Q1 2018

Quarterly Market & Economic Update

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We are now into Year Two of the Trump Administration, and both the country and the financial markets are getting a clearer picture of how the President will run his show from the White House. During Year One, many people were uncertain how Trump would govern; the President himself did little to dispel this uncertainty through many unexpected and sometimes contradictory statements. But the show we're watching now from Washington D.C. looks more like a rerun; not only are we seeing an *Apprentice*-era Donald Trump return to his favorite catchphrase ("Rex Tillerson, you're fired"), we're also seeing a return to Reagan-era Republican fiscal policies in the form of lower taxes and higher deficit spending.

On the campaign trail, candidate Trump talked a lot about the need to grow the economy at a faster pace. Since the global financial crisis in 2008, the U.S. GDP growth rate has held steady at around 2% on a year-over-year basis, a full percentage point lower than the post-WWII average. In recent months, President Trump and Congressional Republicans took the first tangible steps toward achieving a faster rate of economic growth—first with the tax reform bill signed in December, and then with budget and spending agreements this past quarter.

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The shift in the corporate tax rate is likely a game changer for American businesses. Warren Buffett described the impact of corporate taxes perfectly: a business owner may control 100% of a business, but there's always a silent partner (the taxman) who takes 36% of the profits. That is, until recently. The reduction in the corporate tax rate to 21% should provide a large fiscal stimulus to the U.S. economy. How U.S. companies use this tax break—whether they reinvest in their businesses through capital expenditures or return it to shareholders via special dividends and stock buybacks—still remains to be seen.

Then when you add the additional fiscal boost of higher government spending on defense and potentially infrastructure to an economy that's already sizzling, it can be like pouring gasoline on a blazing campfire. We want the economy to grow at a healthy clip; we just don't want it to grow too much or too fast. That may be contrary to conventional thinking, but if the economy runs too hot we could get a potential spike in inflation and in interest rates. That would not only stifle business growth but consumer spending as well.

It was this fear of higher inflation and higher interest rates that spooked investors this past quarter and re-introduced volatility to an unusually placid equity market. Volatility had been absent from the stock market for so long that some investors had placed bets against its return. But the downturn started on February 2 as investors reacted to the favorable January jobs report showing unemployment at its lowest level in many years (4.1%), and roared on for another week until the Dow Jones Industrial Average and the S&P 500 Index both reached correction territory (a drop of 10% from recent peaks.)

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With job growth strong and fewer workers looking for employment, investors sensed that wage inflation was more likely to return—if everyone who wants a job has one, then businesses would have to offer higher wages to entice workers to change employers. Robust job growth and falling unemployment have been bright spots in the economic recovery and current expansion, but to the surprise of many economists wages have not grown at a pace they would expect. A jump in wage inflation would be sure sign that the economy may be running too hot for its own good.

With the double-shot of fiscal stimulus underway in Q1, Trump turned to the next item on his economic reform agenda: trade—a more complicated and perhaps more consequential issue, as seen in the market's reaction to the president's proposed trade actions. The broad tariffs on steel and aluminum imports Trump announced in March can be seen as more of a warning shot in a potentially wider trade war; while the tariff rates are punitive, Trump also granted exemptions to the largest steel importing countries (Canada, Brazil, South Korea, and Mexico) plus the European Union, Australia and Argentina, together representing over half of the total U.S. steel imports in a year.

The real target of Trump's trade ire is China, the country with the largest trade deficit with the U.S. Proposed tariffs on $60 billion of Chinese imports, also announced in March, seek to shrink the expanding U.S.-China trade deficit and counter Chinese requirements for technology and intellectual property transfers. (Exactly which Chinese imports are in scope for tariffs are set to be announced in April.) A trade war would likely have ripple effects across the U.S. economy, rocking some industries more than others. On a broader basis, trade restrictions act as a drag on the overall economy; depending on how far these skirmishes go, they present one of the biggest risks to investors in the current market environment. Case in point, U.S. stock markets wobbled after Trump's Chinese tariff announcement in late March.

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Equity investors also felt pressure from the technology sector during Q1. In particular, the FAANG stocks—Facebook, Apple, Amazon, Netflix and Google—have been among the best market performers by far, but may be vulnerable to downturns sparked by external events. We have seen Facebook tumble from its recent market peak over concerns about user data privacy and protections. Amazon has also taken some heat in recent weeks after President Trump's tweet-storm of misinformed accusations about the company's state and local tax payments and its "bad deal" with the U.S. Postal Service. These attacks on a private-sector company seem odd coming from a pro-business Republican, but let's not forget Trump's origins in the real estate business where he likely retains lots of friends. These large property owners are rightly concerned about Amazon's rise and what it means for their retail tenants. What they and Trump overlook is how technology continues to transform the way companies do business and the way consumers like to shop. This transformation won't likely be slowed by new regulations or anti-trust lawsuits.

The other risk investors should remain attuned to is interest rate risk—in February, rates on U.S. Treasury securities rose by significant amounts across the board, although this rise was contained later in Q1. There seems to be a high level of fear among fixed income investors about a possible spike in inflation and a faster pace of rate hikes by the Federal Reserve. With Jerome Powell now in place as the new Fed chair, the markets will be watching to see how he responds to any changes in the data, including a possible significant uptick in inflation. Powell is largely seen as a steady hand at the helm of the Fed, unlikely to veer the central bank off of the course Janet Yellen set as the previous chair. Expect future Fed statements to be parsed carefully for indications of how Jerome Powell may take action while the markets get used to his governing style.

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Market fluctuations should be no surprise to experienced investors, but we may be facing something most investors have not seen in their market experience—a reversal of a long-term trend in interest rates. Over the last 20 years, we have lived through a long steady decline in interest rates, to the point where they reached their lowest levels in U.S. history. For the most part, bond investors enjoyed this ride—yields may have dropped, but the value of their bond holdings appreciated over this time (because bond prices move opposite of interest rates.) But perhaps most significantly, a sense of calm may have settled in among fixed income investors; many have never witnessed volatility in their bond investments, and if anything expect bond allocations of 40, 50 or 60 percent of their total portfolios to temper their overall volatility. Many of these investors may get a rude awakening if and when the interest rate trend decisively turns, when they discover their "conservative" fixed income allocations could be exposed to as much market risk as their equity allocations.

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The limitations of asset allocation as a strategy to dampen risk will be tested in the event of rising interest rates and the end of the decades-long bull market for bonds. This is why we prefer a different approach—the use of a mathematical hedge to help protect investors against severe market corrections.

Economy

A Goldilocks moment

Where's the inflation? That question has bedeviled economists, central bankers and market watchers in recent years. With the U.S. economy effectively running on all cylinders, an acceleration of prices should be just around the corner. But the eventual uptick in inflation has been a long time coming and still seems a far-off possibility. Both the headline and core rates of inflation (with and without food and energy prices) have been range-bound for much of the last 12 months.

One place to look for inflation is wage growth; tightness in the labor market ought to translate to faster wage growth, and wage growth has improved over the past 12 months but still has not had the break-out moment that would lead to higher inflation. (See chart below.) Normally, a faster rate of inflation would be a bad omen for the economy, and it still may be if an inflation spike prompts the Fed to get more aggressive in rate tightening. Yet, any rise in prices would come off of extremely low levels. Some inflation may be welcome, but too much could ruin this "Goldilocks" moment for the U.S. economy.

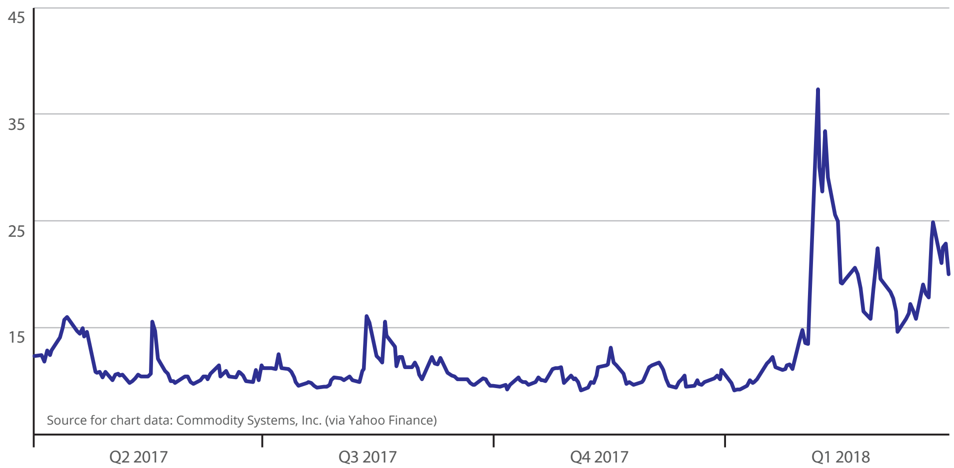
Equities

Fear strikes back

Professional money managers (and some individual investors too) keep a constant eye on the VIX index to get a quick read on stock market sentiment. The index itself is quite esoteric (Google the definition if you're curious about it) but what's important to know is that the VIX is a good gauge of equity market volatility or fear; a higher VIX means stock investors are anxious, while a lower VIX means relative calm. The VIX tends to spike during extreme market or external events, such as after September 11th and at the height of the global financial crisis in 2008.

For much of 2017, VIX was at all-time low levels, hovering around 10.0. For perspective, the one-year moving average for the VIX since 1997 has been around 16.0. That changed in Q1; fear returned to the stock market as investors fretted over potential inflationary spikes, aggressive Fed rate tightening, a U.S. trade war with China, and overvaluation among high-flying tech firms. The VIX spiked in February as the major U.S. stock indexes slid into correction territory, and remained elevated while the market closed Q1 on a down note. (See chart below.)

Chicago Board Options Exchange (CBOE) Volatility Index (VIX)



Losses during the quarter for some notable technology stocks made headlines—Facebook declined 12% for the quarter, while Amazon and Netflix fell over 12% and 13% respectively from their recent peaks—but the sector overall was the best industry performer for Q1, gaining 3.5% for the period. The consumer discretionary sector was the only other industry group on the positive side for the quarter, due primarily to internet retailers. All other industry sectors were in the red--real estate, materials and energy stocks were off over 5% for the period, while consumer staples slumped 7%.

Bonds

Not quite a break-out

Interest rates moved higher during the 1st Quarter, but most of the increase happened during the first two months of the year. The benchmark 10-year U.S. Treasury rate closed in on 3.0% in mid-February, more of a psychologically important level than anything meaningful, before dropping back toward 2.73% by quarter-end. That still represented a significant increase from where 10-year rates began the year (around 2.46%.) Short-term rates also climbed during the quarter, after the Fed hiked rates by quarter-point in March while also plotting two additional hikes for the rest of 2018 and signaling more hikes to come next year.

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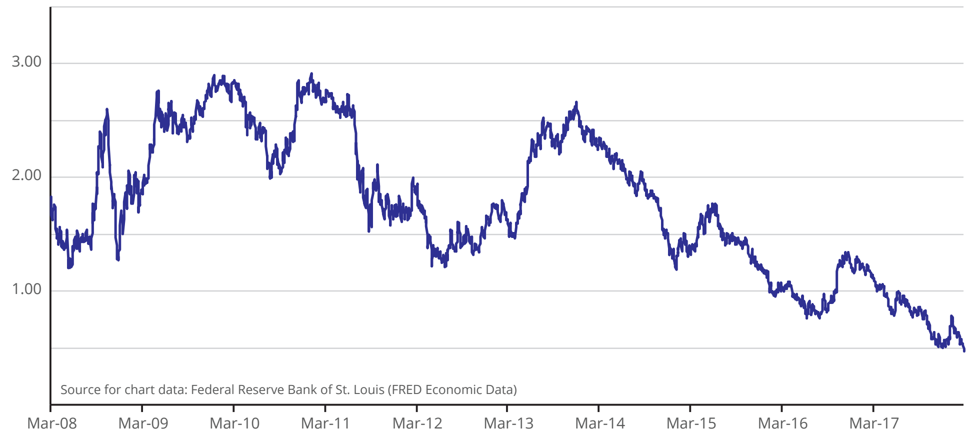
The spread between 2-year and 10-year Treasury rates narrowed to its lowest level in over 10 years (see chart below,) creating a flatter yield curve. (A flattening or inversion of the yield curve is regarded as an indicator of recession.) Bond investors confronted a mix of concerns—from the positive business environment, to inflation fears, to an increase in U.S. government bond issuance and a widening deficit gap. The return of stock market volatility sparked a "flight to safety" of stock investors into bonds that helped contain yields from a full-fledged breakout. Still, a turn in the long-term trend of low interest rates becomes more probable as we progress through this stage of the economic cycle.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity (T10Y2Y)



Outlook

Making a statement

For much of 2017, investors seemed to have turned a deaf ear to President Trump's unpredictable announcements, enjoying the stock market's smooth and steady ride toward lofty valuations despite some heated rhetoric from the Oval Office. As 2018 progresses, investors may have more reason to watch Trump's Twitter feed as he lays out more of his agenda. What happens between Trump's tweets and actual implementation of any trade barriers remains to be seen. Future economic reports for employment, growth and especially inflation will be closely watched for signals on inflation and what tack the Federal Reserve may take on interest rates--will Powell stay cool on the tiller or get more aggressive as inflation rises? There are two Fed meetings planned for Q2; as of this writing, investors believe the next quarter-point hike will come in June. Both meetings will be highly anticipated, if not for the decisions themselves but the statements that will follow.