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Quarterly Commentary – 1st Quarter 2018

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What just happened?

As the first quarter of 2018 has come to a close, now is a good time to catch our collective breath and assess "what just happened" during the first quarter of the year. We'll then walk through some of the trends we feel may impact the period ahead.

If you closed your eyes on January 1st and didn't open them until March 31st you might think you hadn't missed much. After all, the S&P 500 was basically little changed, down 1.2% year to date[1]. For those of us who 'stayed awake,' we experienced enough market whiplash to prove a 1.2% decline doesn't actually reflect the whole story. In contrast to the historically placid 2017, the first quarter of 2018 has brought a significant return to market volatility.

The stock market, as measured by the S&P 500 Index, had an incredible start to the year, rising 7.4% in just the first 18 trading days[2]. But, by late January, the slow burn of rising interest rates that started last September finally garnered investor's attention, and a quick correction of about 12% ensued[3]. We learned quickly that a new investing landscape was upon us.

This commentary will focus on breaking down the key drivers behind what happened across the markets and economy in Q1 2018, and review why these themes may continue to influence performance over the next few quarters:

Key Factors to consider:

- The return of market volatility
- Persistent rise of interest rates
- Trump, Trade & Tariffs
- FAANG & the extended valuation concerns

A sharp change in volatility

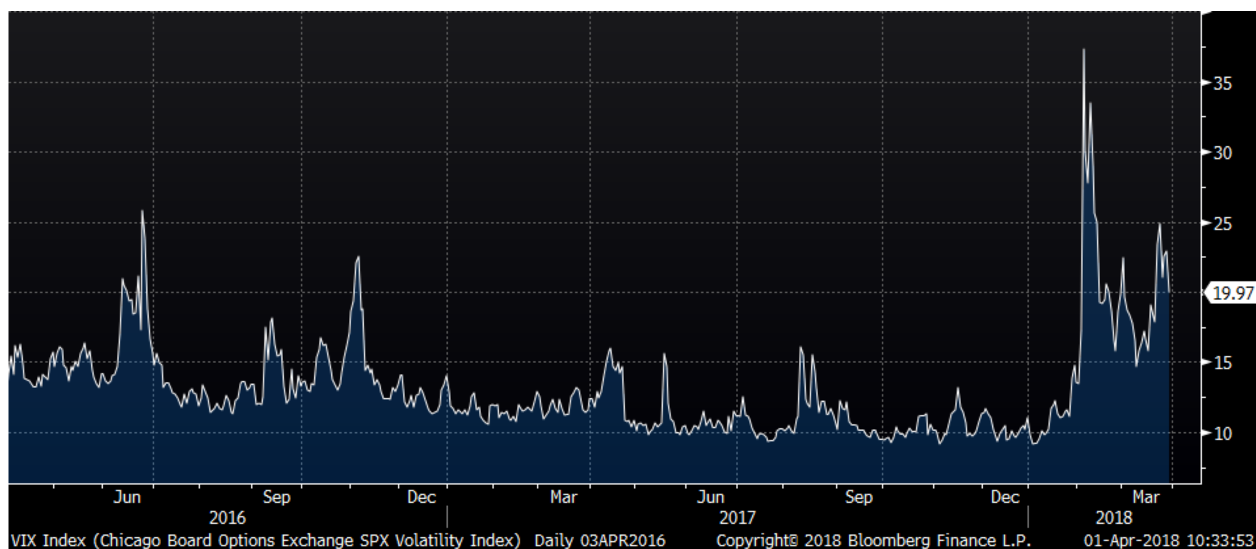
In order to give context to the market fluctuations that have occurred over the past 3 months, it's important to recall just how calm U.S. equity markets were in 2017. Over the full 12 months of last year, the S&P 500 Index only had 8 trading days where it moved more than 1% up or down. This is in sharp contrast to the first quarter of 2018 when there were 23 trading days where the S&P 500 moved at least 1% up or down[4].

So, what just happened? Looking back at the data, volatility really started to accelerate after the 10 year U.S. Treasury yield breached the 2.70% level. After closing 2017 at 2.40%, it only took a 30 basis point increase in yield to trigger the unwinding of a massive set of short volatility trades across the industry, valued at over a trillion dollars. In gambling parlance, a whole lot of people bet the under on volatility, and lost! This sent negative ripples to many corners of the market, and as you can see in the chart below, spiked the volatility index (known as the VIX) to a high of 50 in February, before settling around 20 at the end of this quarter.

While we can't predict how long this period of increased volatility will continue, there are a few things everyone should keep in mind as we ride it out:

- Volatility, as measured by the VIX, is only back to its average level over the past 25+ years.
- Investors tend to make emotional decisions during volatile market stretches. It's easy to get caught up in the daily or weekly fluctuations of a particular index. These emotions are typically amplified when individuals are approaching, or are in, retirement. The key antidote is to have a well thought out plan with your advisor, seek to mitigate risk, and to adhere to the plan with discipline.

TWO YEAR VIEW OF THE VIX[5]



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Higher Interest Rates

The rise in interest rates was an important factor in the change in market complexion, and not just the rise in long-term interest rates. Over the past six months, short-term interest rates as measured by the 2 year note yield and

LIBOR increased by approximately 100 basis points[6]. On March 22nd, the Federal Reserve increased the Fed Funds rate by 25 basis points to the level of 1.50% - 1.75%. This was the 4th rate increase since the start of 2017, and we expect two more rate increases this year. Also of note, the Fed's balance sheet shrunk by $60b in Q1, after shrinking $30b in the Q417, and that shrinking will continue to increases to $90b in the second quarter of this year[7]. We believe the trend in interest rates will continue higher.

Tariffs

There are two additional developments that occurred during the first quarter that resulted in a reassessment of market risk on the part of investors. The first was the imposition of tariffs by the Trump administration, with the threat of more of them still on the table. In January, the Trump administration first instituted tariffs on washing machines and solar panels. This was then followed, a few weeks ago, by new tariffs on steel and aluminum and then with a round of $50 billion worth of additional taxes specifically against a variety of Chinese products. Fortunately much of the steel and aluminum tariffs were walked back because, after all, the main target of Trump's trade ire is towards China, its theft of US intellectual property, and its large trade deficit with us. The former is a legitimate worry, the latter is not. Either way, the markets never like 'trade wars' or 'battles' or 'skirmishes' of any kind. This is now an ongoing part of the macro landscape and China immediately responded in kind to our latest move. This all said, we remain hopeful that a resolution can take place in terms of U.S. Intellectual Property, and that everything we've seen so far is just a messy form of negotiation.

The Nifty Few driving markets

Just as we saw in the early 1970's with the Nifty Fifty, and again in the late 1990's with technology stock, and again in the mid 2000's with bank stocks, over the past few years a small group of a few select companies were among the main drivers of the market indices. Of course, we're talking about Facebook, Apple, Amazon, Netflix and Google (FAANG). These companies achieved extraordinary heights in terms of business dominance, growth, valuation and the adoration of investors. Tech, at its peak, became 25% of the S&P 500, an outsized level relative to history (but still below where it was in 2000)[8]. Things started to change in Q1, as a reassessment of this group of companies began. Facebook had a few privacy issues, Amazon faced a Twitter storm by President Trump, and Tesla, another long-time market darling, ended the quarter under greater scrutiny (in stark contrast to the high praise Elon Musk has long been given). With the outsized gains in these stock's prices over the past few years, and the hyperextended valuations that came with it, this was likely an overdue correction for a group of companies that became incredibly expensive.

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[6] Bloomberg
[7] www.federalreserve.gov
[8] Bloomberg

The Economy

We are now approaching the longest economic expansion in history. The U.S. economy likely ended the first quarter with a growth rate of approximately 2% - 2.5%. This is not yet the 3% we've all been rooting for, especially in light of the tax reform now in place[9], but steady nonetheless. Global growth has been favorable, as the European economy is expanding at its best rate since 2007, and Asia continues to chug along. This implies that, in reaction to the favorable results, central banks will continue on the path to a less accommodative policy. This theme will be with us in the coming years, as fiscal tailwinds battle with monetary headwinds.

Inflation also is ticking up and is something that I'm watching closely.

In the coming weeks, we get to see Q1 earnings, which should be very good, as about half the gains will be due to the drop in the corporate income tax rate. Notwithstanding the new uncertainty on trade, business confidence remains high in response to more competitive taxes and regulatory relief.

Bottom Line

Of all the factors discussed, we believe the changing interest rates and central bank balance sheet landscape is the main culprit for the more challenging investment environment, and the main reason for the sharp uptick in volatility. In this context, corporate valuations and business fundamentals are therefore under greater scrutiny. Tariffs, and the chinks in the armor of our stock market leaders don't help, of course, but we're hoping it is more noise than anything substantive. We must recognize, understand, and acknowledge the factors driving a more volatile stock market, but also focus on the factors that we can actually control: Having a Plan, Acting with Disciple, Exercising Patience, and Maintaining a Long-Term Perspective.

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[9] Bloomberg