Monthly Commentary

April 2018

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During the month of April, the equity markets continued the recent trend of increased volatility with numerous daily swings of more than 1%. The S&P 500 Index, which started the month of April at 2,641, ended the month at 2,648, essentially unchanged[1]. The Index is now down approximately 1% for the year[2].

I'd like to reiterate that, in my opinion, the more choppy nature of stock market is predominantly due to uncertainty over the impact of rising interest rates and the continued drain of Fed liquidity via its balance sheet. The Fed's balance sheet reduction increased to $90b during the 2nd quarter from $60b in the first quarter[3].

One area that didn't stand still in April was the interest rates on the short-end of the yield curve. The 2-year yield, currently at 2.50%, rose 23 basis points (.23%) in April, and that is the highest level reached in 9 ½ years[4]. The 10-year yield rose from 2.74% to 2.96%, but that is no different than the yield seen in February[5].

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Equities and the Economy

U.S. stocks remained in a tug of war between the benefits of fiscal reform versus the headwinds of higher interest rates and monetary tightening. We did see the effect of a tailwind from lower corporate taxes in the first quarter corporate earnings reports, which will likely end the quarter with year-over-year growth in excess of 20%[6], while revenue growth, which has been reported at approximately 10%, has been impressive so far. These results have been helped by the weaker U.S. dollar[7].

With respect to stock market action during earnings season, it is always a great test of what's been priced into a particular stock and what hasn't, let alone for the whole market. There is nothing subtle about these market reactions in very large market cap names. I expect this higher level of volatility to continue.

The economic data has been a bit more mixed, as we saw GDP growth in the first quarter end up just 2.3% and retail sales overall have been modest after a strong 4th quarter[8]. This quarter, we'll see whether or not higher wages, and tax cuts finally showing up in paychecks, will offset the desire to save more and pay down debt. Capital spending has also been modest, as we haven't yet seen the hoped for upturn.

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Interest Rates

We continue to see interest rates across the yield curve trend higher, mostly due to rising inflation expectations, but also in response to the huge amount of Treasury supply needed to finance growing budget deficits. There has been a lot of talk about the flattening yield curve. At the end of April, the spread between the yields of the 2-year Treasury note and the 10-year Treasury note finished the month at just 46 basis points, the narrowest it has been in about 11 years[9]. The meaning of this narrow spread is the "$64,000 question." Does it imply growing market expectations of an economic slowdown driven by a Federal Reserve that tightens too much, or is it just a natural market response to Federal Reserve tightening, with long term rates weighed down by very low interest rates in Europe and Japan?

Since 1955, every single recession has been predated by an inverted yield curve, but not every inverted yield curve was a precursor to a recession[10]. Thus, we don't yet know how this turns out, but we'll continue to watch closely.

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Tarrifs

Fortunately, the recent boil over tariffs cooled down in April. Many countries received exemptions and White House Administration Officials are heading to China to negotiate an agreement on U.S. intellectual property and trade. Everyone acknowledges the significant risks associated with trade skirmishes and I'm hopeful that this meeting will be productive.

The other trade disruption of note, in April, was the sanctions placed on some Russian oligarchs and their companies. Rusal, the 2nd largest aluminum maker in the world, was singled out and the result was that the global supply chains for aluminum were dramatically disrupted. At their peak, aluminum prices in April spiked 30%, but the date to comply with the new sanctions was pushed back. Additionally, the head of Rusal has decided to step down[11]. As a result, during the month of April the price of aluminum increased approximately 15%

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Commodities

Rising commodities prices continue to drive projections for inflation higher. In addition to the wild moves in aluminum, we saw a spike in the price of nickel, while the price of copper was little changed. Oil prices continued to trend higher. Crude oil prices finished the month at their highest level since December 2014, and for all of us that drive, the national average price of a gallon of gasoline rose to $2.81, the highest level since November 2014[12].

The two main drivers of the rise in oil prices are the collapse in production in Venezuela, as their economy deteriorates further, and worries that ending the nuclear agreement with Iran could trigger a new round of sanctions and a drop in their production. This has, thus far, offset a continued rise in U.S. production that hit a record high in April of 10.5mm barrels per day. Global production is approximately 90mm barrels each day[13].

Also of note, agriculture prices moved to the highest level in 9 months. Corn, in particular, is at a 2 year high. It will not take long for the higher agriculture prices to impact the consumer on main-street, and when that takes place we may be in for changes to consumer sentiment, especially if they coincide with higher gasoline costs.

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Conclusion

In conclusion, considering the changing interest rate and monetary policy landscape I believe that investors will be more discriminating about their investments and far more sensitive to valuations and changes in fundamentals. Right now, I believe that economic fundamentals still remain pretty favorable and, in general, earnings reports have been solid. So far this year, the equity markets, overall, have delivered reasonably good performance, especially considering the drag created by the sharp rise in interest rates and an additional $90 billion of Federal Reserve liquidity removed from the financial system.

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