2018 1st Quarter Financial & Investment General Commentary

This General Commentary covers information of general interest on the Firm, Financial Planning, Financial Services, Market Results, Economic & Market Conditions, Economic & Market Outlooks and Portfolio Investment Management. The last page provides a list of indexes returns for each of the market's major categories.

Our sources of information are diverse and vary from period to period. For this period, sources referred to include Greenrock Research, the Wall Street Journal, Investment News, Morningstar, Fidelity Investments, Bob Veres, and others.

INFORMATION OF GENERAL INTEREST

Late in 2017 we launched our new website. We hope you have had an opportunity to access the site. We posted blogs and new information regularly. The web address is www.stjohnfinancial.com.

During the 4th quarter we also contracted with GuideVine to be included on their social medial website to increase our on-line presence to the public. To view our listing go to guidevine.com and then to St. John & Associates under "find an advisor".

We are now in the process of changing over client portfolios including their portfolio designs, asset allocations and the engagement of selected sub-advisors. This is being done with client's accounts one at a time. The process will include our efforts in helping our clients understanding of the portfolio changes, the reasons for changes, the preparation of new agreements and the process for implementing the transfers and the time table. This means for much of 2018 we will be reporting in our commentary on both the current and the new portfolios. We will be in contact with you when we are ready to address your portfolio.

FINANCIAL SERVICES

We are working through the changes necessary for tax reviews under the recent reform passed by Congress and signed by the President. It will be important to review if your withholding allowances (the amount you have withheld for state and federal income taxes) are configured to account for the recent changes to the tax code. We will be reaching out to our full-service clients to request the 2017 tax returns and 2018 payroll statements so we can work with you to make any necessary adjustments.

Speaking of taxes…if you are self-employed you will want to sign up for our Business Tax Letter. We publish it monthly and it includes tax tips and savings ideas that may be just what you need. Contact us to include you on the mailing list.

Any clients approaching retirement at age 65 or older during 2018 needs to both determine their employer-based retirement medical insurance and consider if they will need to apply for Traditional Medicare (Parts A, B and D) or Medicare Advantage (Part C). We can assist you in the decision as well as applying. We have engaged AMS Affordable Medical Solution who can assist you in selecting a Medicare Supplement and drug plan or Medicare Advantage plan.

MARKET RESULTS

It's hard to come up with a good analogy for what we have gone through in the markets recently. The best one that comes to mind is traveling and taking a long flight. Although it was warm and sunny where you flew from, storms pop up and the captain comes on the overhead and tells you there is some rough weather ahead, but he also tells you he will do his best to keep above it, but it may be safer for the time being to keep your seats and fasten your seatbelts. The jarring motion may feel rough because you have been on a smooth ride for the past hour, but he tells you that this is a normal weather pattern and there is nothing to be overly concerned. We have weather events because they are a normal course of our atmosphere. If it doesn't rain, the grass does not grow. Much the same way is the volatility in our markets, and along with that, sometimes we need to sit back and fasten our seatbelts.

What a difference that two months can make in the performance and outlook for the stock market, especially after more than a year of positive returns through the at the end of 2017. With the tax cut looming and inflation not a factor, the forecast was for a continued broad-based market advance. This was based on more global growth, low inflation and accommodative monetary policy. Overall, most investors enjoyed a remarkably smooth and rewarding 2017 and 8 years of slow but steady positive returns. We questioned at that time if the good times could keep on rolling for 2018. Going into 2018, there are no signs of the equity markets pulling back, but we said "that doesn't mean they won't."

Only once before have US earnings expectation risen for so long and as fast as they have this year. Yet investors have not reacted positively to this as share prices are down. After their initial forecasts analysts' valuations have fallen at a speed usually only seen in a crisis. While stock prices may not be at bargain prices, the forward price earning ratios on the S&P 500 has fallen from 18.6 times adjusted earnings to 16.4 times on a current basis, and such P/E ratios have not been seen since 2014 according to Thomson Reuters IBES.

Such a combination of falling share prices and fast rising earnings estimates is rarely seen outside of a crisis, because typically the prospects of higher profits attract investors. The last two times the forward P/E ratio tumbled this far and this fast was the 2010 crisis and the aftermath of the Lehman failure in 2008. Seldom have investors shown so little regard for an earning season in place.

Earnings are expected to go up materially even without the boost of the 2018 tax cuts. S&P 500 companies are predicted to report earnings per share up 18% from a year ago. Even better, overall sales are predicted to be 7%, continuing a rise from last year that is the fastest since 2011, most of this coming from economic growth.

Why are investors not responding accordingly? Perhaps they don't believe the forecast or maybe analysts are dropping their forecast because of investor concerns. The decline in buying volume since the end of January has already resulted in a sharp drop in optimism among analyst with earning upgrades now making up 55% of recent forecasts, from a high of 82% earlier. Such a change in forecast is likely the result of a fear of unfavorable events such as government actions against tech companies, a trade war over tariffs or political unrest. This risk may justify lower share prices even if everything works out for the best. Still it seems like a tug of war between solid economic fundamentals and corporate earnings against the fear of the government actions creating this yo-yo effect in the market.

There could of course be other or additional considerations like undervaluing earnings during periods when companies were not allowed to exercise their buyback rights which in the past absorbed any share disparity between buyers and sellers. A final explanation may be that its just timing. After a run-up of

24% in the S&P last year and the equity gains over the past 8 years could cause investors to fear and be stressed about an inevitable correction in the market.

With so many economic and psychological considerations in play, the market has moved from an unusual tranquil period to return to its more normal volatility. Time will tell if this is a turn in the market's fortune or whether it will resume its favorable pattern of the last several years.

While US stocks seem to grab the headlines, we forget sometimes that most portfolios have other investments. During the quarter, broad domestic indexes had US stocks slightly negative, international stocks only fared slightly better at a near breakeven. Still international stocks are much earlier in their cycle than US stocks and have more growth opportunity in front of them than the late stage US economy. Early cycle environments can also come with its own volatility issues as economies try to stabilize that growth and certainty.

Bonds have also been a major point of concern as the broad bond markets returned a loss of 1.5% during the quarter and with an inflation creeping up to a 2% level, a sustained return between -2% and positive 2% won't be enough to keep up with inflation. The dilemma is although bonds are safe and consistent, they may not provide a positive return especially on an after-tax basis, but still most portfolios still needs bonds for safety and consistency.

The new FED Chair, Jerome Powell, was expected to be on the same course as his predecessor and be of a similar mindset to raise rates at a .25% rate up to 1.50% or 1.75%, but his comments have many wondering if he may be a bit more of a hawk, meaning he may intend to raise interest rates more aggressively with as many as four rate hikes this year. Although rate hikes put a strain on economic growth, he believes the growth stimulus of the tax cut will offset any negative effects from rate hikes.

Most bond prices fell as a result of Powell's testimony to Congress, but the volatility and negative effects of the stock market in February and March demonstrated a stabilizing role of a low correlated alternative such as bonds. While the US Aggregate bond market lost 1.5% for the quarter, we offset some of the traditional bond spaces with inflation protected, short term and floating rates which did better at minimizing the losses of the segment. This allowed the bonds to remain more stable, offsetting the volatility of the equity side of the portfolio.

ECONOMIC & MARKET OUTLOOK

In that we have engaged Greenrock Research Company to work with us on the design and structure of our clients' portfolios, we are included in our commentary their evaluation of the market and economy based on their many years of experience as we set up our new portfolio design, asset allocation and sub-advisor selections.

Volatility and Future GDP

We all love certainty. When we make a decision, we feel best if we have a high conviction. We make hundreds of decisions every week, what route to drive to work, what to eat for lunch, what errands we need to run. Some of our decisions are meaningful and potentially life changing, while others have very little consequences. If we took the wrong route to work, we might be 10 minutes late; but if we choose the wrong investment solutions, that could have significant consequences on our financial future.

When we invest in the stock market, volatility creates the lack of certainty. We do not like that. If we buy a stock or use an investment approach, we get immediate feedback. We can look at our gain or our loss the next day, the next week, and it is reassuring when we have a gain. That is human nature. This is why many investors liked 2017 because there was little volatility, but high apparent certainty. It was an anomalous year, every month closed higher than the previous month and the biggest intra-month decline was 3%. This carried into January as the stock market indices continued to rise, and then we got February. From the high the market dropped 6% in just a few trading sessions, something we had not seen in a while. For many investors, their anxiety rose dramatically because of the uncertainty this created. The certainty of our investments that we saw in 2017 and January disappeared, seemingly overnight.

Let's put 2017 into perspective. There is a measure of risk called the Sharpe ratio; it was developed by Dr. William Sharpe, Professor Emeritus at the Stanford University Graduate School of Business. The Sharpe ratio is a measure of risk adjusted performance. The formula is calculated by subtracting the risk-free return from the stock market return and dividing that number by the standard deviation. The idea is to compare various asset classes not by return but by how much risk was taken to get the return. If you used round numbers, the long-term return of the S&P 500 is 10%, a risk-free rate is 5% and then divide the difference of 5% by a standard deviation of 15%, you would have a Sharpe ratio of 0.33. In 2017 the Sharpe ratio of the S&P 500 was 4, stratospherically high. So, for those investors who liked 2017 and got comfortable with 2017 and January of this year, they did so without the benefit of an historical perspective. That could not continue and will not continue.

So, does this mean we are supposed to like volatility? Stock markets go up or down based on these investors ideas. Momentum investors buy what is going up, while value investors buy off the new low list. If you are a momentum investor, February was not kind to you financially or psychologically. If you are a value investor, you may have been hurt financially but psychologically you are relieved that stocks do not just go straight up.

What is the Future Like?

The short answer is it will not be like 2017. The Sharpe ratio in the future will be much closer to 0.33 than 4. It would not be outrageous to say we will never see a Sharpe ratio of 4 again in our lifetimes. We have no way of knowing what Sharpe ratios will be in the future, but as you will become aware we believe long-term future returns are related to sound investing principles, not anomalous years that provide a false sense of calm. So, our first piece of advice is do not expect to see another 2017 anytime soon, if ever.

We think the future is directly related to GDP. Now, there is a great debate in the works on future GDP growth rates. Our President has said that we will achieve 4% GDP, perhaps higher. Many economists are skeptical. GDP growth over the last five years has been 2.25%, and many economists are suggesting we may get to 2.5%. The next five years investment returns will be dependent on who is right; 4% GDP growth will bring good times and higher prices; 2.5% GDP growth will bring high volatility and lower returns. So, let's look at the factors that might determine what camp might be right.

The following is a list of factors we look at to determine where we might be headed: Fed policy, inflation, interest rates and the strengthening or weakening of the dollar. In addition, we will look at valuation levels to see where we might get returns.

The Fed has stated their policy. They plan to have three more rate hikes for the remainder of this year and three or four next year. In addition, they will reduce their portfolio of fixed income securities. The Fed did all of this in 1937. The Fed lowered interest rates in 1929 in reaction to the depression just as they did in response to the recession of 2008. By 1936 the Fed thought our economy was stable and raised rates in 1937. Luckily for us, our current Fed can look at the mistakes made in 1937 when the stock market fell by 37%. They will need to be very careful; lowering rates creates an immediate solution for the economy while raising rates is like playing with fire. So, it appears rates are going up, and that is generally not good for our economy.

Inflation is a two-edged sword. It will help us with our debt over the long-term, but it can be very hard to control. If we had 2% inflation over the next 36 years, our current debt would look like it was half of what we see in today's dollars. That is assuming we do not increase our debt, which we are currently doing. So, over the long-term inflation helps us. The Fed has been trying to get an inflation target of 2% but has been unable to do so with consistency. So, this also suggests that rates will be higher.

Economies with strengthening currencies provide attractive investment returns while economies with weakening currencies often are not as attractive for investors. For the last 16 months the Euro, the Pound and the Yen have all been strengthening against the dollar. Now this may or may not be a trend; however, historically, these cycles run for 7 years not just one or two years. This would not be taking place if our GDP growth rates were high, so this would suggest caution regarding our future GDP growth rates.

Now all of this can change, and economists point to some factors that may boost GDP. The tax cuts are the most common issue mentioned. There is debate on both the corporate tax cuts as well as the personal tax cuts as to how much additional GDP growth these would add. While the verdict will need time to be rendered, it does not appear to us that the impact will change much.

So, our estimate of future GDP growth is in the 2% area. It will vary year to year as it has in the past, but we think it is highly unlikely to get past 3% annually over the next 5 years and 4% is unlikely. So, we believe that the volatility we have seen is a look into our future. Low growth and volatility is not anyone's dream economic environment, but our dividend strategies will perform very well in that environment.

One word of caution on the indexes. The S&P 500 is currently weighted 24.9% in Tech and 14.7% in Finance. We are all aware of the largest tech stocks (Amazon, Netflix, Google, Facebook & Apple) and the negative press they are currently getting. The S&P 500 is now a very concentrated index, just like it was in 1999. There was a shift away from growth toward value in 2000-2002, and we caution index investors to be aware we could experience a similar phenomenon in the next few years. This would be great for our dividend strategies, but not good for index investors.

Alternative Investments

You will hear us say, likely many times, that all clients need a 3EDGE account. We believe this for two reasons.

1. *You will not be able to achieve your investment return goals by allocating to fixed income.*

The returns of the 10-Year U.S. Treasury during the 1940s, 1950s and 1960s were 2.5%, 0.8% and 2.4% respectively. This was the last time rates were as low as they are today, and the annualized return for the 30 years of the 1940s, 1950s and 1960s was 1.87%. Now you can add something to that to get the corporate bond return, let's say 1% realistically and that might approximate the return of the Barclay's Aggregate Bond Index. BlackRock has suggested the annualized return of investment grade bonds over the next decade will be 2.5% and 1.5% for High Yield. Whatever these returns turn out to be, they will be so low you will not achieve the needed returns your clients need by investing in bonds. Our answer to this dilemma is 3EDGE.

2. *You need a risk on/risk off portfolio now and you will need one as the next decade unfolds.* Projected returns from equities and from fixed income over the next decade will most likely be much lower than historical returns. BlackRock's returns for fixed income are listed above, and they believe the equity returns over the next decade will be 5%. We have all seen similar returns expectations from other sources as well. We have had a stock market that has been rising for nine years, now the second longest rise in history. Our models use a dividend strategy for equities, but our models also use 3EDGE as an integral part of all allocations.

So, with that as a back drop, we thought you would want to see how the 3EDGE portfolios are currently weighted and how that compares with their allocation at the beginning of the year. The charts below tell the story.

3EDGE Total Return Portfolio Allocations

	January 1, 2018	April 1, 2018
Equities	60%	24%
Real Assets	4%	14%
Fixed Income	34%	59%
Cash	2%	3%

3EDGE has gone from a relatively higher level of risk at the beginning of the year to a relatively lower level of risk today. This decline in risk started in February. The last time we had a manager that had portfolios in risk-off mode was in early 2008 when we used Windward Investment Management and all of our clients were happy they had allocations to these strategies.

Now it is anyone's guess as to how this year and next year unfolds. Have we seen the high for equities or will we revert to a rising market later this year? No one has a crystal ball. We simply structure portfolios in an attempt to get reasonable returns in all markets, the crazy up markets like 2017 and the crazy down years that will inevitably be part of our future. Do we know the move by 3EDGE will be right? Of course not! But we are thankful for having them as part of our overall allocations.

CONCLUSION

As the economy and earnings continue to grow, the equity market continues to have an opportunity for higher returns, but each step comes slower and with more volatility. This does not mean we should abandon the aircraft in times of turbulence, but you may want to fasten your seatbelt as we try to avoid the storms.

The rising interest rates will continue to strain the economy and the bond market. The need for bond alternatives that are not highly correlated with the equity market will become more necessary the higher interest rates rise. Although rising interest rates are never good for the economy or stocks and bonds, they are a necessity to deal with inflation and to be in place in the event they are needed to curb a future recession.

As volatility becomes more prevalent, it is important to understand we believe the market rises over long time periods and what happens during the short periods does not change the expectations over the long period.

We believe our change in the client's portfolio design, asset allocation and security selection are both appropriate and timely to provide stable long-term results.

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INTEGRATED FINANCIAL SERVICES

Below are the returns for mutual fund categories making up our clients' portfolios and the major stock market averages. Morningstar sourced these mutual fund returns. Returns beyond one year are annualized.

	1st Qtr 2018	1 Year Average	5 Year Average	10 Year Average
Large-Cap Growth	2.30	20.41	13.81	9.87
Large-Cap Value	-2.55	9.07	10.32	7.66
Mid-Cap Growth	2.15	18.34	11.94	9.39
Mid-Cap Value	-2.21	7.30	10.06	8.87
Small-Cap Growth	2.28	18.07	11.88	10.28
Small-Cap Value	-2.75	5.71	9.10	8.74
DJIA	-1.96	19.39	13.32	9.86
S&P 500	-0.76	13.99	13.31	9.49
S&P Mid-Cap 400	-0.77	10.97	11.97	10.90
Russell 2000	-0.08	11.79	11.47	9.84
Russell 3000	-0.64	13.81	13.03	9.62
Health	1.63	14.27	14.29	13.26
Commodities	0.17	5.68	-7.94	-8.41
Real Estate	-6.89	-2.30	5.55	5.88
Technology	5.04	27.75	19.08	12.81
Emerging Markets	2.01	22.90	4.45	3.03
Intl Large Growth	0.20	20.06	7.62	3.90
Intl Large Value	-1.72	12.28	5.52	2.11
Intl Small/Mid Growth	2.37	28.31	10.43	6.75
Intl Small/Mid Value	-1.03	16.97	7.98	3.63
MSCI EAFE	-1.53	14.80	6.50	2.74
MSCI Emerging Mkt	1.42	24.93	4.99	3.02
MSCI World NR USD	-1.28	13.59	9.70	5.90
Inflation Protected	-0.71	0.77	-0.22	2.41
Intermediate Term	-1.31	1.31	1.73	3.80
Short Term Bonds	-0.34	0.73	1.00	2.18
Multi Sector Bonds	-0.53	3.43	2.93	5.21
Barclays Agg Bond	-1.46	1.20	1.82	3.63
High Yield Bonds	-0.97	3.20	3.82	6.66
High Yield Muni	-0.16	4.69	3.69	4.69
World Bonds	1.13	5.85	1.43	3.05
Fidelity Cash Reserve	0.26	0.76	0.19	0.35