



**Financial
Engines®**

April 2018

Quarterly newsletter



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Achieving calm amidst the volatility.

At the risk of stating the obvious: Market volatility is back. And that's okay. As much as we all enjoyed day after day of smoothly rising returns, we knew it wouldn't last forever. Such a long stretch of calm wasn't normal. Even though the bumpiness we're seeing now may feel unfamiliar, the markets are simply back to business as usual.

Market cycles seem to work themselves out. Think about it. **The stock market has come back from every significant drop it's ever experienced. And then it's climbed higher.** Nobody can predict what's going to happen in the future, of course, but history is certainly reassuring.

And it's also been reassuring to me how you — our clients — are taking the volatility in stride. We didn't see an influx of panicked calls during the recent market correction. And when our advisors reached out to many of you, the conversations weren't fear-based.

Our advisors have been there for you. Calm has prevailed, which tells me our team has kept you informed and helped you maintain focus on the long term. It tells me you understood our August 2017 and January portfolio rebalances reduced risk levels. It tells me you know we're committed to you.

If "calm" isn't exactly how you'd describe yourself right now, however, please call your advisor. Talk about your financial plan. Bring up changes to your personal situation, and make sure you're comfortable with the amount of risk you're taking. If you don't feel reassured after that, please email me at john@financialengines.com.

We're here for you — all of us.

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What we're watching now.

Back to “normal.”

Markets can change direction on a dime. We saw that happen during the first quarter. When we last wrote, we'd just wrapped up one of the least-volatile years on record for U.S. large-cap stocks (as represented by the S&P 500 index).¹

That level of calm was abnormal. After setting a record for length of time between -5% corrections, investors were quickly reminded of what normal market volatility feels like.

The adage, “the market takes the stairs up and the elevator down” bore true, as it took only nine painful trading sessions for the S&P 500 to drop more than 10% from its recent all-time high.

However, it's still too early to tell whether we're moving into a “high-volatility regime” (a period when the CBOE Volatility Index [VIX] is consistently above its historical average), so we're keeping a close eye on potential catalysts for further volatility.

Central banks, rates, and bonds.

One reason normal volatility levels returned was global central bank activity and how it relates to rising interest rates. In the U.S., the Federal Reserve (Fed) kicked off the latest rate-hike cycle back in 2015.

Markets were looking for another three +0.25% increases to the fed funds rate this year. A rise in headline inflation data spooked markets into the belief that this year we could see more than three rate hikes.² However, closely followed core personal consumption expenditure data remains below the Fed's 2% target level, and at its March meeting, the FOMC (Federal Open Market Committee) maintained its three rate-hike outlook for 2018.

Other major banks are normalizing their extremely accommodative monetary policies that have supported markets since the Great Recession. We'll analyze how those moves could affect both stocks and bonds.

¹ [CBOE Volatility Index (VIX) average daily close by year on Chicago Board Options Exchanges]. (March 9, 2018). Unpublished raw data.

² CME FedWatch Tool: Countdown to FOMC - CME Group. (n.d.). Retrieved March 9, 2018, from <http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html?redirect=/trading/interest-rates/fed-funds.html>. Markets showing a 33% chance that rates will be raised four times this year following December 2018 meeting. Highest probability remains three hikes by end of year (target rate at 200-225 bps after the December meeting).



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Bonds have distinct traits that make them an important part of a diversified portfolio despite the rate environment. They provide consistent income, capital preservation, and — given how their returns typically differ from stocks' returns, diversification.

Fears of a bursting “bond bubble” may be — pun intended — overinflated, as bonds have historically shown far lower volatility than stocks. Going back to 1926, a mix of U.S. government and corporate bonds has never seen a negative return over a five-year holding period.³

Our perspective: The big picture.

While markets continue to digest the move toward normal volatility levels and higher interest rates, it's important to look at the big picture and not get lost in a few data points. Plenty of positive bullish underpinnings remain for the global economy and markets in general.

Leading economic indicators point toward continued economic growth. The index shown on the next page is a composite of 10 individual components. Eight of 10 are currently in an “improving” trend; the other two are stable.⁴ Typically, this index has turned over before each economic recession. Right now, it shows no signs of weakening. The U.S. employment situation remains healthy, and global manufacturing and service industries continue to expand. Housing data has stepped back lately, yet things are still very stable. Improved household formations plus the benefit of tax cuts could help boost demand.

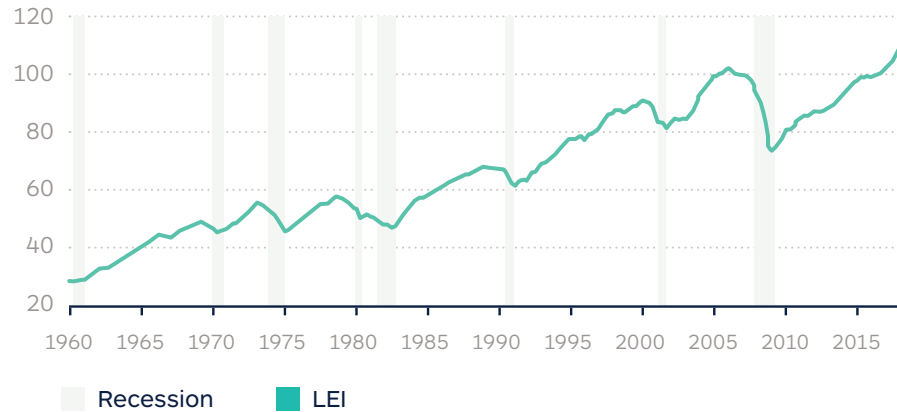
“... it's important to look at the big picture and not get lost in a few data points.”

³ [Ibbotson & Associates, Bloomberg Barclays]. (March 9, 2018). Unpublished raw data. The Research Center analyzed rolling returns over various time frames back to 1926.

⁴ Charles Schwab, FactSet Research Systems, The Conference Board. Leading Economic Index. (March 9, 2018).



Conference Board leading economic indicators index



SOURCE: Financial Engines, Conference Board

For corporations, reported fourth-quarter 2017 earnings and revenue both came in above expectations, and guidance for 2018 is looking for continued improvement. Talk of tariffs and other trade-related changes might be a slight speedbump for some industries, but the recent corporate tax reform should more than make up for those changes.

Diversification for both good times and bad. Volatility and market action in early 2018 were a fitting reminder of why we maintain diversified portfolios in both good times and bad. Our January newsletter covered the importance of staying diversified despite the robust performance of stocks relative to bonds. That same month, we rebalanced most client accounts to reduce the increased risk levels caused by market performance. The timing of our rebalance and the market correction is a perfect example of prudent risk management.

Contact your advisor if you need to better understand what this means for you. We're here to help you keep events in perspective and to answer your questions when things aren't clear.

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