Market Commentary

March 31, 2018

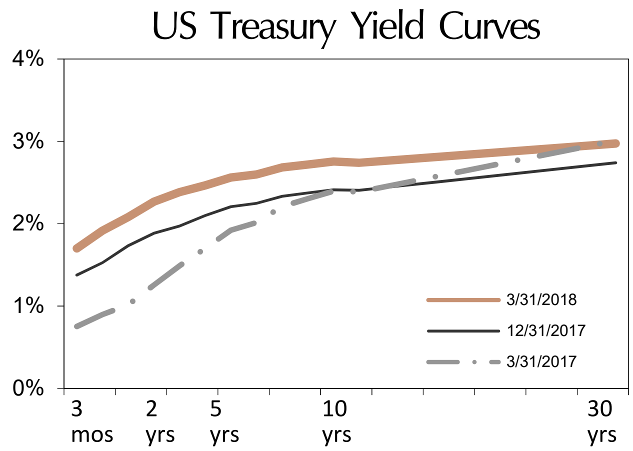
Stocks exploded out of the starting blocks in 2018, in large part due to the passage of the GOP tax cut in late December. On the heels of an impressive Q4 2017 return of 6.6%, the S&P was up another 5.7% in January 2018. The Dow Jones Industrials reached a new all-time high of 2616 on January 26. However, in the span of only a few days, it all changed. Stocks had a breath-taking run, but many investors were likely skittish, wondering how long the good times would last. On February 2nd, the January jobs report was released, and it revealed a higher than expected rate of wage growth. That bit of news appeared benign, but it was the catalyst for a violent sell off, and much higher market volatility over the balance of the quarter. Higher wages (which normal folks believe is a good thing!) could lead to higher inflation and to a more aggressive Fed. And that was enough to spook stock investors.

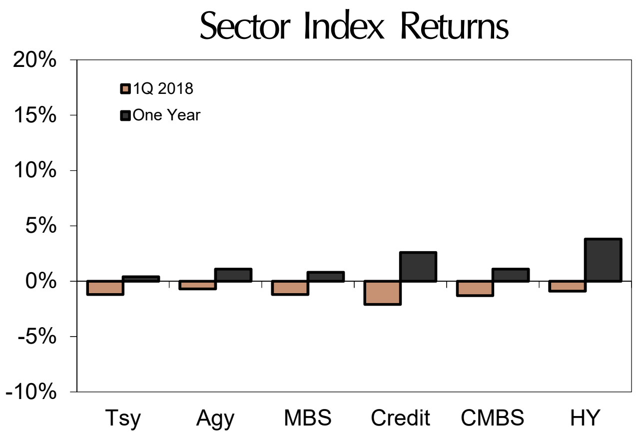
The 5.7% January return for the S&P 500 was wiped out after the first week in February. Stocks traded in a highly volatile sideways pattern for the balance of the quarter. The S&P 500 returned -0.8% in the first quarter. Only two S&P sector groups had a positive return in Q1: Technology (3.5%) and Consumer Discretionary (3.1%). For the past 12 months, Tech has also been the strongest sector by far with a 27.7% return. On the flip side, Telecom (-7.5%) and Consumer Staples (-7.1%) had awful quarters. Small-cap Growth (+2.3%) outperformed in the quarter as the higher earnings estimates of growth-oriented companies continues to benefit this sector. Large-cap Value stocks (-2.8%) lagged in part due to their sensitivity to higher interest rates.

On the international front, Emerging Market equities was the place to be in Q1. The MSCI Emerging Market Index (+1.4%) outpaced both US and Developed International stocks. Developed International equity markets had a tough start to 2018. The MSCI EAFE Developed Markets index returned -1.4% in the first quarter. International Value stocks were the big losers (-4.9%); International Growth stocks had a -3.7% return. And Large Cap (-4.3%) underperformed Small Cap (-3.0%).

The combination of tax cuts, higher budget deficits, fears of higher inflation, and expectations of a hawkish Fed sent interest rates higher through the first several weeks of 2018. The 10-year US Treasury yield rose from 2.4% at year end, peaked at 2.95% in February, and then closed the quarter at 2.8%. For the quarter, the Barclays Aggregate Index returned -1.1%.

As the Fed has gradually increased the federal funds rate, we've witnessed a pronounced flattening of the yield curve. One year ago, the yield of the 30-year US Treasury bond was 1.7% greater than the yield of 2-year Treasury note. That difference has narrowed to less than 0.7% today. Curve flattening is common during a Fed rate hike cycle. Fed policy has a more direct impact on short-term rates. On the other hand, long-term rates are primarily influenced by economic growth and inflation expectations. When the yield curve gets this flat, the likelihood that the Fed may overestimate the strength of the economy, and raise rates too much increases. This could lead to an inverted curve (short rates higher than long rates) and possibly to a recession. To be clear, very few expect a recession in the near future, but a flattening curve can be a signal that economic growth is sputtering.





One of the biggest clouds currently hovering over the financial markets is the escalating trade tensions between the US and China. One of President Trump's major campaign promises was to get tougher on the terms of foreign trade, especially with China. The Trump Administration began to make good on that promise in January and February with a series of small scale duties and tariffs. However, things become more heated in March when the US imposed stiff tariffs on imported steel and aluminum. And that was followed by an additional $50 billion in punitive tariffs on various Chinese goods as punishment for intellectual property theft. Boiled down to its essence, a tariff is a tax paid by consumers. Tariffs raise the prices of targeted goods, reduce consumers' purchasing power and hurt economic growth. Stocks are vulnerable if a full blown trade war erupts.

Just a few months ago, analysts lauded the "synchronous global recovery" with economies throughout the US, Europe and many emerging markets all expanding simultaneously. Many believe this was the primary driver of the powerful stock market rally. However, recent data show that European economies are beginning to roll over. The Citigroup Economic Surprise Indices measure actual data releases relative to expectations. An index below zero means data is coming in below expectations. More than 60% of the world's major economies have Surprise Indices below zero, which is the most since 2016. This is often a good leading indicator for US growth. Note that this downturn coincides with the start of the global wind-down of central bank monetary stimulus. Questions remain as to how "addicted" financial markets will react when central banks curtail the dosage of monetary heroin.