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First Quarter 2018

Financial Market Update

2018 started in much the same way that 2017 ended, with stocks rising week after week and setting new all-time highs along the way. The trend changed in late January, and stock prices retreated a bit when investors began to worry that rising inflation would lead the Federal Reserve to accelerate interest rate increases faster than expected. The selling accelerated on February 2 when the labor department announced that wages rose 2.9%, another indicator that inflation was picking up. In fewer than 10 business days, U.S. stocks, which were hit hardest, fell more than 10%. Stocks continued to oscillate for the next several weeks, proving that volatility had indeed returned to the financial markets.

After all the ups and downs, global stocks as a whole ended the quarter down 1%. Interestingly, this was the first quarterly loss for stocks since September 2015. Losses were most severe in interest rate sensitive areas such as such as real estate and infrastructure. On the bright side, emerging market stocks and U.S. small companies eked out gains.

Major Asset Class Returns

		Q1 2018	2017
Core Bonds - Taxable	(BBGBARC U.S. Agg)	-1.5%	3.5%
Core Bonds - Municipal	(BBGBARC 5Yr. Muni)	-0.6%	3.1%
Global Stocks (as a whole)	(MSCI AC World)	-1.0%	24.0%
U.S. Large Stocks	(S&P 500)	-0.8%	21.8%
U.S. Mid Stocks	(S&P MidCap)	-0.8%	16.2%
U.S. Small Stocks	(S&P SmallCap)	0.6%	13.2%
Foreign Developed Stocks	(MSCI EAFE)	-1.5%	25.0%
Emerging Market Stocks	(MSCI EM)	1.3%	37.3%
Commodities	(Bloomberg Comm)	-0.4%	1.7%
Real Estate	(DJ Global Select REIT)	-5.1%	6.9%

Volatility

In our year-end newsletter, we stressed that despite the current lack of volatility, investors needed to remember that more normalized levels of fear and uncertainty would cause large price swings to return at some point for U.S. stocks. That time proved to be just a few short weeks later, when the first major stock market selloff in quite some time began. In just a few short weeks the CBOE Volatility Index (which measures the collective expectations of traders and investors for future volatility of U.S. stocks) went from abnormally low to slightly above normal. This is a sign that the recent large price swings in U.S. stocks are likely to continue for months to come.

Economic Growth & Company Earnings

The U.S. economy produced 2.3% more goods and services in 2017 than the prior year. While less than most would like, economic output has grown fairly consistently over the past several years and has averaged 2.2% since the great recession.

In contrast, profit growth for U.S. companies has been a bit more sporadic having a terrible year in 2015 when energy companies suffered, but improving in both 2016 and 2017. Still, even with some help from inflation, U.S. company earnings have only averaged 5.1% growth over the past seven years, which does not justify the double-digit acceleration their stock prices have averaged during the same time period.

The short term stimulus resulting from the recent tax cuts and increases in government spending in 2018, however, may provide an opportunity for corporate profit growth to narrow the gap on elevated stock prices.

Trade War?

The Trump administration has several paths to choose from when setting trade policy. They could work to increase globalization, maintain current policy without rocking the boat, disrupt the status quo and try to negotiate better deals, or jump to full-out protectionism with across the board tariffs. Today we are currently in the disruptive phase that involves industry specific tit-for-tat actions as the U.S. imposes tariffs on industries such as steel and aluminum, and foreign governments respond with their own target tariffs, such as those on U.S. agricultural products. Along the way the process will benefit some U.S. industries while hurting others, but as a whole will likely result in increased volatility and angst for the financial markets, as well as investor portfolios.

U.S. Gov. to Increase Borrowing

At the end of 2017, total U.S. Federal debt stood at over $20 trillion. With the passage of the 2017 Tax Cuts and Jobs Act, as well as the Bipartisan Budget Act of 2018, it is now estimated that the federal government will need to issue an additional $5 trillion of treasury bonds to fund the government over the next five years. At the same time, the U.S. Federal Reserve is on pace to reduce its holdings of U.S. Treasury and Agency bonds by roughly $2 trillion. When combined, that is over $7 trillion of bonds that the marketplace will need to absorb over the next few years. If investor appetite for U.S. government bonds does not keep pace with the additional supply, interest rates would need to rise to entice investors to buy those bonds.