STRATEGAS

insight

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After Early 2018 Volatility Roller Coaster, What To Look Forward To

After a sharply higher start to the year and a marked increase in volatility from early-February to mid-March, equity markets appear to have settled out in April. The global economy in general, and the US economy in particular, appear to be in healthy shape with few, if any, discernable signs that a material slowdown or recession is imminent. Advisors should note that global activity gauges (e.g. Purchasing Managers Index or PMIs) are softening, but from extremely elevated levels. (It is easy to forget that readings above 50 mean the economy is expanding.)

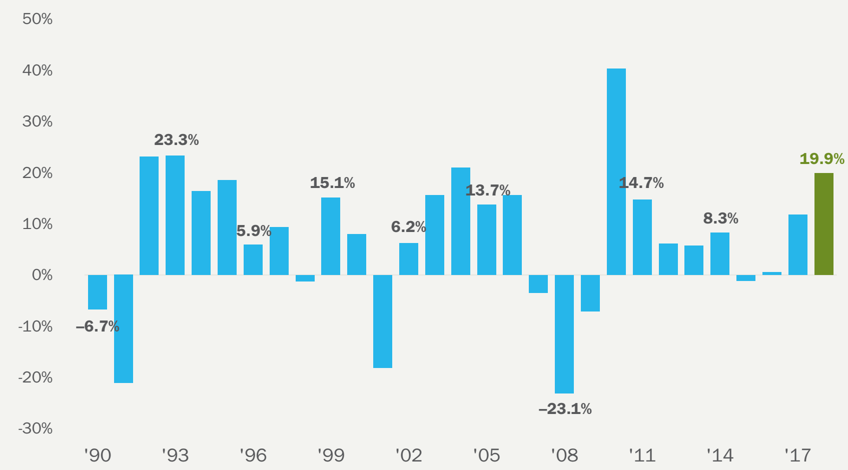
Despite the fact companies are in the midst of reporting earnings results for Q1 2018, macro issues dominate the headlines and investors' mindshare. Fears of a global trade war have increased notably with the Trump Administration's announcement of tariffs on a battery of Chinese goods. Concern, by our lights, appears misplaced—or premature—given the "small" nature (US$50-$100 billion) of the levy relative to the size of annual US-Sino trade (US$710 billion) and the increased probability of a negotiated outcome between the two countries before the tariffs would be put into effect (currently slated for June).

In addition, investors after a period of optimism appear to have discounted the impact of the nearly $800 billion tax and spending package passed last December. Many investors have worried that should companies choose more capital spending or investment now, then their stock prices would come under pressure near term. If the US economy proved unable to accelerate, substantial future debt issues likely loom—and the US Dollar would weaken, perhaps considerably, over time. By our lights, this is a big "if," but it likely

Global PMI: Composite Output

Source: Morningstar

S&P 500 Annual EPS Growth (%)



Source: Morningstar

explains why investors seem to have an impatience to see the capital spending in the US data. Corporate financial planning & analysis (FP&A) is a methodical process and companies are just starting to digest the impacts of the tax plan.

It is also worth highlighting that consumers only began to evidence the positive impact of lower taxes in their paychecks in the second half of February (or early March in some cases) and this increase in take-home pay should lead—as it has historically—to increased spending. A modest off-set from rising oil prices is worth noting. Crude has hovered recently near $70, a price last seen in 2014 when crude was in decline. It helped that the US economic data has been reassuring of late. The leading indicator continues to rise. Jobless claims remain low. The consumer remains a workhorse with retail sales up +0.6% month over month (m/m) in March. US industrial production rising +0.5% m/m shows momentum. Housing continues to take two steps forward and one back with an increase in housing starts in March (and homebuilder sentiment remains elevated).

The lifeblood of stock prices are earnings and interest rates. The recent back-up in rates, particularly the London Inter-bank Offered Rate (LIBOR), does not appear to be overly problematic now. The US Federal Reserve (Fed) has been given "cover" to continue their program of normalizing interest rates. It is tough for the Fed to put the economy in harm's way while raising interest rates inside the pace of inflation and against a weak US Dollar. Today, the "real" Fed Funds rate remains close to zero. Monetary policy remains broadly accommodative. Advisors should, however, make the flattening of the yield curve a focus data point as the economy waits for the positive impacts of capex and consumer spending.

Corporate profits in Q1 are sharply higher year over year (Y/Y) (+22%) and are expected remain strong over the balance of the year given the large tailwind from tax reform. Stock prices, in the aggregate however, may already have largely taken this into account. While increased productivity will provide the longer-term boost to earnings, in the near-term investors need to be mindful of companies' ability to: 1) grow revenues; and, 2) manage costs. The Producer Price Index—the PPI is what producers pay—is now increasing at a faster pace than the Consumer Price Index—the CPI is the price consumers pay. This has created an environment supportive of active share. We are of the opinion that superior operating entities will pull away from the pack while marginal operators will struggle. While the broader indexes may remain range bound, or slightly higher, dispersion between winners and losers is already widening.

In terms of sectors, Financials, Industrials, and Energy appear favorable. Additionally, we would consider Value over Growth, and small and mid-cap shares relative to large-caps domestically.

Data Privacy. One issue still in its infancy for investors is encompassed by the potential for the heightened regulation of technology companies and data privacy. However, despite the testimony (and spectacle) of Facebook CEO Mark Zuckerberg's testimony to the US Congress in mid-April—and the President's Twitter assault on Amazon—Europe appears to be in the driver seat on this issue. Irrespective of where movement is initiated, Facebook and its "FANG" acronym cousins Amazon and Google (parent company Alphabet), appear directly in policymakers' crosshairs on both sides of the Atlantic. Interestingly, for all of the hand wringing over increased regulatory scrutiny, few investors we've spoken to are willing to "give-up" on the forecast of continued growth from the sector. In an environment where "the economy may outperform the stock market" the profitability and price performance of FANG (Facebook, Amazon, Netflix and Google -now Alphabet, Inc.) shares have been important contributors to Index performance and a boon to the passive management argument. To the extent increased attention from regulators casts a longer shadow on the group, another window may be opening for active share to outperform.

International Issues. The most important "international" issue for investors to be mindful of is on the trade front. It is not atypical for attentions to turn to trade in the second year of an administration as domestic pieces of the agenda dominate year one (taxes) and as the Trade Representative's office becomes more fully staffed. The Administration has made trade a central issue of their agenda moving forward and the announcement of US$50 billion in tariffs aimed at China (and an indication of a further $100 billion) was immediately countered by the Chinese with a list of potential tariffs on US goods and services ranging from agriculture and chemicals, to vehicles and whiskey. However, a recent speech by China's president, Xi Jinping, opened the door to high level negotiations between the two countries in advance of the tariff implementations and, as a show of good faith, a further opening of the Chinese economy, decreasing tariffs, protecting the intellectual property of foreign firms, and improving the investment environment. The Chinese economy is likely slowing, but not crashing, as it rebalances from goods to services and has made similar pronouncements in the past and the president will be looking for real concessions this time.

Advisor Takeaway:

The positive impact of the tax cuts may dwarf any of the potentially harmful impacts of tariffs. For this reason, and given the general health of the US economy, we think there could still be plenty of time in this economic cycle and the bull market.

Most sophisticated investors have been taught that tariffs are irrational and globally mounting trade tensions are generally viewed with unease. It could be argued that a trend has emerged in the Trump era in which major, and often controversial, policy pronouncements are made by the President only to be scaled back and diluted toward a more equitable (and far less controversial end point) when the deal is done. Perhaps, from the vantage point of a man whose approach to business was broadly formed in the New York real estate market, this is the "art of the deal" Regardless, a true case in point is the President's hard public line on the North American Free Trade Act (NAFTA), juxtaposed with the steel tariff exclusions for both of our North American trading partners. The Administration was looking to announce a deal in principal on NAFTA negotiations by the end of April. (If an agreement is not reached on this timeline, further negotiations will likely be put on hold as to not conflict with the Mexican general and US mid-term elections later this year.)

Beyond Trade, the lion's share of investors' attentions are being trained on the—at least momentary—cooling of tensions on the Korean Peninsula and the impending summit between US president Donald Trump and North Korean leader Kim Jong Un. While relations between North Korea and the West have long been volatile—each of the last three US administrations have made progress toward peace and denuclearization only to see talks break down and promises broken. There remains skepticism on the eventual outcome of this round of talks. A "peace dividend" might be premature, but any erosion of tensions with North Korea is a positive for global equity markets.

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