Q1

First Republic Private Wealth Management

QUARTERLY UPDATE

First Quarter / 2018

HIGHLIGHTS

Positive fundamentals helped balance the worries over trade in the first quarter of 2018.

- **The global economy continued to show growth across all major regions**
- **Corporate earnings are robust and continue to benefit from tax reform**
- **Inflation remained tame and unemployment continued to fall, keeping the Federal Reserve on its regular pace of interest rate increases**
- **The risk of recession remains low**

OVERVIEW

After the unusually prolonged calm of 2017, volatility returned to markets in the first quarter of 2018. The quarter opened with enthusiasm over the expected benefits of tax reform. However, investors quickly focused on unsettled trade policy, new regulatory concerns in the tech sector and the possibility for quicker interest rate increases. In the first quarter alone, the S&P 500 saw 23 daily moves of over one percent compared to just 8 such movements for all of 2017—one of the least volatile years ever recorded.[1] Yet, despite all the wild swings throughout the quarter, the S&P 500 ended the quarter down by -0.8%.

In U.S. dollar terms, emerging market equities posted the highest return for the quarter followed by U.S., and developed international equities. Fixed income markets were challenged in the rising rate environment.

Data released throughout the quarter showed that economic growth continued on a steady trajectory across the globe. The final estimate of fourth quarter real U.S. gross domestic product (GDP) growth was revised up to 2.9% from an earlier estimate of 2.5%.[2] Real Eurozone GDP growth came in as expected at 2.7%. In Japan, real fourth quarter GDP growth topped estimates at 1.6%, marking eight straight quarters of expansion. In China, real GDP also topped estimates at 6.8%, driven by the growing service sector. While some economic reports eased from 2017, a large number of indicators remain firmly in expansionary territory.

FEDERAL RESERVE STICKS TO ITS INTENDED PATH

The U.S. fixed income environment in the first quarter proved challenging for investors as the Bloomberg Barclays U.S. Gov't/Credit Intermediate index fell by -1.0% and municipal bonds fared only slightly better. As expected, the Federal Reserve raised interest rates 25 basis points in March and stuck to its 2018 rate forecast but slightly increased its expectations for rate increases in 2019 from two to three.

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[1] *Thomson Reuters, as of 4/6/2018*
[2] *All GDP growth figures stated are annual percent change*

The 10-year Treasury bond jumped mid-quarter and briefly touched 2.94%, reflecting an inflation scare and possibly a faster path of rate hikes from the Fed. However, by quarter end, the 10-year Treasury yield declined to 2.74% as inflation fear eased. The smooth transition from Janet Yellen to Jerome Powell also calmed investors, especially after Powell reiterated the importance of economic data to Fed decision-making and set expectations to continue the pace that Janet Yellen had set with previous rate hikes.

U.S. EQUITIES CONSIDER NEW UNCERTAINTIES

After a roaring start to the year, U.S. equities (as measured by the S&P 500) declined in February and March to end the quarter down by -0.8%. The market decline in February was triggered from investor concern that potentially accelerating wage growth would cause the Federal Reserve to raise interest rates faster than previously anticipated. As we highlighted at the time, this fear was unfounded. The growth in aggregate average hourly earnings in January was pushed up by a small number of high earners, while the growth in average hourly earnings for the core production and nonsupervisory employees (which covers the majority of American workers) remained at a reasonable 2.5%.[3]

The following month's data confirmed that inflation fears were misplaced. However, March brought a new set of market concerns in the form of tariffs and the specter of a trade war. Equity markets fell after President Trump announced a new 25% tariff on steel imports and a 10% tariff on aluminum imports. Markets regained lost ground as the Trump administration made concessions to key trading partners but were quickly roiled once again after the Trump administration announced $60 billion dollars of new tariffs on Chinese imports. In addition to fears over tariffs, markets were unnerved by the likelihood of increased regulatory scrutiny on the technology sector after revelations of Facebook's lack of user data protection came to light. However, the fundamental picture of U.S. equities did not change in the first quarter. U.S. companies are expected to report strong earnings, inflation remained moderate and unemployment continued to fall.

DEVELOPED INTERNATIONAL MARKETS DECLINE

Developed international equities fell in sympathy with the U.S. as growth expectations moderated and fears regarding trade wars increased. The MSCI EAFE index fell by -1.5% (in U.S. dollar terms) and underperformed the S&P 500 for the quarter. However, Eurozone PMI stayed above 55 for the entire quarter, signaling that the economy is still very much expanding, led by Germany, Austria and the Netherlands.

Eurozone unemployment fell to a multiyear low of 8.5% in February and inflation remained well below the European Central Banks (ECB) goal of 2%. Given the continued lack of inflation, the ECB has signaled that it will likely stay on track to remove quantitative easing by the end of the year but interest rate increases may still be a ways off.

The Bank of England held interest rates steady as inflation in the U.K. fell to 2.7% annualized in February, giving policy makers a bit more flexibility in raising interest rates which investors expect

[3] *Thomson Reuters, as of 4/6/2018*

to now happen again in May. U.K. equities (as measured by the MSCI U.K.) fell by -3.4% in the first quarter (in U.S. dollar terms) as political uncertainty continued to cause worries for investors.

Japanese stocks (as measured by the MSCI Japan) managed to have a positive quarter, gaining 0.8% as inflows into Japanese equity funds reached multiyear highs. Investors have remained encouraged by the prospects of Shinzo Abe's reforms and the relative value of Japanese equities compared to other developed regions.

EMERGING MARKETS HAVE A STRONG START TO THE YEAR

Emerging Market equities (as measured by the MSCI Emerging Market Index) climbed by 1.4% (in U.S. dollar terms) in the first quarter of 2018. The themes that propelled emerging markets throughout 2017, namely a weakening dollar and accelerating global economic activity, continued to support them in the first quarter of 2018. Brazilian equities in particular performed well, driven by an improving macro environment, declining political risk and rising exports.

Chinese growth remained steady but muted throughout the quarter. Chinese equities (as measured by the MSCI China) returned 1.8% for the quarter and the Caixin Manufacturing PMI fell slightly to 51.0 in March. Talk of U.S. tariffs late in the quarter had a mixed effect on Chinese equities, but the overall growth backdrop has not changed.

CONCLUSION

It has been a volatile start to the year and we think the big market movements seen in the first quarter are likely to continue. While current policies are still stimulative and earnings growth is still expected to be in the double digits for 2018, the tug-of-war between strong fundamentals and inchoate trade policy will serve to keep markets volatile, especially in geographies more vulnerable to slowdowns in trade. Behind the scenes, economic data continues to be upbeat and risk of a recession still appears to be low. Therefore, we continue to believe that staying the course in balanced portfolios is still the best course of action to capture the forthcoming earnings growth and economic improvement.

FINANCIAL MARKET RETURNS

U.S. Equity	Q1 2018	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
Dow Jones Industrial Average	-2.0%	19.4%	13.5%	13.3%	9.9%
NASDAQ Composite Index	2.6%	20.8%	14.3%	18.1%	13.2%
S&P 500 TR Index	-0.8%	14.0%	10.8%	13.3%	9.5%
Russell 1000 Index	-0.7%	14.0%	10.4%	13.2%	9.6%
Russell 1000 Growth Index	1.4%	21.3%	12.9%	15.5%	11.3%
Russell 1000 Value Index	-2.8%	6.9%	7.9%	10.8%	7.8%
Russell Mid Cap Index	-0.5%	12.2%	8.0%	12.1%	10.2%
Russell Mid Cap Growth	2.2%	19.7%	9.2%	13.3%	10.6%
Russell Mid Cap Value	-2.5%	6.5%	7.2%	11.1%	9.8%
Russell 2000 Index	-0.1%	11.8%	8.4%	11.5%	9.8%
Russell 2000 Growth Index	2.3%	18.6%	8.8%	12.9%	11.0%
Russell 2000 Value Index	-2.6%	5.1%	7.9%	10.0%	8.6%

International Equity	Q1 2018	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
MSCI EAFE Index ($USD, net)	-1.5%	14.8%	5.6%	6.5%	2.7%
MSCI AC World Index ($USD, net)	-1.0%	14.8%	8.1%	9.2%	5.6%
MSCI AC World Ex US Index ($USD, net)	-1.2%	16.5%	6.2%	5.9%	2.7%
MSCI Emerging Markets Index ($USD, net)	1.4%	24.9%	8.8%	5.0%	3.0%
MSCI BRIC Index ($USD, net)	2.2%	29.9%	10.7%	6.3%	1.8%

Fixed Income	Q1 2018	1 Year	3 Year (Annualized)	5 Year (Annualized)	10 Year (Annualized)
Bloomberg Barclays US Treasury 1–3 Year Index	-0.2%	0.0%	0.4%	0.5%	1.1%
Bloomberg Barclays US Treasury 5–10 Year Index	-1.5%	-0.3%	0.5%	1.0%	3.5%
Bloomberg Barclays US Long Treasury Index	-3.3%	3.5%	0.4%	3.3%	5.8%
Bloomberg Barclays US Treasury US TIPS Index	-0.8%	0.9%	1.3%	0.0%	2.9%
Bloomberg Barclays US Govt/Credit Intermediate Index	-1.0%	0.4%	0.9%	1.2%	2.9%
ICE BofAML Municipals 1–10 Year A-AAA Index	-0.6%	0.6%	1.1%	1.4%	3.0%
Bloomberg Barclays US Corporate High Yield Index	-0.9%	3.8%	5.2%	5.0%	8.3%
ICE BofAML Preferred Stock Fixed Rate Index	-1.0%	4.1%	5.2%	5.4%	4.4%
JPMorgan GBI EM Global Diversified Index	4.4%	13.0%	5.4%	-0.7%	3.8%

Source: Bloomberg, Morgan Stanley Capital International, Russell®, Standard and Poor's and Barclays.

INDEX DEFINITIONS

U.S. EQUITY

Dow Jones Industrial Average: is a price-weighted average of 30 actively traded blue-chip U.S. stocks

NASDAQ Composite Index: is a market capitalization index of approximately 3,000 common equities listed on the NASDAQ exchange

S&P 500 TR Index: is a type of equity index that tracks both the capital gains of the equities in the S&P 500 and assumes any cash distributions (dividends) are reinvested back into the index

Russell 1000 Index®: measures the performance of the 1,000 largest companies in the Russell 3000

Russell 1000 Growth Index®: measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 1000 Value Index®: measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values

Russell Mid Cap Index®: measures the performance of the 800 smallest companies in the Russell 1000 index

Russell Mid Cap Growth Index®: measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000 Growth index

Russell Mid Cap Value Index®: measures the performance of those Russell Midcap companies with lower price-to-book and lower forecasted growth values. The stocks are also members of the Russell 1000 Value index

Russell 2000 Index®: measures the performance of the 2,000 smallest companies in the Russell 3000 index

Russell 2000 Growth Index®: measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values

Russell 2000 Value Index®: measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values

INTERNATIONAL EQUITY

MSCI EAFE Index: is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada

MSCI AC World Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets

MSCI AC World Ex US Index: captures large and midcap representation across 22 of 23 developed marketing countries (excluding the US) and 23 Emerging Markets countries

MSCI Emerging Markets Index: is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets

MSCI BRIC Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance across the following 4 emerging market country indexes: Brazil, Russia, India and China

FIXED INCOME

Bloomberg Barclays US Treasury 1–3 Year Index: measures the performance of U.S. Treasury securities that have a remaining maturity of at least one year and less than three years

Bloomberg Barclays US Treasury 5–10 Year Index: measures the performance of U.S. Treasury securities that have a remaining maturing of at least five years and less than 10 years

Bloomberg Barclays US Long Treasury Index: includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value

Bloomberg Barclays US Treasury US TIPS Index: the index includes all publicly issued U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value

Bloomberg Barclays US Govt/Credit Intermediate Index: the index measures the performance of the USD-denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years

Bloomberg Barclays US Corporate High Yield Index: measures the USD-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issues with an emerging markets country of risk, based on Barclay's EM country definition, are excluded

ICE BofAML 1–10 Year AAA–A Municipal Securities Index: is a subset of the BofAML U.S. Municipal Securities Index and includes all securities with a remaining term to final maturity less than 10 years and rated AAA through A3, inclusive.

ICE BofAML Preferred Stock Fixed Rate Index: this index is designed to replicate the total return of a diversified group of investment-grade preferred securities

JPMorgan GBI EM Global Diversified Index: is an investable benchmark that includes only those countries that are directly accessible by most of the international investor base. This index exclude countries with explicit capital controls, but does not factor in regulatory / tax hurdles in assessing eligibility

DISCLOSURE

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