VAUGHAN NELSON
first quarter 2018

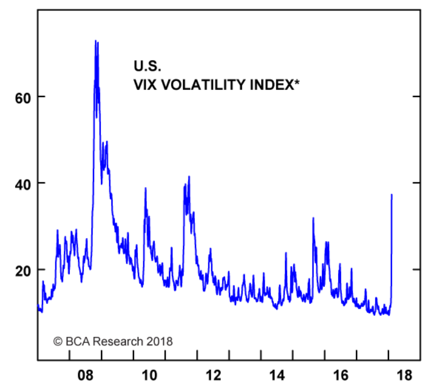
INVESTMENT *perspective*

Reversing the trends of 2017, U.S. markets moved lower in the first quarter of 2018 and volatility increased significantly. For the first quarter, the S&P 500 and the Russell 2000 Value fell approximately -0.76% and -2.64%, respectively.

Volatility returned to the market as liquidity conditions tightened and as interest rates increased due to a modest increase in inflationary pressures and an anticipated increase in U.S. Treasury issuance to fund expanding deficits **(Chart 1)**. Stocks and bonds both generated negative returns for the quarter. The positive correlation between stocks and bonds likely enhanced the volatility in February as factor based strategies were required to reduce the gross exposure of their portfolios. With the yield on the 2-year U.S. Treasury now higher than the dividend yield for most stocks, further increases in Treasury rates will likely continue to pressure stock valuations.

Chart 1

Volatility Is Back



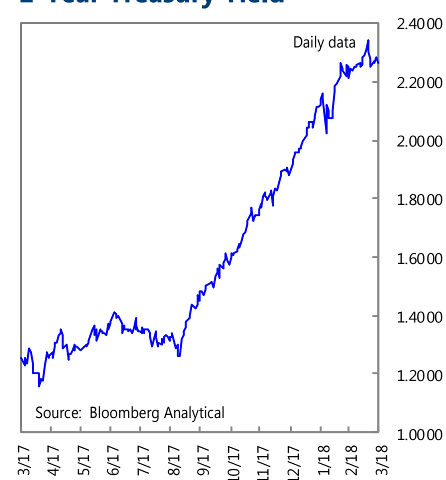
* CHICAGO BOARD OF OPTIONS EXCHANGE SPX VOLATILITY INDEX. SHOWN SMOOTHED EXCEPT FOR LATEST DATA POINT.
** SOURCE: CFTC.

Offsetting the downward pressure on stocks from higher interest rates is the combination of increased federal spending and a material reduction in corporate tax rates. While the acceleration in global synchronized growth has likely peaked, we do expect the U.S. to continue to grow at a modest rate, further tightening employment conditions. Earnings growth should remain positive in 2018. However, rising input costs, increased corporate borrowing costs, and further tightening by global central banks will likely keep volatility elevated throughout 2018.

Just like the U.S. equity markets, the fixed income markets endured an extremely volatile first quarter. The Federal Reserve followed through with a fully anticipated quarter point increase in the federal funds rate to 1.75%. This increase plus market expectations for two additional moves this year pushed 2-year Treasury yields to the highest level since 2008 **(Chart 2)**. While the Treasury yield curve did flatten with short term yields rising more than long term yields, total returns for the quarter were negative from 2-year (-0.17%) to 30-year (-3.89%) bonds. In the broad market, the Bloomberg Barclays Aggregate Index was down 1.46%, with all sectors posting negative returns. Corporate bonds were the worst performing sector weighed down by volatility in the equity markets and increased new issue supply due to merger and acquisition activity. During the quarter, credit spreads increased from 99 basis points to 116 basis points over comparable U.S. Treasury yields.

Chart 2

2-Year Treasury Yield



Over for conclusion.

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The municipal bond market was also negatively impacted by the rise in interest rates, increased supply, and less demand from banks and insurance companies as a result of the reductions in tax rates. For high-income earners, the increase in municipal market yields makes new purchases even more attractive, both relative to other investment alternatives and on an absolute return basis.