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Q1 2018 Market Commentary

The first quarter of 2018 turned out to be a roller coaster of a ride for financial markets. No longer are we faced with the bull-market-in-everything environment that a lot of investors have become accustom to. Just when you thought your March Madness basketball bracket had gone sideways, the markets grabbed your attention.

The volatility that began shaking up markets in early February, reared its ugly head again in March. Over the week of March 19, the Dow Jones industrial average, an index that tracks 30 large U.S. stocks, sank almost 6%, losing more than 1,000 points on that Thursday and Friday alone.[1] At the same time, Standard & Poor's 500 stock index (S&P 500) dropped about the same 6%, and the Nasdaq fell 6.5%.1 What is behind this shift? Below we outline our thoughts on where financial markets are currently and where they are potentially heading after the first quarter of 2018.

Are We Buying The Hype?

Whether it's China, interest rates, or Facebook, there is a lot of hype out there today.

As of right now, the U.S. and China are in a trade dispute, not a trade "war," as hyped by the media. As far as the tariffs are concerned, the U.S. has made most of its allies exempt from steel tariffs and the Trump Administration has cooled its rhetoric… for now. Our guess is that someone, be it Wall Street or within Trumps cabinet, got to him, telling administration officials to dial it back. With that said, this is something the markets are paying close attention to and as we write this commentary, the trade dispute has deepened with the U.S. unveiling new tariffs against China, and Beijing promptly retaliating. While this could be posturing from both countries, designed to pressure negotiators on both sides, there is a possibility that a trade war could ensue, which would be deeply troubling for almost all global markets. The way we look at it, Trump views the stock market as the ultimate arbiter of his policies, and hopefully the recent selloffs and volatility send him a message.

The S&P 500 jumped 2.7% on the Monday after the tariffs were announced, it was the biggest one-day jump since August 2015, as fears about a trade war with China eased.1 Investors were encouraged by comments from U.S. Treasury Secretary Steven Mnuchin, who said the administration was "working on a pathway to see if we can reach an agreement as to what fair trade is for them." All in all, China's initial response to Trump was mild, threatening only $3 billion in new tariffs, a rounding error. We'll be paying close attention to talks between Mnuchin and China's top economic policymaker, Liu He.

One aspect of the market that is always under the microscope is interest rates. What was interesting was that after the Federal Reserve increased the federal funds rate again on March 21st, interest rates fell thereafter. This was likely caused by a myriad of factors such as trade anxieties, tame inflation and/or a mediocre first quarter GDP. Yields could rise again if the stock market comes back quickly, but one thing for sure is that the markets are calling the tune on rates, not the Fed.

The sell-off in the technology sector, specifically around Facebook was another headline grabbing event. An industry with such spectacular growth is bound to face growing pains and public relations headaches, but we do not see imminent regulations or legislation that will hit the industry, which will pledge to self-regulate. For a lot of the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google), news was so great for so long, I think investors forgot that negatives can happen from time to time.

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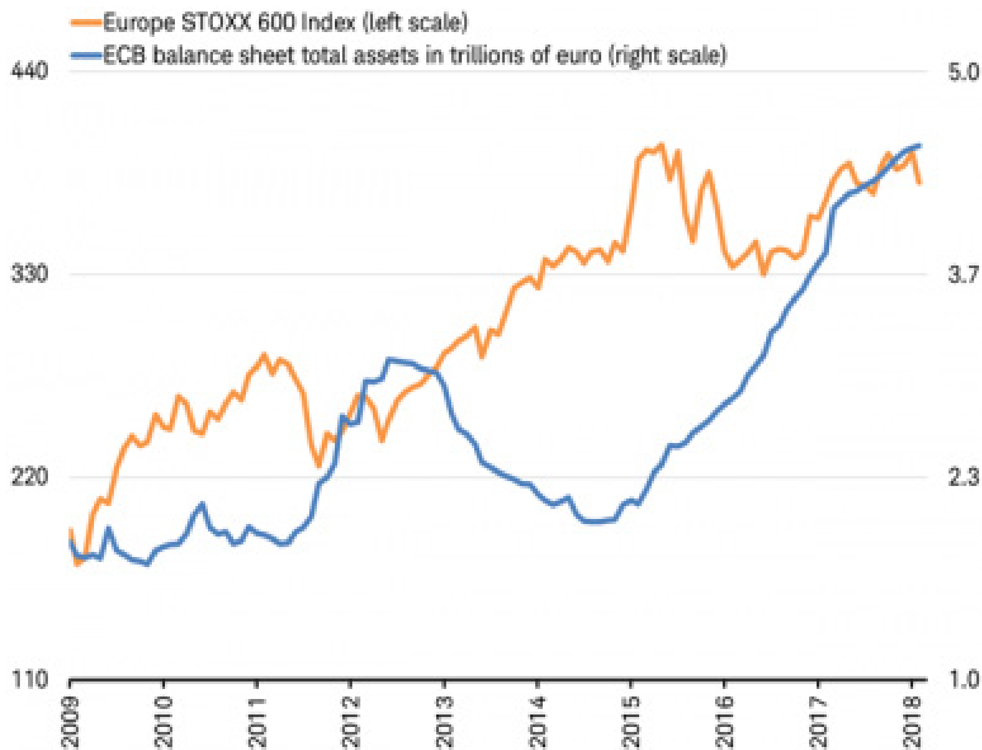
Investors, always willing to believe in technology companies, spent the last three years piling into their shares with abandon. Now the intellectual underpinnings of that rally are being tested. Was all that a valid reason for the entire sector to sell off? Or was it the extremely rich valuations? Time will tell.

Domestic markets finished mixed for the quarter, with the S&P 500 index finishing -0.76%, the Nasdaq index +2.59% and the Dow Jones Industrial Average index -1.96%.1 This was the first down quarter for the S&P 500 since the third quarter 2015.1 In addition, the S&P 500 has just printed two consecutive down months, something that hasn't happened since January and February of 2016. 1

International Markets

In Europe, Mario Draghi, the head of the European Central Bank (ECB), made it clear that ECB is satisfied with its base-case inflation outlook. As Draghi has become more confident in that outlook, he is on track to retire quantitative easing (QE) this year as anticipated. With growth improving, the tapering of QE bond buying that began this year will continue. This has proven to be a favorable combination for European stocks in the past. As the ECB tapered and then trimmed QE from 2012 through 2014, European stocks posted strong gains, as you can see in the chart below.



Source: Bloomberg data as of 3/14/2018.

As headwinds start to abate in Europe, we see opportunities presenting themselves. With global growth looking positive and earnings coming around, we are constructive on the region.

It's been a rough few weeks, both for Japanese prime minister Shinzo Abe and for the Japanese stock market. Reelected just five months ago, Abe is facing growing demands for his resignation

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after an official cover-up scandal that had been ready to boil over for the last year. As a result, Abe's approval rating has slumped towards levels from which few Japanese prime ministers struggle to recover. Meanwhile, hit hard by not only the scandal questions but the overall nervousness in global markets, the TOPIX along with the Nikkei 225, both major Japanese stock indices, have slumped from their late January highs.1 With a strong corporate governance increase and a sharper focus on delivering shareholder value, will Abe's signature "Abenomics" revitalization policies survive his possible political demise?

Driven by strong EPS growth and credit growth, along with steady global growth and strong earnings, we remain positive on emerging markets as well. The volatility that rocked global markets in March did not scare investors away from the sector either. An estimated $8 billion flowed back into the sectors stock and bond markets, according to IIF Data Solutions, Inc..[2]

China is always front of mind when talking about the sector. The announcement last year by MSCI of its intention to include Chinese 'A'-shares in its emerging markets index this summer marks another milestone in the progressive liberalization of China's capital market. We feel that this can only help investors and add much needed transparency around these companies.

Bond Land

The message of the last few weeks is that the largest and arguably most important financial market of all, the U.S. treasury market, could care less about the recent volatility. The retreat of long term U.S. treasury yields from their February highs despite the equity turbulence, shows that the bond market simply does not buy this pessimistic macroeconomic story. For investors this is highly reassuring, at least for the coming quarters.

The fact that bond investors seem unworried about inflation or overheating does not mean that Trump's protectionism and fiscal profligacy are harmless. Despite the fact that financial markets are sometimes completely wrong, the U.S. bond market is more than just an indicator of financial opinion. The long-term interest rates set in bond markets have such a strong impact on business conditions that changes in investors' views can influence economic reality almost as much as vice versa.

In municipal bonds we are still seeing strong credit. Bankruptcies were extremely low last year with only seven Chapter 9 filings out of around 80,000 municipal debt issuers.[3] In addition, the concerns over unfunded pensions continue to subside in large part due to the strong return in equity markets. State and local government plans are now funded at 70%, a significant increase from 2016.[3]

Bigger Picture Still Looking Good

With the recent narrow-minded focus on tariffs and trade over the past several weeks, investors might have forgotten that the underlying foundation of the U.S. economy remains solid. Investors should have reason for optimism due to the strong earnings forecasts we are seeing. S&P 500 firms are forecast to have grown profits 17% in the first three months of 2018 from a year earlier![4] That would mark another strong period of earnings in what's become a lengthy string of robust quarters.

Despite these weaker first quarter growth projections, business sentiment remains very optimistic. In addition, the Institute of Supply Management (ISM) Non-Manufacturing Index and the accompanying ISM Manufacturing Index sit at solid levels.1

Stock market behavior and volatility can be maddening at times, but focusing on the longer term, remaining disciplined, and refraining from kneejerk reactions tends to dampen that madness. The U.S. economy still looks healthy, inflation

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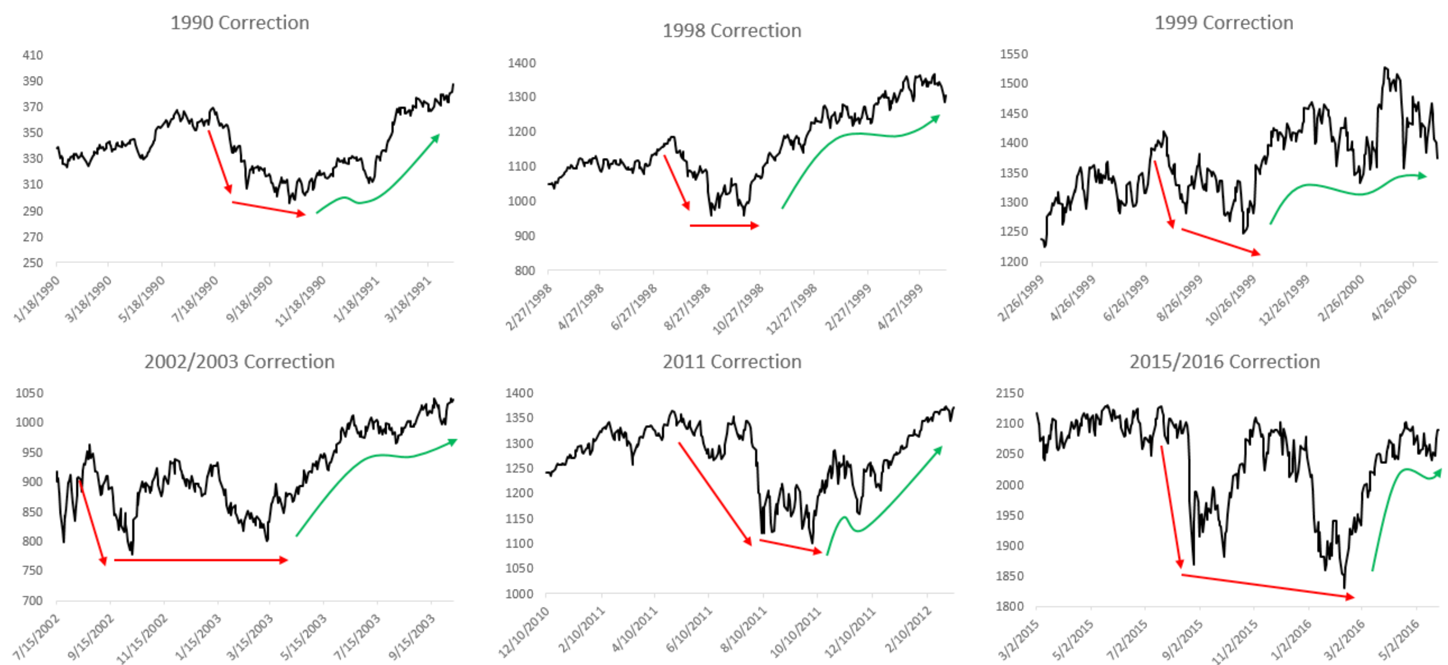
pressures remain modest, and earnings growth has been strong; all of which should allow the bull market to continue, albeit with increased volatility. "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it," said Warren Buffett.

Some investors say the pullback in sentiment was necessary given how much confidence metrics have risen in the last year. I cannot stress enough how powerful the U.S. equity dip-buying behavior has become. It's a near-religion at this point. Investors are at a point where they close-their-eyes-and-buy. We view the market corrections as much-needed shakeouts from euphoric sentiment.

Overall, signs do not support a bear market. Expect volatility to remain elevated. As shown below in our updated "correction matrix," over the last six market corrections, volatility has remained elevated with markets oscillating up and down for the 3-6 months following a correction.



Data source: Bloomberg

The economy shows few signs of slowing down materially, but markets remain skittish about a possible trade war. The Fed looks to continue its gradual path of normalization and doesn't seem overly concerned with the recent stock volatility.

"Investors should maintain a long-term perspective that extends longer than one election cycle or economic cycle," says Roman Ciosek, HighTower Westchester's Managing Director & Partner. "Patient investors tend to be rewarded in the long run."

So, in conclusion, beware of the hype. We all tend to get sucked into media madness. Over the long term the markets tend to ignore the hype. Market action has been short-term focused, leading to some volatile daily moves. Don't ignore what happens on any given day but keep it in context of the bigger picture.

We thank you for your continued trust.

[1] *FactSet financial data and analytics. www.factset.com*

[2] *IIF Data Solutions, Inc. http://www.iifdata.com/*

[3] *Bank of America Merrill Lynch. "The RIC Report - Stepping off Easy Street." Stepping off Easy Street, 13 Mar. 2018, pp. 1–29.*

[4] *https://www.yardeni.com/pub/peacockfeval.pdf*

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