow pace.

INFLATION EXPECTED TO TREND TOWARD 2.0%



Source: Bloomberg. History through 12/31/2017. Bloomberg consensus forecast through 12/31/2019. PCE – Personal Consumption Expenditures.

The chart below shows the returns for the first quarter.

	Trailing Returns (%)						5-Year Risk Stats		Other Metrics			Representative Benchmark
	Last Qtr	YTD	1-Year	3-Year	5-Year	10-Year	Std. Dev.	Max. Loss	P/E	EPS Gr.	Div. Yld.	
Bellwethers												
S&P 500	(0.8)	(0.8)	14.0	10.8	13.3	9.5	9.5	(8.4)	17.4	11.8	2.0	*S&P 500*
DJIA	(2.0)	(2.0)	19.4	13.5	13.3	9.9	10.2	(9.0)	17.0	12.5	2.3	*Dow Jones Industrial Avg.*
Market Cap												
Mega	(1.9)	(1.9)	13.1	11.7	13.0	8.9	10.3	(8.4)	17.5	11.3	2.1	*Russell Top 50*
Large	(0.8)	(0.8)	14.7	11.4	13.6	9.4	10.0	(8.6)	17.5	11.6	2.0	*Russell Top 200*
Mid	(0.5)	(0.5)	12.2	8.0	12.1	10.2	10.3	(12.8)	17.7	12.5	1.7	*Russell Midcap*
Small	(0.1)	(0.1)	11.8	8.4	11.5	9.8	13.8	(16.8)	17.3	12.3	1.5	*Russell 2000*
Micro	0.7	0.7	13.5	8.0	11.8	9.2	15.0	(21.0)	15.5	13.4	1.2	*Russell Micro Cap*
Style												
Value	(2.8)	(2.8)	6.8	7.9	10.7	7.8	10.2	(10.4)	15.0	10.6	2.5	*Russell 3000 Value*
Core	(0.6)	(0.6)	13.8	10.2	13.0	9.6	10.0	(8.8)	17.5	11.9	1.9	*Russell 3000*
Growth	1.5	1.5	21.1	12.6	15.3	11.3	10.5	(8.8)	20.8	13.4	1.3	*Russell 3000 Growth*
S&P 500 Sectors												
Consumer Discretionary	3.1	3.1	16.9	12.2	15.7	14.6	11.6	(8.0)	21.1	14.4	1.3	*S&P 500/Cons. Disc.*
Consumer Staples	(7.1)	(7.1)	(0.9)	5.4	8.6	9.5	10.4	(8.6)	16.5	9.4	3.0	*S&P 500/Cons. Staples*
Energy	(5.9)	(5.9)	(0.2)	(1.2)	(0.4)	1.3	16.6	(38.7)	19.2	31.0	3.0	*S&P 500/Energy*
Financials	(1.0)	(1.0)	18.0	14.3	15.5	5.2	13.5	(15.2)	13.9	10.4	1.8	*S&P 500/Financials*
Health Care	(1.2)	(1.2)	11.3	5.6	13.9	12.2	11.8	(13.1)	15.9	10.8	1.7	*S&P 500/Health Care*
Industrials	(1.6)	(1.6)	14.0	11.7	14.0	8.9	11.3	(11.3)	18.0	11.9	2.0	*S&P 500/Industrials*
Information Technology	3.5	3.5	27.7	19.9	20.6	14.2	12.5	(8.2)	19.4	12.7	1.2	*S&P 500/Info. Tech.*
Materials	(5.5)	(5.5)	10.5	7.4	9.9	5.9	14.3	(22.7)	17.3	12.0	2.0	*S&P 500/Materials*
Telecomm	(7.5)	(7.5)	(4.9)	4.7	4.1	5.8	14.6	(13.8)	10.6	4.3	5.6	*S&P 500/Telecomm*
Utilities	(3.3)	(3.3)	1.9	8.2	9.2	7.1	13.8	(12.7)	16.0	6.1	3.9	*S&P 500/Utilities*

Source: Morningstar Direct. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

International Markets

International markets were largely mixed for the quarter. Softening economic data in Europe and the heightened risk of trade wars drove developed markets, as measured by the MSCI EAFE Index, lower by -1.5%. Emerging markets fared better, increasing 1.4% during the quarter. Similar to the US, the best performing sector in international markets continued to be Technology, returning 1.8%. Utilities also managed to increase 1.2% during the period. All other sectors fell, with Telecom (-4.1%), Materials (-2.9%), and Consumer Staples (-2.8%) dropping the most.

European equities fell 1.9% with several key European markets. Germany, the United Kingdom, and Switzerland also declined by more than 3% in Q1. Additionally, Europe became more divided politically as anti-establishment parties gained ground in the recent Italian elections, resulting in a hung parliament. Despite the political uncertainty, consumer confidence in Italy actually rose to a two-year high and markets increased 5.4%, bucking the trend of its European peers.

In Japan, stocks modestly rose 1% in the quarter, outperforming other developed countries. Despite some increased risks in the developed world, economies are growing and corporate profits are increasing. The price-to-earnings ratios have fallen to 15 times for developed international versus 22 times for the US Emerging Markets.

Emerging markets rose 1.4% in the quarter, outperforming US and foreign developed markets. Brazilian and Russian markets rallied 12.5% and 9.4% respectively on strong economic prospects. The Chinese economy demonstrated resilience in the face of potential tariffs and markets responded positively (+1.8%) to solid trade. It was not smooth sailing everywhere as Indian stocks fell 7% on increased scrutiny of state-owned banks' ability to manage bad loans.

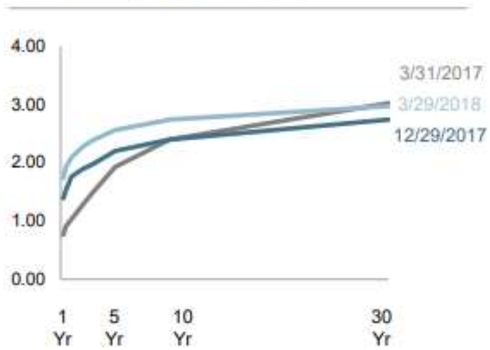
Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
Country performance based on respective indices in the MSCI World ex US IMI Index (for developed markets), MSCI USA IMI Index (for US), and MSCI Emerging Markets IMI Index. All returns in USD and net of withholding tax on dividends. MSCI data © MSCI 2018, all rights reserved. UAE and Qatar have been reclassified as emerging markets by MSCI, effective May 2014.

Fixed Income Markets

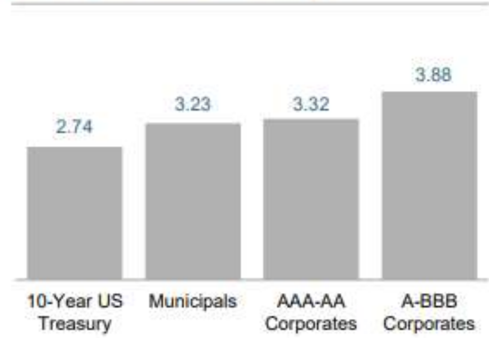
The broad US bond market's performance suffered this past quarter as yields across the US Treasury curve rose to multi-year highs. The Bloomberg Barclays US Aggregate Bond Index returned –1.5% this past quarter, the 14th worst quarter since the index's inception. The story of the year centered on the rise of short-term funding costs.

The LIBOR rate spread over the overnight index swap (OIS) is a proxy for bank borrowing costs and widened to levels not seen since the European sovereign debt crisis. Historically this spread served as a warning to investors of underlying market stress. The widening, however, is largely driven by technical pressures, uncertainty surrounding repatriation, and a flood of US Treasury issuance, rather than fundamental lending stresses.

US Treasury Yield Curve (%)



Bond Yields across Issuers (%)



Period Returns (%)

** Annualized*

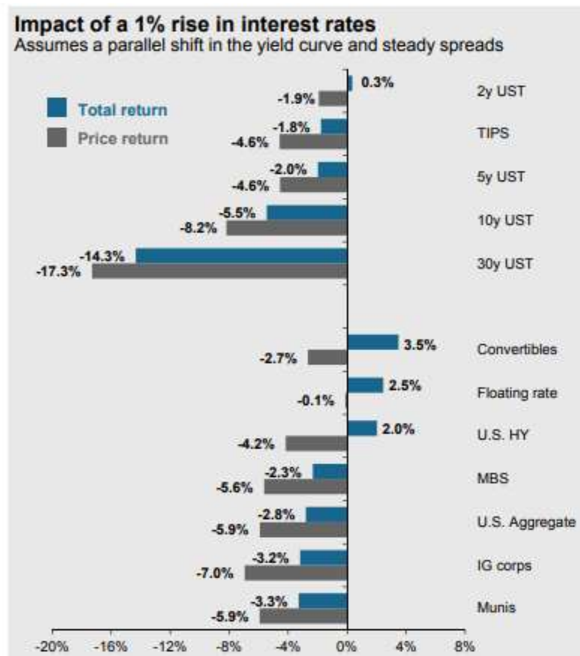
Asset Class	1 Year	3 Years*	5 Years*	10 Years*
Bloomberg Barclays Municipal Bond Index	2.66	2.25	2.73	4.40
Bloomberg Barclays US Aggregate Bond Index	1.20	1.20	1.82	3.63
Bloomberg Barclays US Government Bond Index Long	3.53	0.45	3.28	5.75
Bloomberg Barclays US High Yield Corporate Bond Index	3.78	5.17	4.99	8.27
Bloomberg Barclays US TIPS Index	0.92	1.30	0.05	2.93
FTSE World Government Bond Index 1-5 Years	5.77	2.36	-0.37	0.57
FTSE World Government Bond Index 1-5 Years (hedged to USD)	1.01	1.06	1.21	1.93
ICE BofAML 1-Year US Treasury Note Index	0.66	0.54	0.42	0.71
ICE BofAML 3-Month US Treasury Bill Index	1.11	0.53	0.34	0.34

One basis point equals 0.01%. **Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Yield curve data from Federal Reserve. State and local bonds are from the S&P National AMT-Free Municipal Bond Index. AAA-AA Corporates represent the Bank of America Merrill Lynch US Corporates, AA-AAA rated. A-BBB Corporates represent the Bank of America Merrill Lynch US Corporates, BBB-A rated. Bloomberg Barclays data provided by Bloomberg. US long-term bonds, bills, inflation, and fixed income factor data © Stocks, Bonds, Bills, and Inflation (SBBI) Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). FTSE fixed income indices © 2018 FTSE Fixed Income LLC, all rights reserved. ICE BofAML index data © 2018 ICE Data Indices, LLC.

Global fixed income markets experienced strong performance in Q1 with a majority of the strength driven by Japan, Europe, and local currency emerging market debt. In Japan, the Yen strengthened. Sovereign debt in Europe showed resilience following the much anticipated Italian general election in March. Contrary to preliminary polls, the outcome was a surprise with anti-establishment parties doing better than expected. The backdrop of synchronized global growth, higher commodity prices, and generally low inflation helped local emerging market debt deliver strong Q1 performance.

Municipal bonds outperformed their taxable peers delivering –1.1% this past quarter. Investors benefited from a shorter duration profile and higher allocations to instruments with better credit quality. As expected, new issuance dropped dramatically during the quarter totaling $62.8B, which was a 32% decline relative to Q1 2017. Retail demand remains robust while sluggish supply is expected to persist through the remainder 2018, which should support the municipal market. However demand from institutional buyers has pulled back as the reduction of corporate tax rates increases after-tax yields generated through corporate debt relative to tax-exempt municipal bonds.

	Yield		Return			
U.S. Treasuries	3/31/2018	12/31/2017	2018 YTD	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
2-Year	2.27%	1.89%	-0.17%	2 years	0.67	-0.35
5-Year	2.56%	2.20%	-1.02%	5	0.92	-0.30
TIPS	0.69%	0.44%	-0.79%	10	0.55	0.24
10-Year	2.74%	2.40%	-2.39%	10	1.00	-0.29
30-Year	2.97%	2.74%	-3.89%	30	0.93	-0.32
Sector						
Convertibles	6.14%	6.35%	2.41%	-	-0.29	0.89
Floating Rate	2.57%	2.05%	0.52%	3.1	-0.20	0.39
High Yield	6.19%	5.72%	-0.86%	6.2	-0.22	0.72
MBS	3.30%	2.91%	-1.19%	7.4	0.80	-0.10
Broad Market	3.12%	2.71%	-1.46%	8.4	0.86	0.05
Municipals	2.65%	2.26%	-1.61%	9.9	0.51	-0.01
Corporates	3.76%	3.25%	-2.32%	11.1	0.46	0.35



Source: Barclays, Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg and are represented by – Broad Market: U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; Corporate: U.S. Corporates; Municipals: Muni Bond 10-year; High Yield: Corporate High Yield; TIPS: Treasury Inflation Protection Securities (TIPS); Floating Rate: FRN (BBB); Convertibles: U.S. Convertibles Composite. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield to worst. Convertibles yield is based on US portion of Bloomberg Barclays Global Convertibles. Correlations are based on 10-years of monthly returns for all sectors. Change in bond price is calculated using both duration and convexity according to the following formula: New Price = (Price + (Price * -Duration * Change in Interest Rates))+(0.5 * Price * Convexity * (Change in Interest Rates)^2). Chart is for illustrative purposes only. Past performance is not indicative of future results.
Guide to the Markets – U.S. Data are as of March 31, 2018.

Economic Outlook

U.S. Equity Markets

The S&P 500 index rose 5.6% in the first month, which was the biggest gain for a January since 1997. This was followed by a record one-day spike in the CBOE Volatility Index (VIX), the first 10% market correction since early 2016, and a subsequent 8% rebound. The US 10-year Treasury yield rose 0.50% to 2.90%, hitting its highest point since the “taper tantrum” in late 2013. Strong Q4 corporate earnings and a much larger than expected federal government fiscal stimulus package provided the initial boost, but this was undone when a spike in average hourly earnings, released with the January payrolls data, triggered an inflation scare. The result is that 2018 looks different from last year along a number of significant dimensions:

1. More fiscal stimulus adding to already strong global growth momentum.
2. Labor market inflation pressures, centering on the United States.
3. President Donald Trump implementing trade tariffs following a year in which he was less protectionist than feared.
4. More market volatility, implying larger risk premiums across asset classes.

The outlook for corporate profits this year is particularly robust. The chart below shows the regional industry consensus forecasts for EPS growth in 2018. The stand-out is the upgrade in the U.S. EPS growth forecast to nearly 20%. Four to five percentage points of this can be attributed to the impact of the corporate tax cuts, but even accounting for this, the surge in profit expectations is impressive. EPS forecasts are also robust for the rest of the world. Japan looks the laggard at 5% growth, but this follows more than 30% EPS growth in 2017.

Source: MSCI and Institutional Brokers' Estimate System (IBES), as of February 2018. Markets reflected by the MSCI USA Index, MSCI Japan Index, MSCI Emerging Markets Index and MSCI EMU Index. Indexes are unmanaged and cannot be invested in directly.

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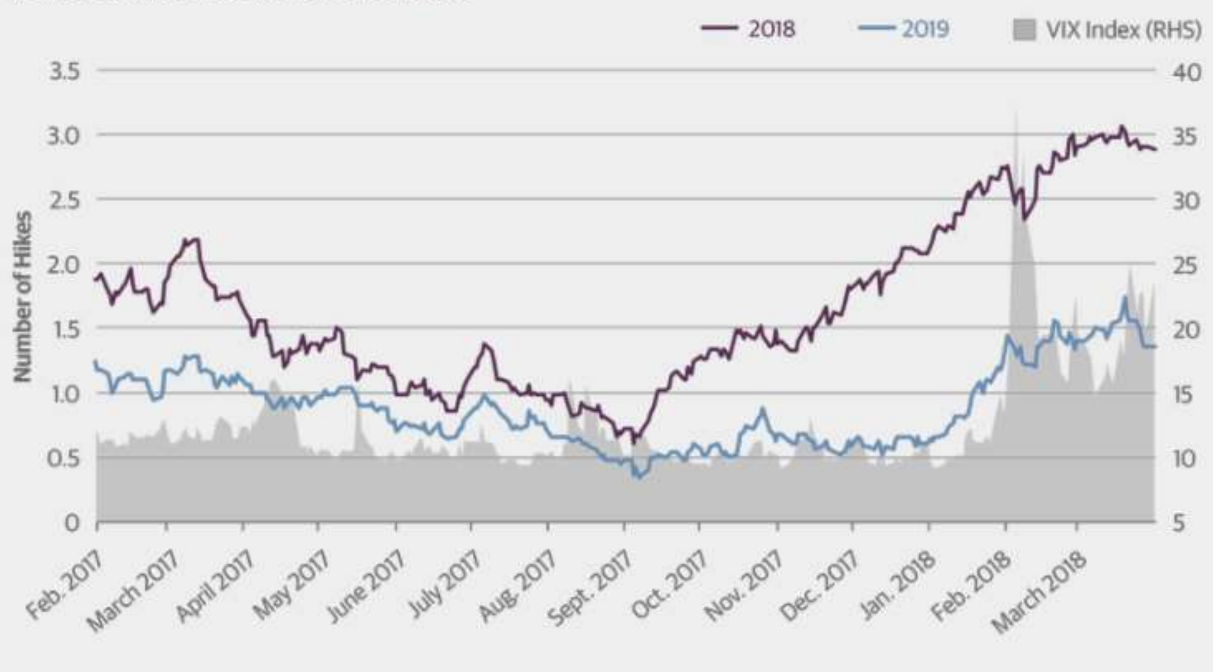
Markets are right to be nervous about a steeper hiking path than previously anticipated, as tighter monetary policy will pave the way of the next recession. While fiscal policy will boost GDP growth in 2018 and 2019, by 2020 the fiscal impulse will fade, turning instead to a modest drag on growth. By that time monetary policy will be meaningfully tighter, with the fed funds rate climbing as high as 3.50% by the end of 2019 and the Fed's balance sheet likely to have shrunk by close to $800 billion. Tighter fiscal and monetary policy, along with rising policy uncertainty ahead of the 2020 presidential election, will likely prove to be too much for an overextended economy to bear. In all likelihood, the next downturn will occur sometime in late 2019 through mid-2020.

Further complicating the story is the risk of a global trade war sparked by protectionist actions taken by the Trump administration. Steel and aluminum tariffs are in place now that are likely to have some modest inflationary impact. On April 3, President Trump set off another trade skirmish when he announced the imposition of tariffs on $50 billion of Chinese imports, which prompted China to retaliate on April 4 by imposing tariffs on $50 billion of U.S. goods. Expect more protectionist trade and investment policies in place by the end of the year.

Number of Hikes Priced into Fed Funds Futures



Source: Bloomberg, Guggenheim Investments. Data as of 3.30.2018. VIX is the ticker for the Chicago Board Options Exchange SPX Volatility index, which reflects a market estimate of future volatility. Past performance does not guarantee future results.

International Markets

2018 will be a pivotal year for global equity markets. The global economy should continue to hum along, with both developed and emerging markets maintaining their momentum. However, the era of cheap money will slowly draw to a close, bringing with it new uncertainties. Global equity markets broadly appear to be pricing in significant earnings growth and some regions such as Europe and Asian emerging markets are more attractively valued than the US.

The synchronized expansion we have seen around the world over the course of 2017 looks set to continue in 2018. After being narrowly driven by a few countries like the US and China, the expansion will broaden out into Europe, Japan, and various emerging markets, suggesting that the cycle has further room to run. Strong liquidity, more supportive fiscal policy in a number of major economies, and easing lending conditions should all help support global growth over the course of the coming year. Inflationary pressures have remained subdued, but will pick up as the recovery advances.

In Europe, earnings are expected to recover alongside a pickup in inflation over time. Modestly higher interest rates can benefit earnings in the financial sector, while rising commodity prices would tend to benefit energy and materials companies. However, any disappointment in earnings or rapid increase in interest rates could prove disruptive. In Europe and Japan, equity valuations as of October 2017 were still below their post-crisis peak in 2015, though close to their long-term historical averages.

In Asia, strong economic growth is expected in China and India to feed through to better corporate profits across the region as many emerging markets trade more on corporate and sector fundamentals. Furthermore, China's emphasis on consumption over government investment and India's ongoing structural reform efforts may create conditions for continued economic and corporate earnings growth over both the short and longer terms.

Fixed Income Markets

One of the stories of 2018 has been the lift in government bond yields. As of mid-March, the 10-year US Treasury yield has risen by 0.50% and the estimate for the 10-year US Treasury yield is around 2.8%. This is based on an expected path for the Fed funds rate over the next few years plus the term premium. The estimate includes an expectation of the likelihood the US will experience a recession by 2020, which means the Fed will be lowering rates.

At 2.9% in mid-March, the U.S. 10-year yield is marginally on the inexpensive side of fair value. US 10-year Treasury yields could rise to 3.0% or slightly higher over the next few months as inflation starts to pick up. The breakeven inflation rate, which is the difference between the yield on the nominal and 10-year inflation protected bond, has risen from 1.75% in September to 2.1% in mid-March. It's not uncommon for the breakeven inflation rate to reach 2.2% - 2.5% late in the cycle. This means that cycle forces are still moderately negative for U.S. Treasuries, but valuation is now a constraint on how much further yields can rise.

Long-term interest rates remain very low, especially compared to historical averages, despite a clearly improving global economy and Fed tightening. However, in 2018, some forces like further hikes in the federal funds rate, stronger economic growth, and lessening accommodation by other central banks should push yields higher. This increase in rates should result in weak total returns on Treasuries and some high-quality corporate bonds. This suggests that other fixed income sectors, like high-yield debt or emerging markets will perform better relative to other asset classes.

Summary

In 2018 real growth in the US economy will average around 3%, which should translate into stable or growing corporate assets. Most likely, the next US recession will likely come in late 2019 to mid-2020.

New spending may allow the economy to run hotter, but it also raises the risk of overheating. The US economy hasn't experienced a sustained period of above-average growth and inflation at any point over the past 10 years. This environment brings with it the possibility of rising interest rates. Of course, the Fed has been raising rates since 2015. The pace of tightening, however, has been much more gradual than usual, which has allowed financial conditions to remain easy and real activity to strengthen in recent years. But a sharper and sustained rise in rates and inflation is a risk with which a new generation of investors has never seen.

Investors who focus only on rising US interest rates and the aging US equity bull market may miss some or all of the good news emanating from growing economies around the world. Economic policymaking is becoming more pro-growth, contributing to the synchronous and largely non-inflationary rise in global GDP.

Tax reform has also created opportunities in municipal bonds. While the new law limited the deductibility of mortgage interest payments, state and local taxes, and other write-offs, it preserved the tax-free treatment of interest on most types of municipal issues. This, coupled with an expected drop in new issuance in 2018, should support municipals, even in a rising interest-rate environment. Municipal bonds have outperformed similarly rated taxable bonds year to date and continue to trade at attractive valuations compared to US Treasuries and corporates.

While the worst of the volatility from the first quarter appears to have subsided, we don't expect markets to revert to the historic calm they exhibited in 2017. The late cycle is here and US equity valuations, though significantly less expensive than they were at their January highs, remain pricey compared to the rest of the world. Interest rates have stabilized at higher levels and seem likely to move gradually higher still. But there's still plenty of good news all over the world for investors who know where to look and despite the length of the US expansion, we continue to adopt a risk-on position in our asset allocation.

It's not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You have to be patient and disciplined, too. With our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk advisor to learn more.

For more information, please contact Redhawk at either retirement@redhawkwa.com or (952) 835-4295.