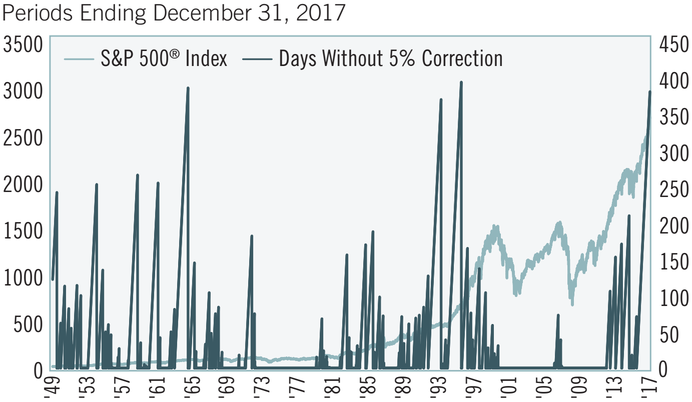
The Return of Volatility

The first quarter of 2018 marked the first time since the third quarter of 2008 in which both stocks and bonds registered losses, albeit on a modest scale. Stocks, as measured by the S&P 500® Index, declined 0.76% for the latest quarter, and bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, fell 1.46%. After a very strong start in January, stocks shifted into correction mode and have stayed there on concerns about trade, inflation, and large technology stocks. In fact, the S&P 500 Index had the longest streak ever of trading days without a 5% pullback—404 days—broken in early February (See chart: *Days Without 5% Pullback in S&P 500® Index*).

DAYS WITHOUT 5% PULLBACK IN S&P 500® INDEX

Periods Ending December 31, 2017



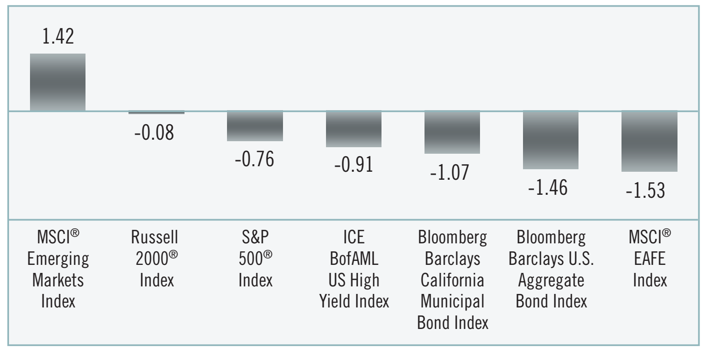
Data is obtained from Strategas and is assumed to be reliable.
Past performance is no guarantee of future results.

In the U.S., growth stocks outperformed value stocks during the quarter, and small stocks slightly outperformed larger ones. Foreign markets, represented by the MSCI EAFE® Index, were down 1.53%, and emerging markets, per the MSCI Emerging Markets Index, posted a gain for the quarter, of 1.42%. The 10-year U.S. Treasury yield backed up during the quarter from 2.40% to 2.74%. This pressured many fixed-income issues, as well as bond proxies in the equity market. California municipal bonds and high-yield debt slightly outperformed the Bloomberg Barclays U.S. Aggregate Bond Index, falling 1.07% and 0.91%, respectively (See chart: *Index Returns*).

Inflation fears picked up somewhat during the quarter due to stronger wage gains, but longer-dated Treasuries still don't appear to be meaningfully concerned about inflation at this point. We do think a tightening labor situation could push wage gains to accelerate modestly, to over 3%, but global competition should continue to limit wage pressures. It should be noted that the 10-year yield still stands below 3% despite meaningful tax reform, a continued effort by the Federal Reserve to shrink its balance sheet, and six increases in the short-term borrowing rate since late 2015, which marked the beginning of the end of its zero interest rate policy. Historically, a sub-3% reading for the 10-year Treasury is still a relatively low interest-rate backdrop for stocks.

INDEX RETURNS

Quarter Ending March 31, 2018



Data is obtained from FactSet Research Systems and is assumed to be reliable.
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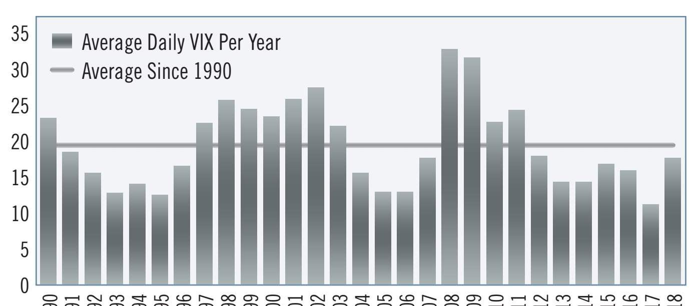
A CHOPPY QUARTER

Equity volatility, represented by the CBOE Volatility Index® (VIX®), was bound to stage a pickup from last year's exceptionally low levels, and this has certainly been the case in early 2018. (See chart: *Average VIX*, which shows 2017 as registering the lowest annual average volatility on record at 11.09, and average volatility at 19.31 across the entire time period). The initial correction in the equity market was driven almost entirely by large hedge funds that bet against volatility on borrowed money and were forced to cover their short positions and sustain massive losses. The VIX skyrocketed from below 10 to over 50 at one point as these leveraged positions were unwound. Many investors were forced to de-risk (sell equities) when the VIX rose significantly.

AVERAGE VIX®



Data is obtained from the Federal Reserve Bank of St. Louis and is assumed to be reliable.
Past performance is no guarantee of future results.

This bout of turbulence eventually calmed, and stocks were recovering nicely, when President Trump announced plans to slap tariffs on steel and aluminum, sparking fears of an escalating global trade war. Now that the battle lines have been drawn between the U.S. and China, we will see how the tariff negotiations get resolved over the next quarter or two. We still believe that both sides recognize that escalation would only hurt both countries.

Just as fears of a trade war began subsiding in March, news of Facebook data privacy issues made headlines and triggered a sell-off in many large-cap technology stocks, which clearly have been market leaders. Technology stocks have not undergone a significant correction in several years and may experience some short-term weakness due to regulatory and political risk. Still, many of these companies have very innovative business models and are enabling a "digital transformation" in corporate America. This change still appears to be fairly early on for many businesses and consumers.

GROWTH AHEAD

Remember that market corrections, as much as they are unpredictable, sharp, and painful, are necessary to remove excessive speculation and shake out weak stockholders. We still believe that businesses will be growing their earnings over the next couple of years and that the market will ultimately reward this growth with positive returns in the mid-to-high single-digit range. The shape of the yield curve is certainly worth monitoring over the next year or two, and we would like to see it steepen.

As always, we remain focused on investing in high-quality businesses with a sustainable competitive edge. We believe this is the best long-term defense in times of heightened uncertainty.

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Kayne Anderson Rudnick believes that superior risk-adjusted returns may be achieved through investment in high-quality companies with market dominance, excellent management, financial strength, and consistent growth, purchased at reasonable prices.

The **S&P 500® Index** is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The **MSCI® EAFE Index** is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. The **MSCI® Emerging Markets (EM) Index** is a free-float adjusted market capitalization index tracking the equity performance of global emerging markets. The **Bloomberg Barclays U.S. Aggregate Bond Index** is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The **ICE BofAML U.S. High Yield Index** tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The **Bloomberg Barclays California Municipal Bond Index** is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more. The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested.