Monthly Commentary

May 2018

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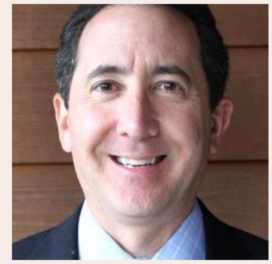

Market volatility across the globe persisted through the month of May. However, U.S. economic data and corporate earnings continued to improve, while economic indicators were somewhat less favorable internationally. As the result of some recent global economic calamity, investors sought safety in the sovereign debt of the U.S., Germany, France, and the U.K., leading to an unexpected decline in interest rates in these countries. As an example, the U.S. 10-year Treasury yield ended the month at 2.86%, after closing at a high of 3.11% mid-May (still up about 50 basis points year to date), and the German 10-year yield is back down to just .40%[1].

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As I mentioned in the April commentary, the market's reaction to news overseas is a byproduct of the shifting liquidity landscape. With the European Central Bank only a few months away from scaling back its Quantitative Easing program again, I expect to see more volatility in European bond markets over the coming quarters.

Equities and the Economy

First quarter earnings season in the U.S. ended impressively with earnings per share growth in excess of 20% (about seven tenths came from the tax cut), while companies recorded revenue growth of about 8%. The S&P 500 Index was up 2.2% during May and was up 3.1% year-to-date[2].

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After modest first quarter GDP growth of 2.2%, we're seeing growth accelerate during the second quarter. Currently, the consensus estimate is approximately 3% growth, with high-end estimates peaking 4.8% (if the Atlanta Fed is right).[3] This growth has helped U.S. small cap stocks the most, as they have the highest level of exposure to domestic demand.

So far in 2018, we have witnessed equity valuations come down as a result of price to earnings multiple compression in the face of higher interest rates. However, recent positive economic results in the U.S. has pushed back against the P/E compression and stabilized earnings multiples.

We are continuing to see inflationary pressures building across the economic landscape. Labor costs are rising, mostly due to the shrinking supply of labor relative to the still strong demand.

1,2 Bloomberg
3 Atlanta Federal Reserve

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This, of course, is great for employees, but could impact profit margins for companies. Additionally, higher transportation costs will make their way thru the supply chain in coming quarters, as companies attempt to pass on these higher prices to consumers. The consumer has the benefit of higher wages and lower taxes on one hand, but higher gasoline, higher interest expense on their credit cards, and a low savings rate on the other hand.

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International Economy

The complexity of the global economic landscape continues to deliver unexpected events and surprising results. The events of May included three such examples in Turkey, Argentina, and Italy. The Turkish lira plunged by 10% vs the U.S. dollar as worries about the growing dictatorship of President Erdogan combined with an economy that has a wide current account deficit and rising inflation (up 12.2% y/o/y)[4]. It took a 300 bps interest rate increase from the central bank of Turkey to stem the decline in the Lira in May.

In Argentina, the peso collapsed by 17% in May vs the U.S. dollar[5]. A wide current account deficit and rising inflation were the two main reasons. Recently elected President Macri just couldn't get ahead of the legacy problems he inherited from his predecessor and the market seems to have lost patience. The Buenos Aires Merval index closed down by almost 5% in May and it took a rate hike to 40% in short term interest rates from their central bank that finally stemmed the decline in the peso[6].

While most of us don't think or worry about what is going on in Turkey and Argentina, the news and market behavior in May resulted in a reconsideration of all emerging markets, many of which have had nice appreciation since 2016. Long term, I remain positive on emerging markets, but lean more towards those in Asia.

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Italy was front and center as well. The Italian 2-year yield began the month well below zero at -.30% and got as high as 2.84% on May 30th[7]. As of this writing it has fallen back to +.91% but still well above those early month lows. [8] Most of this volatility has been driven by political discourse stemming from the formation of the new coalition government between the Northern League and Five Star Movement. Concerns over the populist policies promoted by these parties could threaten European Union budgetary rules – of which Italy is already perilously close to breaking.

4-8 Bloomberg

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Commodities

Commodity prices, particularly oil, experienced significant swings in May. West Texas Intermediate crude started the month at about $68.5 and got as high as $72.35.[9] After the Saudi's and Russian's unofficially decided to increase production, oil prices fell back near $65[10]. The U.S. consumer can use some relief here as gasoline prices have jumped by 18% year to date[11].

Conclusion

The US stock market begins June little changed for the year which should be considered a good performance in the face of the sharp rise in interest rates that we've seen year to date. As we get deeper into the monetary tightening both in the US and abroad, the heightened volatility is just something we have to get used to. Again, 2017 was the anomaly on that front.

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9,10 AAA
11 Bloomberg

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