Market Commentary

March 14, 2018

This month we wanted to share a piece with you written by our fellow Investment Committee Member Scott Welch, CIMA®, Chief Investment Officer of Dynasty Financial Partners.

"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

If You Can Keep Your Head…

If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you…

("If", by Rudyard Kipling, 1910)
**Please see full poem located at the end of this market commentary*

We suspect many people are at least passingly familiar with the first line or two of Rudyard Kipling's classic poem "If" but rarely, if ever, have read the whole thing or thought about its context. It was written as an ode of paternal advice from father to son, and in honor of the heroism and stoicism of a British mercenary who lead a *losing* raid against the Boer government in South Africa – a raid that ultimately lead to the second Boer War (1899 – 1902). So, to be clear – the protagonist was a *mercenary*, he *lost*, and his actions led to a *war*. Clearly, he deserved a poem written in his honor.

But the market actions of late January and early February brought this poem to mind, as panic (briefly) overtook the markets, and it clearly was critical to "keep your head when all others about you were losing theirs."

A few contributory factors to the market decline include:

1. There were signs that inflation was finally rearing its head – wages were increasing and commodity prices had risen with the dollar's continued slide.

2. Investors reacted by selling off Treasuries and driving interest rates up. This caused equity prices to drop because future cash flows were being discounted at a higher rate.

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3. Short-term interest rates rose to levels that were higher than the dividend yield on the S&P 500 – so some investors naturally rolled out of stocks (to lock in gains), de-risk their portfolios, and reallocate back into fixed income now that they could generate a positive return.

4. The market witnessed a "great unwind" of leveraged "short volatility" positions — a vicious cycle of forced selling driving volatility higher, forcing more selling, driving volatility higher, lather-rinse-repeat.

In early February, I suggested, "*Given the underlying economic and earnings environments, we expect this to be a temporary slide. Maybe not a V-shaped bounce back (though it wouldn't shock us), but we don't expect the free-fall to continue – we think the professional investors will come back in if levels fall too much further*."

Well, what we witnessed over the remainder of February more or less bore out our expectations. The market did regain its footing over the course of the month and, as of February month-end remains in mildly positive territory year-to-date. All that really happened in late January and early February is that the market gave back the incredible (we might argue "stupid") rally we had through the first three weeks of January.

We view the events of late January and early February as healthy – the final "death spasm" of market reliance on central bank policy, and a return to more normalized market conditions – volatility returns, earnings and fundamentals matter, and a reminder that stocks can go down sometimes as well as always up.

Current Economic & Market Landscape

- Despite market volatility, the global economy remains solidly positive right now:

    - US Q4 2017 GDP estimates remain at 2.6%, and Q1 2018 estimates are at 2.9%, with Q2 estimates rising to 3.0%. Economic expansion is expected to slow down after that, however, and the consensus estimate for all of 2018 is 2.3% (source: *The Wall Street Journal*). The ultimate impact, however, of (a) the tax law changes, (b) any potential infrastructure deals ending up on the President's desk, and (c) the outcome of the recently announced tariff policies all could dramatically change the economic outlook for the US over the remainder of 2018;

    - Both the US manufacturing and services sectors remain well in expansionary mode – the ISM manufacturing index came in at an incredible 60.8 in February (up from 59.1 in January), and the non-manufacturing index is at 59.9 through January; anything above 50 is considered expansionary;

    - Inflation fears were a primary driver of market volatility at the end of January and the beginning of February, the result of higher reported wages and higher commodity prices (driven partially by a weak dollar). But it is hard to see what the fuss is about. Through January, the US CPI hovered around 2.1% -- higher than the previous few years, to be

sure, but still directly in line with the Fed target of 2.0%. *TradingEconomics* anticipates a CPI level of 2.5% by year-end 2018 – higher than previous years but hardly high by historical standards. What this seems to be, in other words, is a change in market sentiment to the historical market "narrative" of "lower for longer". We would be glad if the market returned to more "normal" expectations regarding interest rates and inflation – the risks are (1) that they rise faster and higher than expected (which we view as unlikely), or (2) that the Fed over-reacts and raises rates more quickly than needed, thereby choking off economic expansion in the face of only "normal" inflation levels;

- With the preponderance of S&P 500 companies having reported for Q4 2017, corporate earnings are up an astonishing 14% YoY, on an 8.2% increase in revenues. The earnings and revenue "beat rates" (i.e., actual performance coming in better than estimated) are 77.2% and 76%, respectively, both well above historical averages. We remain especially pleased with the upward trending capital investment spending (source: *Zachs Earnings Report)*;

- The Eurozone Q4 2017 GDP growth rate was a solid 2.6%, and 2.5% for all of 2017 – very solid given Europe's troubles in the aftermath of the financial collapse of 2008. That growth rate is expected to taper slightly through 2018, and the consensus estimate for the year is 1.9% - 2.0% (source: *TradingEconomics*);

    - Manufacturing all across the Eurozone remains solidly expansionary, with the Markit manufacturing index falling slightly to 58.6 in February from 59.6 in January 2018. Likewise, the Services index fell slightly from 58.0 to 56.7 from January to February (anything above 50 is expansionary) (source: *TradingEconomics*);

    - Unemployment fell to 8.6% in January 2017, a 9-year low, and annualized inflation through January came in at 1.2%. Expected inflation for all of 2018 remains under 2.0%, another reason we simply do not see a major inflation spike in 2018 (despite market fears) (source: *TradingEconomics*);

    - ECB Mario Draghi wants to taper his quantitative easing program, but remains frustrated by low inflation rates and a strengthening euro (or, perhaps more accurately, the continued weakness of the US dollar);

- Japan's Q4 GDP expanded 1.5% (annualized), and represented the eighth straight quarter of positive GDP growth. The consensus estimate for 2018 GDP growth is 2.3% - 2.4% (source: *TradingEconomics*);

- China's (official) growth rate for Q4 was again stable at 6.8%, slightly lower than (official) estimates. (Official) estimates remain that the Chinese economy will slow slightly in 2018, down to 6.4 – 6.5% (source: *TradingEconomics*).

Economic & Market Outlook

- The global economy is growing, though an economic slow-down (not recession) is expected in the second half of 2018. The wild cards are the longer-term effect of (a) the recently enacted US tax law changes, which so far have been stimulative to short-term expansion; (b) uncertainty over the enactment of infrastructure spending in the US (we are doubtful), and (c) the ultimate outcome of Trump's recently announced trade tariff policy, which we view as potentially harmful to continued global growth;

- Manufacturing in particular remains expansionary in most major regions of the world, though it appears to be slowing down slightly;

- Somewhat to our surprise, the US dollar remains weak. We believed that an expanding US economy and tightening of Fed policy would stabilize or strengthen the dollar, but investment flows, anticipation of an ultimately slowing economy, and negative real rates in other parts of the world continue to drive the dollar downward;

- Inflation is a question mark. The market seem to be anticipating an unexpected spike in inflation, as wages and dollar-based commodity prices increase, but we just don't see it. Inflation may (probably will) rise, but (we believe) not to levels that should impact economic expansion;

- The primary risks to an otherwise generally positive economic outlook are (1) Trump's announced trade policy, which we fear may trigger a global counter-response (and no one wins in a trade war, especially consumers); (2) geo-political events (specifically North Korea), though we view that risk as minimal, especially following the "good feelings" of the recently concluded Winter Olympics in South Korea; and (3) that the Fed acts too soon in raising rates and chokes off the expansion (New Chairman Powell's recent public commentary seems to minimize this risk);

- The consensus view remains that, barring unforeseen events, the Fed will seek to raise rates 3-4 times in 2018;

- We remain in somewhat "uncharted waters" as Trump seems intent on piling on fiscal stimulus in the midst of an already expanding economy – it is working, but the inflationary and deficit impacts may have significantly detrimental longer-term affects;

- Solid GDP, earnings, and revenue growth, combined with low (but rising) rates, make for a positive market environment likely to continue through at least the first half of 2018, but even with the sell-off in late January, equities still look expensive to us;

- Market volatility spiked for a variety of reasons in late January and early February, but seems to have calmed down as panic subsided and the "short vol squeeze" unwound itself. Many investment strategies benefit from rising interest rates and "normal" market volatility, so investors should view this "return to normalcy" as a net positive, even if day-to-day fluctuations require recalibration of investor sentiment;

- EM and EAFE markets continue to have better valuations than the US (though they are by no means cheap). The USD trend is the wild card for US investors – should the recent slide continue, it will provide a nice currency tailwind to non-US returns for US investors;

- The US yield curve remains fairly flat (~60 bps between the 2-year and 10-year yields), but we believe the risk of inversion has abated, as lower longer-term growth rates and technical investment flows compete with higher inflation expectations on the long-end of the curve. We do expect rates to "grind higher" over the course of 2018;

- At these rates and credit spreads, the public credit markets still look very expensive to us, though coupons are probably safe as corporate balance sheets are in good shape. Several of the "opportunistic credit" managers we follow have begun to "de-risk" their portfolios in anticipation of rates and/or spreads widening back out from current levels;

- For investors who can access the private markets and handle some degree of illiquidity, we still believe there are better opportunities in the private markets versus the public markets, though investors face compressed premiums versus historical levels, driven by huge investment flows over the past 18-24 months;

- As was true in 2017, we believe 2018 should continue to be constructive for alternative investments. We continue to believe that hedge funds generally will deliver superior performance than their liquid alternative brethren, because of less liquidity and leverage constraints;

- We continue to believe that increased volatility and increased dispersion between individual security prices should result in better opportunities for active management;

- Global commodity supply continues to exceed demand, but a falling dollar, should it continue, will benefit the real asset complex;

- While we generally are constructive on the global economy and overall market performance, the public markets are not cheap. While we see little reason why the current market rally cannot continue for the next 3-4 months (though with the key difference of a return of more "normal" market volatility), we also believe that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.

We believe that the abbreviated market disruption was a result of over-exuberance in early January and the natural unwinding of unnatural underlying market conditions. We close with fairly consistent advice, which very well might be a wealth management paraphrase of Kipling's classic poem: "Stay calm, let others panic, stay diversified, don't try to trade volatile markets, and keep your time horizon in synch with your financial plan."

Sincerely,

Brad Griswold	Sean Linder, CFA	Will Velekei, CPA, CFP®
Managing Partner	Financial Advisor	Financial Advisor

If You Can Keep Your Head…

If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you,
But make allowance for their doubting too;
If you can wait and not be tired by waiting,
Or being lied about, don't deal in lies,
Or being hated, don't give way to hating,
And yet don't look too good, nor talk too wise:

If you can dream—and not make dreams your master;
If you can think—and not make thoughts your aim;
If you can meet with Triumph and Disaster
And treat those two impostors just the same;
If you can bear to hear the truth you've spoken
Twisted by knaves to make a trap for fools,
Or watch the things you gave your life to, broken,
And stoop and build 'em up with worn-out tools:

If you can make one heap of all your winnings
And risk it on one turn of pitch-and-toss,
And lose, and start again at your beginnings
And never breathe a word about your loss;
If you can force your heart and nerve and sinew
To serve your turn long after they are gone,
And so hold on when there is nothing in you
Except the Will which says to them: 'Hold on!'

If you can talk with crowds and keep your virtue,
Or walk with Kings—nor lose the common touch,
If neither foes nor loving friends can hurt you,
If all men count with you, but none too much;
If you can fill the unforgiving minute
With sixty seconds' worth of distance run,
Yours is the Earth and everything that's in it,
And—which is more—you'll be a Man, my son!

("If", by Rudyard Kipling, 1910)

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