Economic Commentary

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"Just when I think I learned the way to live, life changes"

- Hugh Prather

As we noted in our last commentary, 2017 was a historic period for the stock market due to the absence of volatility during the year. The activity over the first three months of the year suggests the opposite might be true for 2018. After surging over 7% in the first four weeks of the year, the stock market experienced the widest fluctuations in years. The S&P had 12 daily moves greater than 1%, six in excess of 2% and one daily move over 4%, which was the largest single one-day drop since the Debt Crisis of 2008. Adding in the intraday swings experienced in the quarter, the volatility has been far sharper than the ending numbers suggest. To add context to these numbers, the drop from the January 26th high to the February 9th low was the largest decline the stock market has experienced since late 2015.

Despite the upswing in volatility, markets were relatively unchanged for the quarter. Domestic equities (S&P 500 Index) ended the quarter with a modest decline of -0.76%. International equity markets were mixed, with developed markets (MSCI EAFE Index) falling -1.53% and emerging markets (MSCI Emerging Markets Index) gaining 1.42% for the quarter. Federal Reserve rate hikes continued to pressure bond markets, and fixed income returns (Barclays Intermediate Aggregate Index) finished the quarter down -1.05%, despite a "flight to quality" rally in March.

The action of the first quarter was not surprising (we discussed as much in our last letter), although we did not expect such swings so early in the year. The economy, domestic as well as global, remains strong and corporate earnings are expected to surge in the coming year. The tax reform package enacted late last year should provide further support to economic growth. The volatility we are seeing now reflects two factors which were last in play together during the early 1990's – rising interest rates and rapid economic growth.

We believe the recent volatility is due as much to fear of rising rates than anything else. We have long stated our belief that the market has underestimated how far rates must rise. Investors are just beginning to recognize how much catch up is needed. Janet Yellen held rates too low for too long and the Fed must now act aggressively in the face of robust economic growth.

The best example of a scenario with such strong economic growth and rising interest rates was in 1994. Following the recession caused by the First Gulf War, the Fed was hesitant to raise rates for fear of slowing what was perceived to be a fragile economy. By the time the FOMC realized growth was stronger than expected, it was already too late to move gradually. Fed Chairman Alan Greenspan acted aggressively to rectify the error and moved the Fed funds rate from 3% at the beginning of the year to 5.5% by the end of December. Markets had not witnessed such a large rate move since Paul Volker acted in 1980-81. Counting the December 2017 hike and three additional hikes in 2018, the moves this year will nearly equal the 1994 moves on a percentage basis.

Despite surging corporate earnings and strong GDP growth, the stock market spent most of 1994 in the red. By July of that year, the S&P 500 was down over 10%, despite surging corporate profits. Earnings growth eventually topped rising rate concerns and a year-end rally turned the market positive by the end of December. The next four years were positive for stock market returns, and stand as one of the strongest points in market history.

We are not predicting a weak market like 1994, but the similarities in 2018 are strong enough to draw observations about the risks that we might be facing today. Economic growth suggests rates should be far higher than they are today. Periods of rapid rate moves worry markets. This risk should not be underestimated. Rising rates impact the market and the economy on many levels. As rates rise, spending for both consumer and business products becomes more expensive and consumption slows. Higher finance costs lower profits and allow fewer debt fueled buy-back programs. Companies which have borrowed heavily will see debt service costs rise and default rates will almost certainly increase. Perhaps most importantly, equity valuation models use interest rates as an input and higher rates will lead to lower price models as an output.

As if the rate environment were not enough, policy issues have also moved to the forefront of investor concerns. The issues are many. Trade issues, particularly with China, have risen rapidly this year. Tariffs have been announced on several products and more are expected. The thought of a trade war has instilled visions of the Smoot-Hawley Act and the Great Depression in the minds of many. There is no indication we will reach this level, but the mere existence of new tariffs has been sufficient cause for concern.

Trade issues aside, political tensions continue to be elevated in many parts of the world. Strife in the Middle East or Far East Asia can easily spiral out of control, causing global consequences. The massive stock market rally of the late 1990's was a direct result of the end of the Cold War and the resulting sense of peace that swept the globe. A renewal of Cold War-type conditions would certainly reverse many of the positives seen since that time.

Domestic political risk is also rising, although this should be a positive, barring a constitutional crisis. Markets love a stable, consistent government much more than a highly active, interventionist government.

Legislative gridlock has long been a positive stimulus for stock prices. We saw this in the late 1990's, in 2013 and in 2017. If there is political risk in 2018, it is that gridlock will suddenly end, in some form.

The world is undergoing a lot of change, and change can sometimes be painful. Change is not necessarily bad, but the failure to react to changing conditions can be costly. We expect economic conditions to remain vibrant for the foreseeable future. However, conditions are evolving in business and in international affairs. We will invest accordingly and turnover is likely to increase over the balance of the year.

Strategy and Market Outlook

Despite the recent volatility, global financial markets remain healthy. The normal functioning of a healthy financial market requires the adjustment of security prices to rationally reflect changing economic conditions and to correct valuation distortions. The economy remains strong, but not all companies can or will profit equally. This economic strength is also helping to push interest rates higher; a trend which will have multiple implications in the months ahead. In general, we expect bonds to face headwinds while we believe stocks will remain relatively resilient.

As we move deeper into the late phase cycle of the bull market, we should expect to see continued rotation within equity holdings, as investors react to changing conditions. Individual stocks or entire segments of the equity market may see declines, even as the broader markets continue to show strength. The portfolios we run for our clients will not be immune from this rotation, and we expect turnover to increase in coming months.

While the market remains healthy, risk levels do remain high in this environment. Investor sensitivity to these risks is exacerbated by the spontaneity of the "Policy by Twitter" phenomenon we now see on a regular basis. We now have an increased risk of unintended consequences from a poorly worded Tweet.

We continue to mitigate some of this risk by gradually moving money out of stocks and into bonds as the equity markets rise. We still see positive equity returns for the year, but taking some money off the table and moving into safe assets seems like a prudent move, even in a rising rate environment.

As we look to the balance of the year, we see the current cycle favoring larger companies. Firms with scale and efficiency will better survive an environment in which technological innovations are pressuring profit margins. Companies with higher cash flows and a greater level of internal financing can better survive a rising rate environment than companies that are highly reliant on external financing. These companies may also be larger beneficiaries of the regulatory reform movement we have seen in recent months.

Bonds continue to provide stable income and safety of principal, but they will also act as a hedge in the event of a severe correction. However, tariff talks, international tensions and the break-neck speed of technological innovations leave a very muddled picture for the rate outlook. Trade wars have been known to reverse economic cycles and plunge interest rates into record low territory. Technology is also a potent force against rising inflation. However, a weaker dollar, rising tariffs, a decade of ballooning budget deficits, and improving economic conditions all point to the likelihood of inflation and interest rates moving higher.

Global inflationary pressures have been dormant for more than a decade, giving the Fed the luxury of adopting a slow and gradual pace in normalizing interest rates. This is increasingly untenable. We believe the Fed may need to abandon this approach to monetary normalization, even as the stock market faces increased volatility. We expect rates to move higher, barring a "risk off" environment caused by a shock to the system.

The interaction between stocks and bonds will be an interesting dynamic to watch unfold, but for now, we maintain our positive outlook for the year ahead.

As always, please contact us should you have questions.

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