Economic & Market Commentary

Volatility is back! After being dormant for more than a year, with 2017 experiencing the lowest equity volatility since records were kept (including the longest period ever without a decline of five percent), volatility returned with a vengeance in the first week of February. January started the year with a continuation of 2017's complacency, which resulted in a "melt-up" of the U.S. stock market, led by Amazon, Netflix, several semiconductor companies and some special situation stocks. Market commentators were talking about entering a blow off phase of this bull market. Some were even calling the S&P 500 to reach 3500 (from 2872 in January) before a downturn might occur. Then came February and, with the release of the employment data for the prior month, it was reported that average hourly earnings grew by 2.9%. Inflationary fears were stoked and interest rates immediately shot up (the 10 year Treasury reached 2.94% from 2.40% on January 1st). U.S. stocks reacted with a decline of more than 10% over the ensuing nine trading days and we were quickly in a "correction" zone. February's downdraft was broad and virtually all stocks suffered. March started to recover some of the lost ground of February, then at mid-month the Facebook data privacy issues became the media and investor attention of the day and helped drive the equity market back down to "correction" territory. This handful of volatile events brought U.S. stocks into negative territory for the quarter. Virtually all measures of U.S. stock performance were in the red. Small cap stocks were down slightly less than large cap and growth well outpaced value, which lagged significantly.

The rest of the world's equity markets followed the U.S. with 80% of the 30 markets tracked by The Wall Street Journal ending the quarter with negative results. According to the Financial Times, global markets suffered a loss of $4.2 trillion during that February period. The only notable exceptions were Brazil (+11%) and Russia (+7%), and the Russian market suffered a significant decline in early April, so it is now in the red. Bonds were down as well, with the Bloomberg Barclays U.S. Aggregate Bond Index down 1.46%. So, it's safe to note that most asset classes produced negative results for the initial quarter of 2018, a rare occurrence since this bull market began in 2009. If there is a good side to the increased volatility we have experienced, it is that it has taken stocks to a "correction" mode, and reduced the risks to equity ownership. During the January "melt-up", stocks reached 21x trailing earnings (18-19x forward earnings) - richly valued by historical standards. The stock market decline took about two multiple points off that price/earnings ratio, bringing prices to a fairer level, given today's economic circumstances.

Our base case for the 2018 environment can justify equity valuations in the current range. The economies of the world look to be in synchronized expansion. The U.S. should be able to show real growth in the 3% area. Fiscal stimulus is estimated to add 0.7% to projected GDP in 2018, and 1.5% of GDP in 2019, on top of last year's growth of 2.5%. First quarter U.S. growth is expected below that (+2.8% est.), due to slower retail sales in the quarter ascribed to harsh weather. However, "animal spirits" are expected to reemerge and lead the way for the balance of the year. Consumers are in improved shape (although balance sheets are getting tighter) as wages are improving and tax cuts should begin showing up in pay checks. For corporations, business is good and tax cuts should be beneficial to capital spending and productivity. Fiscal stimulus from tax cuts, and infrastructure and defense spending will add close to $1.5 trillion of stimulus (this is not all clear sailing as the federal deficit is projected to reach a problematic 5% of GDP by 2019 – but this is tomorrow's problem). As usual, we are at the start of a new earnings reporting season, as we write this. Expectations are for strong earnings, with gains in the mid-teens for both the quarter and the year. A good business environment and the impact from corporate tax cuts prompt this optimism. We wrote last time that the newly passed corporate tax cut could add $10 to S&P 500 aggregate earnings for the year, and that data point could reach $150 per share. According to Bloomberg, the current 2018 consensus is $156 per share. On balance, the current backdrop looks good from our point of view.

That is not to say there are no risks that need to be considered. Quite the contrary, while last year the visible risks were ignored, investors seem to have them more in focus this year. Obviously the economy and earnings will have to develop along the lines described above. The biggest risk here is an impending downturn in the economy. There are no signs of that on the horizon and we don't expect any to develop in the visible future. Inflation is currently increasing, but is tame and should remain so. The progress of wage growth could lead to inflationary tendencies, so this will have to be watched.

Monetary policy could be a problem area. The Federal Reserve Board is supposed to have seven members. Only three have been appointed to date, leaving four to be filled. Chairman Powell and the other two are rookies and, unlike Chair Yellen, Mr. Powell is not a trained economist. The Federal Reserve (Fed) has signaled its intention to increase short interest rates and to reduce its $4.5 trillion balance sheet. The expectation is for 2-3 Fed Funds rate increases this year and a balance sheet reduction based on a run-off of maturities. The pace and frequency of rate increases and how the balance sheet is reduced could create problems, as we have said before. Errant moves by the Fed have been known to tip the economy in the past, so these actions will have to be closely watched.

Large fiscal stimulus, when the economy is already performing well, could also create problems. We would prefer a "goldilocks" scenario (not too hot, not too cold) for the economy, so the impact of a large jolt from fiscal stimulus needs to be monitored. Then, there is the potential of an expanded deficit to 5% or more of GDP, while the projection is for tomorrow (2019) it could easily become a problem today.

Finally, there is the whole area of geopolitics, which investors largely ignored last year, and fortunately did not create problems. But Syria, Russia, North Korea, China and trade policies have all reignited global fears. All of this is imposed on an administration that is inexperienced, mercurial, and distracted by instability among its staff, outside investigations and the problem of mid-term elections. All of which are increasing the odds of mistakes. Many of these risks are unknowable and can't be calibrated, so we are forced to rely on the economic facts as we know them. This leads us again to focus on companies with attractive growth prospects selling at discounts to our estimate of fair value.

FIXED INCOME

As mentioned earlier, bonds posted negative returns this quarter, as rates rose across the yield curve, with the most significant increases coming in the shorter end of the curve (3 years or less), where yields rose by 33-41 basis points. Yields rose the least in the longest part of the curve, with the 30-year Treasury Bond's yield increasing by only 23 basis points. This caused the yield curve to flatten even further as the difference between 30-year and 10-year yields fell to 34 basis points compared to 61 basis points a year ago. The bond market experienced greater volatility this quarter, with the 10-year Treasury yield rising 55 basis points during the quarter to reach nearly 3%, before falling back to end the quarter only up 34 basis points at 2.74%. Heightened trade tensions between the US and China as well as the political turmoil between the US and North Korea were significant drivers of the drop in yields from their peaks this quarter as investors sought safety in bonds. For the quarter, the Bloomberg Barclays Aggregate Bond Index returned -1.46%, the first negative quarter since the election spiked yields in the fourth quarter of 2016.

Jerome Powell took over from Janet Yellen as the new Chair of the Federal Reserve in February. He is perceived as being far more hawkish than his predecessor; however, in his comments following his first Fed meeting as Chair in March when the Fed raised the Federal Funds target rate by 25 basis points he allayed some of the concern that the Fed might raise rates too aggressively. He particularly took issue with the focus on the Fed "dot plot", which charts the 15 Fed members' expectations for the Federal Funds rate in future years. The dot plot shows a slim majority expectation for 2 or fewer additional rate increases this year and at least three more rate hikes in 2019. Chair Powell emphasized that the dot plot is not an agreed upon rate path by the Fed, but simply a chart of the Fed board members diverse views on the expected future path of rates.

Chair Powell was particularly non-committal in his forecast for rate increases and followed the familiar refrain that the rate path was data dependent, in particular regarding inflation, employment figures and wage growth. Inflation did slightly tick up during the quarter from 1.7% to 1.8%, but still remained below the Fed's target of 2% as measured by the PCE (Personal Consumption Expenditures) Index. In addition, although job growth has been quite strong over the past year, averaging gains of 188,000 per month, it did evidence some weakness in March when only 103,000 jobs were added which was significantly below the consensus figure of 185,000. While unemployment remained at 4.1%, average hourly wage growth remained relatively sluggish rising 2.7% over the past year, based on the March reading. We believe the reason for this modest wage growth is the large number (5 million) of part-time workers who are seeking full-time employment, as well as an additional 450,000 workers that have stopped seeking employment and are inhibiting wage pressure by providing a readily available workforce as demand for workers rises.

Although there was some discussion at the March Fed meeting about moving away from an accommodative monetary policy stance towards a neutral or restraining factor for economic activity, the Fed has several new external variables to consider when deciding upon the appropriate level of interest rates. For example, the US engaging in a trade war with its trading partners would dampen economic growth, while the 2018 tax cuts should spur economic growth. Currently, the Fed considers the long-term Federal Funds neutral interest rate to be 2.9%, a level at which it would neither boost nor detract from economic growth (this rate is below historical levels).

The benefit of the rise in interest rates over this quarter and past year is that investors are earning higher yields on the bonds purchased, as securities in their portfolios mature. At the same time, we have limited duration exposure, in order to lessen the impact of rising rates on the current portfolio positions. This strategy will deliver growing interest income to portfolios, while offering some protection against rising interest rates.