Investment Perspective

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SPEED BUMP

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The new year began with stocks continuing their dizzying ascent. Investors poured money into the market on an improving outlook for corporate earnings and perhaps also due to a *fear of missing out.* Against a backdrop of stretched valuations, the stage was set for a bit of a blow-off. And indeed, the S&P 500 suddenly retreated by 10% in early February. Markets have since remained skittish.

Investors last confronted a correction of this magnitude two years ago. Coming on the heels of the strong performance in 2017, it marked a wake-up call for some; a reminder that the confluence of robust returns and very low volatility had actually been an anomaly.

Last year, the S&P 500's average daily change (up or down) was a mere 0.3%, the lowest in more than a generation. There were only eight occasions with a one-day move of +/- 1%. In contrast, over the first 71 trading days this year, the average daily change (up or down) amounted to 0.9% with 28 +/- 1% moves (eight of those being +/- 2%).

Hit a speed bump or Jersey wall?

While unsettling, the recent stock price pullback and spike in volatility is a normal event. In the midst of the bull market that began in 2009, stocks have experienced five other drops of 10% or more. Today's environment may feel worse than it is because stocks have not fallen this hard in some time. And last year's equity returns left some investors with a false sense of security.

Those five prior corrections, on average, produced a 14% loss and persisted for about three months. The magnitude and duration will obviously differ but short-term corrections often play out in a similar fashion: Prices decline rapidly — and often inexplicably — setting an initial low. They partially bounce back as some investors buy the dip. Prices then drop back down near that earlier low, sometimes breaking through it before establishing a bottom. At that point, the selling pressure subsides and some bargain hunters enter the fray.

The current sell-off feels like another speed bump, not the end of the bull. There is no sign of the widespread euphoria that occurs at market tops. And historically, equity bear markets coincide with recessions. If anything, U.S. economic growth is strength-

ening, buoyed by loosened fiscal policy and a pick-up in capital spending. A recession hardly seems around the corner.

Watch the Fed

Of course, economists and market strategists have a dismal record of correctly forecasting recessions. But the U.S. economic recovery *is* getting a bit long in the tooth. The later stages of a business cycle tend to see the rise of inflationary expectations as bottlenecks occur and wage pressures emerge. This phenomenon explains the Fed's tightening stance.

Ironically, the large fiscal stimulus in the pipeline could accentuate the boom-bust cycle, forcing the Fed's hands. An accelerating economy could aggravate the inflation picture, particularly with the labor market being so tight. The Fed may then have to act more aggressively than it would otherwise. The path of Federal Reserve policy will have a large impact on the timing of the current cycle.

All about earnings

In the meantime, stocks will face a critical test over the next several weeks as much of corporate America reports first-quarter earnings. The rosy profit outlook has been the main pillar supporting the market. And expectations are high and rising.

According to Thompson Reuters I/B/E/S, analysts anticipate an 18% increase in S&P 500 earnings on revenue growth of about 7% for the quarter. If achieved, this profit surge would mark the fastest pace since 2011. The recent slashing of the statutory corporate income tax rate (from 35% to 21%) will account for a meaningful share of the earnings growth.

Wall Street expects this momentum to persist over the entire calendar year as profit margins widen. Also, many U.S. multinationals will be repatriating some of their overseas cash thanks to more favorable tax treatment of that income (the rate dropped from 35% to 15.5%). A portion of this $3 trillion horde will be used to repurchase company shares, further goosing EPS. Dividends should also benefit.

This year's combination of lower stock prices and rising earnings has brought the S&P 500's Price/Earnings multiple back down near its 25-year average. But while valuation may be somewhat more reasonable than it had been when the year began, stocks will certainly be pressured if the earnings figures or management guidance fall short of expectations.

No winners

Until recently, financial markets had seemed largely impervious to the erratic events and blustery tweets emanating from the White House. That changed in early March, when the president fired some new salvos on the trade front. His initial tweets called for tariffs on steel and aluminum imports to protect those domestic industries. Later, President Trump called out China for its unfair trade practices and threatened to levy tariffs on $150 billion of imports.

Trump had telegraphed his protectionist tendencies during the election campaign with his call to pull out of NAFTA being the most obvious example. The president faces very few political or constitutional constraints to hinder his pursuit of such policies. And the issue certainly resonates with his voter base. The specter of a trade war has added further to stocks' volatility and poses an ongoing risk.

A financial blogger and CNBC contributor, Josh Brown, joked that this is the second part of Trump's tax plan — eliminating capital gains taxes by eliminating capital gains. In all seriousness, while few economists see the merits of duties on steel and aluminum, China has absolutely been infringing upon U.S. intellectual property for years. But that does not mean that "trade wars are good, and easy to win".

A real, not paper, tiger

China has benefited greatly from globalization. Since joining the World Trade Organization (WTO) in 2001, their per capita GDP has risen by a factor of eight. And the Chinese have accumulated $1.2 trillion of U.S. government bonds thanks to our voracious appetite for their products. On the other hand, China is also the fastest-growing export market for American goods.

The historian Niall Ferguson coined the term *Chimerica* back in 2007 to describe the symbiotic relationship between the two nations. However, Sino-American tensions — economic, geopolitical, and military — will likely intensify and may well end up marking the defining struggle of the twenty-first century; our second Cold War as the two nations wrestle for supremacy on multiple fronts.

But for now, the Chinese seem more interested in diffusing trade tensions than embarking on a new battle. In a recent speech billed as a "major address", President Xi Jinping promised foreign companies greater access to Chinese markets and committed to further economic liberalization. Specifically, he pledged that China would increase imports, improve protection of intellectual property, and ease controls on foreign investment. There was really nothing substantively new here — merely lip service — yet still a signal that China would prefer to avoid a trade war.

And in the words of *Politico.com* Contributing Editor Zachary Karabell, the only way to win a trade war is not to fight it. Trump's tariffs would increase import prices, potentially nudging up inflation. They would also prompt a series of tit-for-tat measures that would hamper U.S. exports. The messaging is mixed but fortunately the president seems to be backing off a bit.

Ok for now

The recent turmoil reminds us that financial markets tend to enter a more volatile phase as a business cycle matures. A number of uncertainties and seemingly-ominous headlines exist today but that has been the case over the entire span of the bull market.

On balance, the economic, earnings, and interest rate backdrop still appears favorable. The U.S. economy has finally achieved traction; both business and consumer confidence remain high. And the trade spat should end up a skirmish rather than a war. While we do not expect a reprise of the robust 2017 stock performance, the evidence suggests that this market cycle still has legs. But volatility is back.

— Christopher J. Singleton, CFA, Managing Director

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