April 3, 2018

March's market noise continues

The market volatility we saw in early February persisted through March – and has now continued into the start of April. Since the S&P 500 peaked on January 26, the index moved at least 1% on a daily basis on half of the 43 trading days through the end of March.

"This contrasts to only one move of greater than 1% during 2018 prior to that peak and is a far cry from the calm seen in 2017, when the S&P 500 produced a 32-year volatility low with only eight days with moves of at least 1% for the full year," shared Managing Director of Equity Portfolio & Technical Strategy Michael Gibbs.

However, a healthy backdrop for the U.S. equity markets exists amid all the recent market noise – and U.S. economic conditions remain quite healthy. In a recent Federal Open Market Committee (FOMC) press release, the Fed highlighted strengthening of their economic outlook. Growth in the remainder of the year is expected to be relatively strong, with an unclear impact from fiscal stimulus such as corporate tax cuts and increased spending.

Having raised short-term interest rates again on March 21, Fed officials are split in their expectations of whether there will be two or three more hikes this year. "Since December of 2015, including this month's hike, the FOMC has raised rates six times for a total increase of 1.75%. Over the same time frame, the 10-year Treasury has risen only 0.55%, and we saw the Treasury yield curve flatten during the month," explained Doug Drabik, senior vice president, Fixed Income Services Group.

The Fed expects inflation to drift gradually higher, while the unemployment rate is anticipated to fall to nearly a full percentage point below what it considers a long-term sustainable level in 2019 and 2020. However, the risks of a monetary policy error are increasing.

While well-intentioned, tariffs raise input costs, invite retaliatory tariffs on U.S. exports, disrupt supply chains and increase global investment uncertainty. "The bigger concern has been the reaction of our trading partners, which, to date, has been muted – giving rise to the hope the worst-case fears about a trade war are more likely not going to be realized," according to Washington Policy Analyst Ed Mills. The financial markets have responded to a one-step back, one-step forward set of trade policy decisions.

	12/29/17 Close	3/29/18 Close	Change Year to Date	% Gain/Loss Year to Date
DJIA	24,719.22	24,156.41	-562.81	(2.28%)
NASDAQ	6,903.39	7,062.66	+159.27	2.31%
S&P 500	2,673.61	2,641.60	-32.01	(1.20%)
MSCI EAFE	2,050.79	2,005.67	-45.12	(2.20%)
Russell 2000	1,535.51	1,529.75	-5.76	(0.38%)
Bloomberg Barclays Aggregate Bond	2,046.37	2,016.48	-29.89	(1.46%)

Performance reflects price returns as of 4:00 ET on March 29, 2018.

Here is a look at what's happening in the economy and capital markets, as well as key factors we are watching:

Economy

- Real GDP growth was likely at around a 2.5% annual rate in 1Q18 (advance estimate due April 27), with slower growth in domestic demand, but expectations of growth for the remainder of the year remain strong.
- Job growth has remained strong, but the pace should eventually slow as the job market continues to tighten – the labor market and inflation continue to be areas of focus for the Fed.
- The Federal Open Market Committee raised the federal funds target to 1.50% – 1.75%, and officials are split in their expectations of whether there will be two or three more rate hikes this year.
- "The risk of a more substantial trade war has been a main financial market concern," explains Chief Economist Scott Brown.

Washington policy

- Fear of trade wars and possible missteps dominated D.C. this past month. "There is solace in the hope that the bark may be worse than the bite and tough announcements get negotiated down toward more workable outcomes," outlined Ed Mills, Washington policy analyst.
- The threat of a government shutdown has been removed until October 1, as Congress finally passed a FY18 spending bill almost six months late. This bill adds another round of fiscal stimulus (on the back of the tax cuts) coming out of D.C. – boosting both domestic and military budgets. Included in the deal were a

number of policy items, including new gun regulations, but avoiding any changes to healthcare policy (which likely signals a near-term truce on healthcare fights).
- The largest overhaul of the Dodd-Frank Wall Street Reform Act cleared the Senate on a 67–31 vote, signaling momentum for the deregulation of community and regional banks. “We anticipate a bill signing before August that should provide a boost to bank lending, profitability and flexibility,” shared Ed Mills.

Equities

- Behind March’s market volatility is a healthy backdrop for the equity markets.
- “Longer term we continue to embrace the theme that the secular bull market has years left to run,” according to Chief Investment Strategist Jeff Saut.
- Valuations for U.S. equities are more favorable after the recent price decline. Managing Director of Equity Portfolio & Technical Strategy Michael Gibbs states, “We favor strategically buying into sectors and, more specifically, shares of individual companies exhibiting the most favorable fundamentals.”
- The S&P 500 P/E, on a forward-looking 12-month basis, is now 16.1x, in line with its five-year average.
- Earnings growth is strong on a global basis, with U.S. earnings growth expected to reach the upper teens this year and the low teens next year.

International

- International equity markets exhibited volatility during March with trade war concerns impacting both Europe and the emerging markets, according to European Strategist Chris Bailey.
- In Europe, the formation of the German government buoyed hopes that ongoing European economic reform could be forthcoming, which would benefit the region, although the results of the Italian general election results were inconclusive.
- The risk of a “cliff-edge” Brexit instability period was reduced when the U.K. and European Union agreed to a 21-month transition period after the initial two-year period elapses at the end of March 2019.
- Beyond trade tensions, China's commitment to significant change was reinforced by the conclusions of the most recent National People’s Congress. By contrast in Japan a continuing property-related corruption scandal impacted even the senior political ranks in Japan.
- The fall in the U.S. dollar during the month combined with a further lessening of diplomatic tensions around the Korean peninsula continued to encourage global inflows into the emerging markets.

Fixed income

- While the siren call for a bond bear market continues, Treasuries are rallying. Post the Fed’s recent move that raised interest rates, the yield curve is flattening.
- A bond bubble exists – not in low-risk assets like high-grade municipals or Treasuries -- but in lower credits and highly leveraged companies, such as Tesla.

- Cracks in credit, widening spreads in LIBOR-based instruments, and a flattening yield curve suggest a conservative risk posture in debt investing, according to James Camp, CFA, managing director of Fixed Income, Eagle Asset Management.
- Regarding the Treasury yield curve, the 2-year to 10-year spread has narrowed. “The long end of the curve has fallen in yield, while the short end of the curve has ticked up,” stated fixed income strategist Doug Drabik.

Bottom line

- Inflation and interest rates remain low from a historical standpoint, but are likely to move higher over the course of the year, potentially causing additional bouts of volatility.
- Given the strong economic and earnings backdrop, pullbacks should be normal in nature and viewed opportunistically.
- As always, a well-diversified portfolio in line with your long-term goals should allow you to participate in upside potential as well as serve as a ballast for any short-term volatility that may arise in the coming months.

If you would like to discuss your plan and/or portfolio, or have any other questions or concerns please give us a call

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