Morris Capital Advisors, LLC

Investment Commentary
March 31, 2018

Snow in March!!

The northeast section of the country experienced some unusual weather patterns over the past several months. The new year started with bitter freezing cold and then turned to an extended warm spell in February, with some days in the 70's. It was so warm that some began to pack away winter clothes. The arrival of March, however, changed everything. The temperature dropped and it began to snow, and it snowed every week. While many suffered noisily in the snow and the slush, some of us (skiers) celebrated. The mid-week storms produced excellent conditions on the slopes, sunny days, cold temperatures, and the crowds were gone. We skied with the place to ourselves and couldn't have been happier. We knew it wouldn't last forever, but it didn't matter.

At the same time the stock market "weathered" some changing conditions, as well. A strong move up early in the year extended the market rally that had been fueled for many years by accommodative policy as the Fed flooded the market with massive amounts of liquidity and pushed interest rates to historic lows. The upward move in the stock market was extended more recently by the potential benefits of tax reform and the rollback of regulatory burdens imposed during the Obama administration. The move took a sudden turn, however, as interest rates began to reflect the reality of stronger economic growth and rising inflationary pressures. The Fed had already expressed its intention to begin the process of adjusting interest rates to more normal levels, and at the same time began the process of reducing its balance sheet that had grown dramatically over many years of quantitative easing. As the yield on 10-year US Treasury securities approached 3% the markets reacted.

As so often happens, the downward move in stocks quickly accelerated. Investors had clearly become complacent with the long-term upward move in the market accompanied by a decline in volatility. Measures of stock volatility, such as the VIX, fell steadily to lows last seen in 2006. Unbeknownst to many, however, the downward trend in volatility had attracted hedge funds designed to exploit the move, using leverage to amplify returns. Volatility jumped when the market turned downward and many of these hedge funds reacted to the move as the VIX spiked higher. They were forced to cover their leveraged positions at any price and the market dropped 10% in just a few days. Many of those hedge funds were forced to shut down, inflicting catastrophic losses on their investors.

This type of market decline, however painful, can often yield benefits by shaking out investment strategies based on flimsy assumptions amplified by leverage. At the same time it can help to adjust market valuations to more reasonable levels. The recent decline, for example, pushed the price earnings ratio on the S&P 500 index down to 16, a level that is much more reasonable for this point in the market cycle. It is a healthy thing to remind investors market adjustments are part of the investing process, especially when viewed in an historical context. Since 1980, the market has experienced a 10% decline in 22 of the 38 years, and in 14 of those 22 years the S&P 500 has registered a positive return. It has been three years since the last 10% correction, and, with history as our guide, the market could rebound. It would be nice if it was always sunny and warm, but these market storms can produce some good investing opportunities.

The market recovered a portion of the hedge fund fueled decline, but continues to experience a higher level of volatility. Investors are uncertain about the course of economic policy and the underlying strength of the recent economic rebound. While GDP rose during the 4th quarter of 2017, and personal income rose in both January and February, the rise in interest rates is a concern. At the same time, the yield curve as measured by the difference between the 2-year and 10-year Treasury yield continues to decline. This "flattening" of the yield curve often proceeds a recession, or could be an indicator that the strength of the economic rebound is suspect. On the other hand, with the market at more reasonable levels, positive earnings results could push stocks back up again. If the Fed remains cautious as they begin to unwind the stimulus of the past several years, and if companies can achieve mid single digit growth in revenue and earnings, the stormy markets of the past few months could be more of a distant memory.

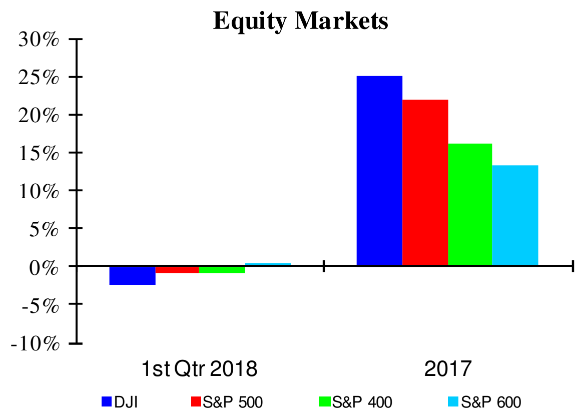
Clearly, it is very difficult to forecast the real direction of the markets at any time, and given the many crosscurrents, it is harder now. We believe it is more prudent to remain disciplined in our investment process and continue to search for stocks that are favorably priced relative to underlying fundamentals. It will give us the best chance to weather the market storms that invariably hit the markets.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

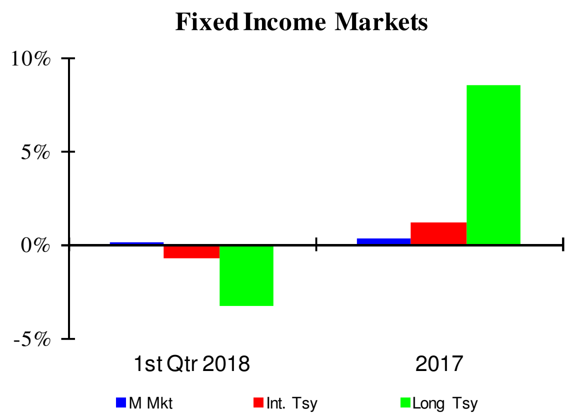
Market Summary
March 31, 2018



The stock markets began 2018 very much like they ended 2017: in a steady upward march led by the technology titans. Measures of market volatility remained near all time lows, mirroring investor complacency, and ignoring signs of trouble in the fixed income markets.

However, by late January a steady increase in intermediate and long-term rates, driven by positive economic news and reaffirmation of the new Fed policy to reverse quantitative easing, finally got the stock market's attention. Once the ten-year bond began to threaten the 3.0% level, competition from bond yields became too attractive to ignore. Equity markets began to falter, and then began to sharply correct. The market displayed its vicious sense of humor, as alternative investment strategies that depended on a constant decline in volatility almost instantly backfired, leading to large liquidations of long equity positions. While this panic selling quickly subsided, the technical damage was done and equity markets continued to demonstrate sharp swings that investors haven't seen in many years.

The quarter ended with modest declines in most equity indices. Growth oriented sectors generated positive returns, whereas income oriented groups such as utilities, energy companies and consumer staples suffered material depreciation.



Interest rates across the maturity spectrum marched steadily higher throughout most of the first quarter of 2018. Economic news mostly surprised to the upside, the Fed's new chairman reaffirmed the policy to gradually reverse quantitative easing, inflation trended higher, and the combination of tax reform and a massive omnibus spending bill caused estimates of the federal deficit to be revised sharply higher. The yield on ten year U.S. Treasury Bonds, widely viewed as a benchmark for equity valuations, nearly breached the 3.0% level, and shorter-term treasuries rose considerably.

On balance, however, short rates rose more than longer term yields, causing the yield curve to flatten substantially, suggesting that fixed income investors are skeptical that the recent uptick in economic activity will be sustained. In any event, bonds across the maturity spectrum recorded negative total returns for the quarter.