Market Commentary

First Quarter 2018

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The first quarter of 2018 saw an abrupt end to the extended period of low volatility to which investors had been accustomed. After a rapid rise in equity prices during January, February greeted investors with a sharp increase in interest rates, the first two 1,000-point decline days in the Dow Jones Industrial Average, and spikes in volatility that had been previously unseen by a generation of investors. Because all this activity came within the same calendar quarter, overall returns for the three-month period mask the underlying volatility. The benchmark S&P 500 Index declined by 0.8% on a total return basis during the first quarter. While this decline for the quarter was quite modest, the ride was far from smooth. In fact, we can discern four distinct market moves in the three-month period. After the S&P 500 began the year with a sharp 7.5% jump through January 26, the Index reversed sharply and suffered a 10.1% decline in only 9 trading sessions. The Index then rebounded 8.1% over the next month before once again reversing direction and selling off by 5.2% through quarter end. The 10-year Treasury note yielded 2.74% at quarter end, meaningfully higher than the 2.41% yield at the end of 2017. During the quarter the 10-year note yielded as much as 2.91% before a rally in bond prices pushed yields lower during the final week of the quarter. Returns for most fixed income holdings were modestly negative during the quarter as higher rates along with inflationary concerns moved rates across all maturities higher.

Economic and Market Outlook

In our last commentary we noted the extremely subdued volatility in markets lasting for all of 2017 having been both rare and somewhat disconcerting. We had written that we were looking for a modest pullback to consolidate the gains from almost two years of consecutively rising prices. What we did not expect was how soon volatility would return and how violent and sudden the pullback would be. If we step back from the hysteria and look at the market and the economy, we find little has changed. Corporate revenues and earnings are at all-time highs and continuing to grow at a meaningful rate. Unemployment is very low and job openings are increasing. Inflation remains below the 2% Federal Reserve target. Longer-term interest rates, while higher than a few months ago, are at similar levels to where they were in early 2017. To us, the main change has been in investor sentiment.

We can point to several potential catalysts for the volatility during the quarter. Foremost would be the fears of higher inflation (and subsequent higher interest rates). While inflation has been trending modestly higher for several months now, it remains below 2%. Interest rates have also moved higher in recent months, but the 10-year Treasury note is only about 20 basis points (0.20%) higher than it was in late 2016. Fears of trade wars with our largest trading partners is also a concern, but we point out that most of the talk about tariffs has been just that – talk. Trade negotiations are seemingly being conducted in public rather than behind the scenes as previously done. Headlines may spook investors but until we see tariffs put in place, we urge caution against trading on what might happen. Finally, we can point to the privacy concerns with Facebook which put the previously one-way trade on FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) in jeopardy. Any or all these issues had a hand in driving volatility higher. Volatility is not the enemy of the investor. In fact, stocks have an expected higher return that bonds *because* of the volatility inherent in owning equities.

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Congress continues to underwhelm us with their inability to pass any meaningful legislation on a myriad of issues. Continued short-term budgetary fixes seem to be the norm, with Congress in late March agreeing to an omnibus spending bill for the six-month period through September 30, 2018 and congratulating itself on this "accomplishment." Spending trends are moving higher and there seems to be no political will for the budget reform necessary to slow the growth in national debt. Looking to other potential headwinds for financial markets, we note the same "known" unknowns we have been watching for most of the past year. The next few months may see a change in US-North Korea relations with plans for a meeting between President Trump and Kim Jong Un this Spring. Although the Mueller investigation drags on, it has been nearly a year with little evidence of anything directly tying the President to Russia. We are wary that Special Counsels have a way of "finding" crimes, and the longer the investigation proceeds, the more likely something that may affect markets could surface.

Oil prices continued to firm through the quarter, continuing a trend that began a year ago, leaving crude prices near two-year highs. For the quarter, oil rose approximately 7.5% from $60.42 at the end of 2017 to $64.94 on March 31. With modestly higher global GDP growth forecasts, many commodity experts expect oil to trade in the $60-70 range barring faster economic growth or supply shocks. Consumers are adapting to higher energy costs, with oil prices about 30% higher than last summer. Higher spending on energy may offset some of the benefits from higher take-home pay the recent tax cuts generated.

Portfolio Positioning

Client portfolios are positioned for moderate, sustained economic growth. Understanding we are nine years into an economic expansion, we remain vigilant in looking for signs of a potential downturn. With the best employment picture in over a decade, rising corporate profits and continued low inflation, there are scant signs of economic distress. During the past few months there has been a bit of bifurcation in the equity markets with technology continuing to move steadily higher, while interest-sensitive areas like financials and utilities have lagged significantly. After the recent pullback, we think equities are near fair value, particularly when using forward earnings estimates. At the March Federal Reserve meeting, the FOMC moved rates 25 basis points higher in one of the most telegraphed moves in history. Focus continues to be on whether there will be two or three more rate hikes during 2018. We have long counseled that it is not where interest rates are today that matters much to investors, but rather, where they are expected to be in 12-18 months. The Fed provides us with a "dot plot" showing the individual interest rate expectations of each voting member, although history has shown these estimates to differ from actual interest rates by a significant margin over time. The brief inflationary scare prompted by the January jobs report has subsided and we continue to believe that interest rate increases, inevitable during a period of economic growth, will be measured and gradual.

Conclusion

Looking out through 2018, we believe corporate earnings and interest rates remain the two key variables for investors to watch. We foresee few if any signs of a downturn in the economy over the next 12-18 months. Expectations of strong growth in earnings for 2018 with continued growth in 2019 bode well for the earnings side of the equation. Depending on both the overall level of interest rates as well as the expected trajectory of rates over the next 12-18 months, we can determine a fair multiple to apply to those earnings. While volatility may be with us for a while, this can be utilized to investors' advantage to make changes in portfolios when price distortions occur.

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