



Second Quarter 2018 Outlook and Commentary

Before we comment on the first three months of 2018, 2017 merits one last glance. Global stock market returns were excellent, but more striking was the complete absence of the kind of big swings that test investors' nerves. The Dow Jones Industrial Average of thirty leading, blue-chip U.S. companies spent 239 out of 251 trading days within a 1% intraday range, **the least volatile year in history**. The biggest pullback for the year was just 2.8% (a gentle ride down over the course of six weeks), with only 1995 having a smaller drawdown. Every month in 2017 was higher than the last for the first time ever.

Well, that was nice while it lasted. As if on cue, volatility came rushing back almost as soon as the calendar changed. Initially the big moves were up, leading to our mid-January observation that U.S. stocks were "melting up" and could be in a bubble. U.S. markets began to reverse course in the last week of January and by February 8th the broad indexes had fallen a bit over ten percent. The drop marked the first correction (a decline from a recent high of at least ten percent) since early 2016. Shares rebounded sharply but the wild swings continued; in the last two weeks alone, U.S. stocks have had nearly as many days up or down at least 1% as all of 2017.

Global stock markets appear trapped in a tug-of-war between upbeat investors focused on booming corporate profits and a robust global economy, and gloomier folks who insist on thinking about what could go wrong. The news on the earnings front is about as good as it gets. Analysts are now estimating that S&P 500 company profits will be up 17.3% in Q1 2018 as compared to Q1 2017. The second quarter is anticipated to be even better. Some of that is due to lower corporate tax rates, but a lot of it is a consequence of the robust global economy combined with only modest cost pressures.

If earnings are that strong, what's not to like? For one thing rising interest rates. During the first month of 2018, the yield on the benchmark U.S. 10-year Treasury bond climbed steadily from 2.38% to 2.72%. When the January employment report showed the highest year-over-year wage growth in more than eight years, bond investors nervously contemplated the possibility of accelerating wage inflation and faster than planned Fed tightening. The 10-year Treasury yield climbed further and appeared headed for 3.00%. At that level, bonds might look relatively more attractive than stocks, a prospect that helped trigger February's correction¹. As it turned out, the yield never got to 3.00% and has since settled in at around 2.80%, in part due to economic data coming in a bit softer than anticipated. In the meantime, fears of sharply rising interest rates have been eclipsed by worries over a US-China trade war.

¹ Another factor in the late January/early February correction was "leveraged volatility ETFs." These products were designed to do extremely well if volatility stayed low, with the possibility of going bust if volatility spiked. As happens sometimes with these obscure Wall Street concoctions, when these securities blew up, much of the stock market followed in tow.

Shortly after President Trump's election we flagged trade as the most significant policy risk. While noting it as a concern we've been cautiously optimistic on the subject. We remain so, but with a bit more emphasis on "cautiously" and a bit less on "optimistic." The trouble started in early March when Trump announced that he would be imposing tariffs on overseas steel and aluminum producers. As initially structured, the tariffs would have predominantly hit allies. To his credit the President adjusted course, eventually exempting almost all countries other than China. He then announced tariffs on an additional \$60 billion of Chinese goods, flouting World Trade Organization procedures as he did so. China retaliated by announcing its own tariffs, carefully calibrated in scope to match U.S. actions. Trump appeared to raise the ante by an additional \$100 billion, but it's not clear whether any of the announced or threatened tariffs will ever materialize. Stay tuned.

Global investors are left to wonder whether we are in the early stages of a trade war or instead witnessing the sort of belligerent rhetoric that often precedes productive negotiations. The short answer is that no one knows, but a few comments are in order. First, as economist and New York Times columnist Paul Krugman suggested recently, while trade wars aren't helpful, the actual economic impact might be relatively modest. Krugman is a Nobel Prize winner for his work on international trade, so he's worth listening to. He went on to caution, however, that companies have deployed huge amounts of capital based on the current trade regime. While the economic consequences might be modest there could be severe disruption for specific companies. It's also important to remember that China is known as "the Great Assembler." A lot of the goods comprising China's trade surplus include components made in other countries. So, even if the Trump administration directs tariffs at China, many of our allies will be negatively impacted. Finally, it should be noted that while the President is focused on tariffs, one of the most important trade issues is the lack of intellectual property protections for foreign companies selling products in China. One hopes that is part of the end game that trade warriors like U.S. Trade Representative Robert Lighthizer have in mind.

Lost in all of the headlines over tariffs is the fact that the global economy doesn't look quite as strong as it did three months ago. Manufacturing activity in March was down in 21 out of 30 leading economies with the weakest numbers coming out of Europe (German industrial production just suffered its biggest drop since August of 2015). In the U.S. tighter lending standards over the last year or so seem to be keeping a lid on consumer spending. The softening is pretty modest, and growth in the U.S. will get a boost when increased federal spending flowing from the recent \$1.3 trillion spending deal² kicks in over the next two to three months. In any case, if the economy is shifting into a slightly lower gear that's not necessarily bad news for the stock market. Back in January and February, capital markets were gripped by fears of soaring interest rates. Those fears were premised on the idea that economic data would come in too strong and force the Fed to raise interest rates faster than anticipated. That's still possible, especially if wage growth accelerates. But slightly weaker economic growth makes a disruptive interest rate spike less likely.

² Between the accelerated spending and the new tax law, the federal deficit is now projected to exceed \$1 trillion in 2020, an astonishing number considering the strong economy. The ratio of debt to GDP will exceed 100% within a decade. Over the long term excessive debt will take a significant toll on the economy. In the short term the impact will be positive.

The other issue weighing on the stock market in recent weeks is a significant pullback in the highest-flying technology companies, most notably the so-called FANG³ stocks: Facebook, Amazon, Netflix and Google/Alphabet, Inc. Each of the four is down significantly more than the market since early March. A lot of the pullback is the inevitable result of share prices climbing too fast; Amazon and Netflix had each doubled in price over not much more than a year. In addition, though, there have been worries over the Facebook/Cambridge Analytica scandal involving the abuse of users' social network data during the 2016 presidential campaign. The threat of increased regulation of companies like Facebook and Google is in the air. Facebook is especially vulnerable, since it charges advertisers hefty prices based on microtargeting that would be less effective under a tighter privacy regime. Matters got a bit worse for tech stocks when Amazon found itself in President Trump's crosshairs over its contracts with the U.S. Postal Service and, perhaps more to the point, Jeff Bezos's ownership of the Washington Post.

Of the three issues bedeviling the stock market during the quarter—interest rates, an incipient trade war, and the tech stock pullback—the latter concerns us the least. Congress has enough difficulty keeping the government open; it's doubtful it will seriously tackle the complex issue of data privacy. And with the exception of Facebook, voluntary changes in business practices won't have a huge impact on business models. President Trump may continue to pick on Amazon, but surely he will notice that voter rolls are chock full of Amazon Prime subscribers. Interest rates continue to present a downside risk but less so than they did at the turn of the year—in part because the global economy has softened slightly, and in part because we've already absorbed a significant increase in rates without major disruption. Continuation or escalation of tit-for-tat tariff announcements may be the biggest wild card. In recent days the hot rhetoric seems to have cooled down a bit. On the U.S. side that might be due to pushback from the agricultural sector, which featured prominently on China's list of tariffs. Still, trade is an issue that President Trump and his political base feel very strongly about, so it's far too early to sound the all clear.

A little over a month ago, the bull market in the U.S. celebrated its ninth anniversary. It has been a powerful run, and, as we noted three months ago, valuations had become quite stretched. If trade war headlines or other concerns were to push stocks down a bit further in coming months, that could bring valuations more in line with historical averages. Eventually, higher interest rates are likely to slow the economy and cool the US stock market, but that does not preclude the possibility for another upswing in the short-term.

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³ FANG is not to be confused with FAAMG—too many acronyms to keep straight! The latter represents the five massive “platform” companies Facebook, Apple, Amazon, Microsoft and Google/Alphabet, Inc. Apple and Microsoft (a) aren't subject to the same concerns over regulation as Facebook and Alphabet, Inc., (b) haven't come under fire from President Trump, and (c) aren't as richly valued. As a result, they've held up better than their higher-flying brethren.

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