April 2018

Market review

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U.S. equities stumble but fundamental strength remains

Key highlights:

- A potential trade war between the U.S. and China, coupled with negative stories about some of the market's largest technology companies, dominated headlines.
- Volatility returned to equity markets and reminded investors that it should not be overlooked. As a result, there was a shift to safety.
- The Fed's hiked interest rates in March for the first time under Chairman Jerome Powell.

During the first quarter of 2018, domestic stocks posted their first quarterly loss in more than two years. This underperformance was somewhat surprising given that U.S. equities, led by large caps, had an exceptionally strong start to the year, supported by a stable economic backdrop and better-than-expected fourth quarter earnings. However, in February, they experienced a broad market-based selloff, triggered by signs of rising inflation and investors' worries that the Federal Reserve (Fed) might raise interest rates faster than expected. This sudden turn broke their longest winning streak in almost 60 years.

Both the S&P 500 Index (-0.76%) and the Dow Jones Industrial Average (-1.96%) moved into negative territory for the quarter. Small caps (measured by the Russell 2000 Index) and mid caps (S&P 400 MidCap Index) narrowed their quarterly losses to -0.08% and –0.77%, respectively. Although there was a rotation in March with growth stocks (measured by the S&P 500 Growth Index) lagging value stocks (measured by the S&P 500 Value Index), growth continued to outperform for the quarter (1.93% vs -3.57%). Based on the S&P 500 factor indexes, momentum and growth were the strongest strategies for the quarter while low-volatility, high-dividend strategies were the weakest.

Nine out of the 11 S&P 500 sectors were negative for the quarter. Despite a weak March (-3.90%) and recent pressure owing to Facebook's privacy concerns coupled with some profit taking following a strong run, Information Technology remained the best performing sector for the quarter, returning 3.53%. Telecom Services (-7.48%) and Consumer Staples (-7.12%) were the weakest sectors for the period.

Stock market volatility (measured by the Chicago Board Options Exchange Volatility Index or VIX), after peaking in February and falling in March, remained at elevated levels (see Exhibit 1).

The chart also illustrates that volatility spikes occur with some frequency over the course of a market cycle. In perhaps one sign of a potential shift to more active investment management approaches, *The Wall Street Journal* noted that, "the return of volatility, along with worries of an economic slowdown, has elevated the strategy of picking individual stocks rather than broadly investing in an index."[1]

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[1] *The Wall Street Journal*, "U.S. Stocks Surge, but Dow Industrials and S&P 500 Fall for the Quarter", Gold, Riva; Wursthorn, Michael. March 29, 2018.

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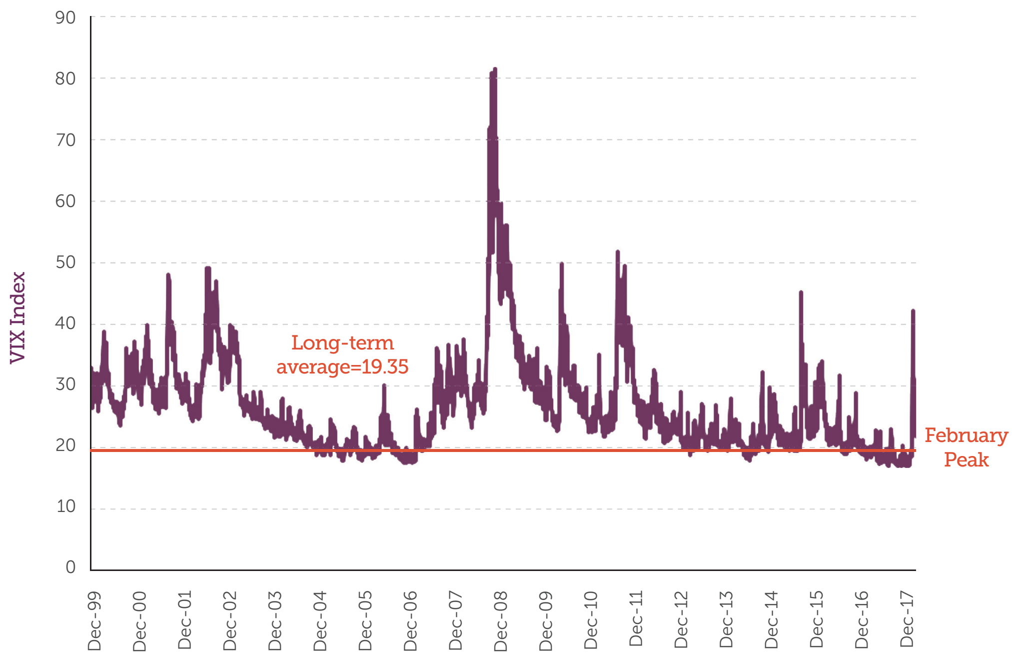
Exhibit 1: Market corrections occur with frequency over time



Source: Bloomberg, 3/31/18.

Trade war fears flare up

Recent worries about a potential trade war between the U.S. and China, coupled with negative stories about some of the market's largest technology companies, have dominated headlines. The initial salvo was launched by the U.S. with its announcement of tariffs on steel and aluminum. China responded swiftly by imposing tariffs on $3 billion worth of U.S. imports.

Foreign equities start off year by following U.S. lead

All major international equity regions were negative for the second consecutive month in March. Some regions, led by Latin America, remained positive for the quarter. In general, the currency exchange effect was positive for most regions for the quarter. International equities have largely followed similar trends as their U.S. counterparts in 2018, having kicked off the year with strong performance. A depreciating U.S. dollar helped further boost January returns for U.S. investors. As in the U.S., overseas stocks experienced a selloff in February, partially due to the possibility that the low interest rate environment may be coming to an end, as well as being shaken by fears of a global trade war later in the quarter. Developed international equity markets (measured by the MSCI EAFE Index) lost -1.41% for the quarter, while emerging market equities (measured by the MSCI EM Index) were positive for the quarter at 1.47%.

With a shift to safety, U.S. fixed income ends quarter with a rally

Weathering a difficult start to the first quarter, the majority of U.S. fixed income markets experienced positive performance by quarter end as investors moved to safer investments. However, the broad U.S. fixed income market (measured by the ICE BofA ML U.S. Broad Market Index) ended the period down -1.44%. U.S. Treasury bonds (measured by the ICE BofA ML Treasury Master Index), with a surge in March, reduced their quarterly loss to -1.19%. Longer-dated U.S. Treasurys underperformed for the quarter. Overall, the risk-off environment had a greater effect on U.S. Treasurys than the Fed's hike in March, the first of its kind under the newly installed Chairman Jerome Powell. Two-year U.S. Treasury rates, which tend to be more sensitive to central bank policy, rose 2 basis points to 2.27%, their highest level in almost a

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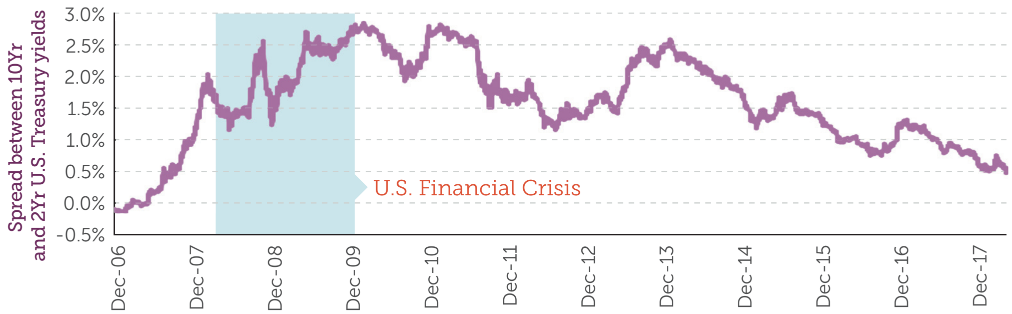
decade. Conversely, the 10-year U.S. Treasury yield fell 12 basis points to 2.74% due to the risk-off sentiment. By the end of the quarter, the spread between 10-year and 2-year U.S. Treasury yields narrowed to 47 basis points (see Exhibit 2). The last time U.S. Treasurys traded this tightly was before the financial crisis.

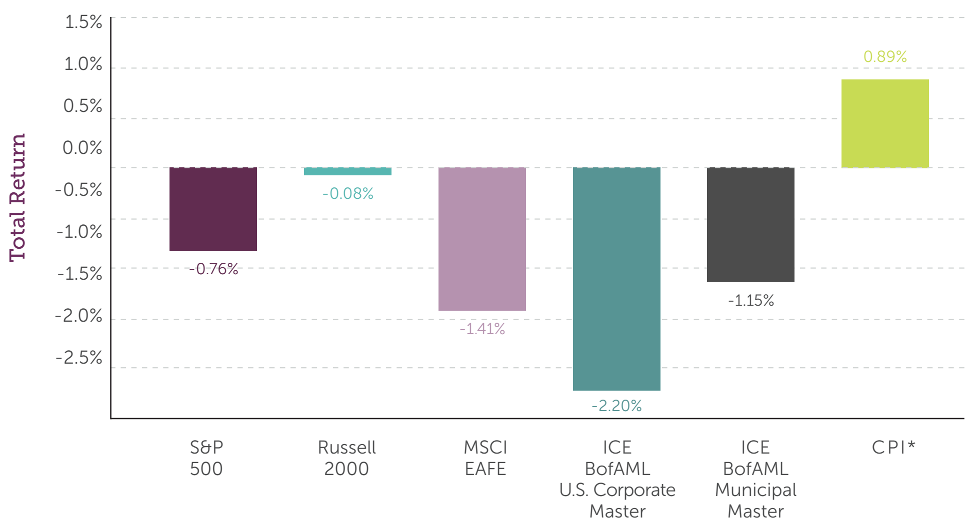
Exhibit 2: U.S. Treasury spreads tightest since before Global Financial Crisis



Source: Bloomberg, 3/31/18.

Down -2.19 for the quarter, investment grade corporate bonds (measured by the ICE BofA ML Corporate Master Index) slightly underperformed U.S. Treasurys as spreads between corporate and U.S. Treasury yields widened. Municipals (measured by the ICE BofA ML Municipal Securities Master Index) held up slightly better than U.S. Treasurys for the quarter, down only -1.13%, which was somewhat surprising as, historically, this is a seasonally weaker period for municipals since investors have typically used these holdings to fund their April tax payments. Significant slowdowns in municipal issuance prevented deeper losses earlier this year, as new supply fell nearly 50% year-over-year in 2018. Leveraged loans (measured by the Credit Suisse Leveraged Loan Index) were the only positive domestic fixed income market for the quarter, up 1.58%. With investors favoring safer, higher quality bonds, the high yield market (as measured by the ICE BofA ML US HY Cash Pay Constrained Index) was down -0.92% for the quarter.

Exhibit 3: First Quarter 2018 Market Returns



Source: Bloomberg, 3/31/18. *CPI is 3 months as of February 28, 2018.

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Glossary

The **Standard & Poor's 500 Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The **Chicago Board Options Exchange Volatility Index (VIX)** shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 Index options.

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that Index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The **Standard & Poor's 400 MidCap Index** is a capitalization-weighted index of 400 publicly-traded companies with a medium amount of market capitalization.

The **Standard & Poor's 500 Growth Index (S&P 500 Growth)** is a capitalization-weighted index of 500 stocks that exhibit strong growth characteristics.

The **Standard & Poor's 500 Value Index (S&P 500 Value)** is a capitalization-weighted index of 500 stocks that exhibit strong value characteristics.

The **MSCI EAFE (Europe, Australia, Far East) Index** is recognized as the preeminent benchmark in the U.S. to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America. Returns are in U.S. dollars.

The **MSCI Emerging Markets (EM) Index** is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index that consists of indices in 23 emerging economies.

The **MSCI Euro Index** captures large-cap representation across the 10 Developed Markets (DM) countries in the European Monetary Union. With 124 constituents, the index covers approximately 70% of the free float-adjusted market capitalization of the EMU. Returns are in U.S. dollars.

The **ICE BofA Merrill Lynch U.S. Broad Market Index** tracks the performance of U.S. dollar denominated investment grade debt publically issued in the U.S. domestic market, including U.S. Treasury, quasi-government, corporate, securitized and collateralized securities.

The **ICE BofA Merrill Lynch Treasury Master Index** measures the total return performance of U.S. Treasury bonds with an outstanding par that is greater than or equal to $25 million.

The **ICE BofA Merrill Lynch U.S. Corporate Master Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with at least one year remaining to final maturity.

The **ICE BofA Merrill Lynch Municipal Securities Master Index** measures total return on tax exempt investment grade debt publicly issued by U.S. states and territories, and their political subdivisions, including price and interest income, based on the mix of these bonds in the market.

The **ICE BofA U.S. Cash Pay HY Constrained Index** tracks U.S. dollar, Canadian dollar, British Pound, and Euro denominated debt rated BB+, BB, or BB- issued in major domestic or Eurobond markets. Qualifying securities must have 12 months or more until maturity, a fixed coupon, and a minimum outstanding of $100mm. Index constituents are capitalization-weighted based on current amount outstanding, the current market price, and accrued interest.

The **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Released monthly by the U.S. Department of Labor's Bureau of Labor Statistics, the Consumer Price Index is commonly used to measure inflation.

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