Market Commentary

June 12, 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)

Things just got interesting – maybe. It is hard to write anything definitive given how quickly events are unfolding. Investors were taking turns being spooked by possible trade wars, cancelled (but now rescheduled) Korean denuclearization summits, and elevating unrest in the Middle East. The US market continues its volatile tug-of-war between heavy fiscal stimulus and tightening monetary policy. Interest rates and the US dollar finally started to act the way we've been expecting them to (rising and strengthening, respectively), causing a "risk off" run in many EM assets.

And then along came Italy. The populist and left-leaning 5 Star party attempted to form a government with the nationalist, anti-establishment, and right-leaning League party (with both parties being anti-Eurozone), only to see the Italian President Sergio Mattarella block that formation and reject the coalition's choice for Economic Minister (Paolo Savona, who was viewed as being far too much of a Eurosceptic). Those two parties will now try to re-form a workable coalition, or Italy will need to have new elections, and the concern is that populist and/or anti-Eurozone activists will gain power. As Europe's third largest economy (behind Germany and France), the thought of Italy leaving the Eurozone is simply intolerable to the markets, and they reacted violently.

At the root of the problem is Italy's declining economic, fiscal, and banking health, driven by the effects of massive immigration, a *de facto* voluntary tax system, a bloated entitlement state, and widening gaps in wealth and prosperity between the relatively wealthy North and the poor South. The fear was that the new coalition government would seriously consider leaving the Eurozone in order to get out from under the economic guidelines and constraints that Zone members must adhere to (specifically, acceptable budget deficits).

But let's slow down a little. It is interesting to note that while *short-term* Italian bond yields spiked, the increase was not nearly as dramatic in *longer* (i.e., 10-year) yields, suggesting that investors put a low probability on Italy actually exiting the Eurozone. Further, even as we write this, the markets have rebounded, seemingly believing this to be a short-term phenomenon but perhaps not a long-term problem. A majority of Italians in a recent poll favored remaining in the Eurozone and, with the exception

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of “Brexit”, the nationalist/populist movement in Europe has lost traction in most countries. Finally, the awkward 5 Star – League coalition seems to be making progress toward actually forming an acceptable government; if successful then no new election will need to be held.

Italy is notorious for its inability to maintain stable governments (averaging one change in government per year since the end of World War II), so the 5 Star – League government is unlikely to be able to implement such a massive change as leaving the Eurozone before the already tenuous coalition falls apart (assuming it forms). Germany, France, the ECB, and the IMF will exert *massive* pressure on Italy to remain in the Eurozone, undoubtedly taking a similar “stick and carrot” approach as when dealing with Greece a few years ago.

Finally, since the initial Greek/Southern Europe crisis, the Eurozone is economically more healthy and the ECB has implemented several policy tools (e.g., the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)), that would provide at least a partial “firewall” should the Italian situation spin out of control.

We simply don’t view this as a long-term risk, at least based on what we know now. Things can always change for the worst, but we believe cooler heads will prevail (we feel the same way about the zigzagging US trade negotiations, though those currently seemed headed in the wrong direction as well). Short-term volatility may make investors uncomfortable but we believe the ultimate outcomes will be tolerable.

A more nuanced question revolves around the effect on central bank policy. The ECB President Mario Draghi wants to begin tapering the ECBs quantitative easing program, and the belief was that, with the Eurozone economy fairly stable and the euro finally weakening versus the US dollar, he would perhaps begin to do so in September. He now likely will be forced to wait, at least until the political outcome in Italy is more clear (perhaps as early as late July, but more likely to be September or October).

The Fed has a different problem. It has signaled strongly that it wants/plans to raise rates again in June, and then perhaps again in September, and the disciplined unwinding of the Fed’s balance sheet continues as planned. But the US yield curve is very flat (with only ~50 bps difference between the 2-year and 10-year Treasury rates), and as the Fed raises the short-end of the curve while “flight to quality” investment flows drive down the long-end, it may find itself in the unwanted situation of generating an inverted yield curve. The market would probably not react well to that, as inverted yield curves are sometimes a harbinger of impending economic recession (with a 12-18 month time lag).

We don’t see this as a meaningful risk, as the underlying reasons for an inversion, should it occur, will have more to do with investment flows versus signaling a weakening economy, and investors should be able to understand that. But even though we view the current market volatility and uncertainty as, frankly, a healthy return to more “normal” market conditions, there is no question that navigating the markets has become more difficult for investors and central bankers alike.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic Landscape

Despite significant recent market volatility, the global economy remains reasonably positive right now:

- Q1 GDP growth in the US came in at 2.2% (down slightly from earlier estimates). GDP growth is expected to accelerate through Q2 (3.2%) and Q3 (3.1%) before slowing in Q4 (2.9%), bringing the consensus estimate for all of 2018 to 2.8% (source: *The Wall Street Journal*);

- There is uncertainty regarding this forecast, however, as the ultimate impact of the tax law changes and the outcome of ongoing trade negotiations could dramatically change the economic outlook for the US over the remainder of the year. Specifically, current trade negotiations seem to be taking a protectionist-leaning turn for the worst, as the Trump administration seems increasingly resolved to impose tariffs on both Europe and China –actions that would almost certainly result in retaliation policies that would affect both inflation and global growth;

- Inflation (as measured by CPI) rose 2.5% year-over-year in April, in line with market expectations and tracking slightly above the Fed target of 2.0% (source: *TradingEconomics*).

- We believe inflation will continue to tick up but that it does not yet constitute a primary risk to economic growth. Further, we believe the Fed will allow inflation to run slightly "hot" before stepping in more aggressively;

- The consensus estimates are that the Fed will raise rates at least two more times in 2018, in June and then again September. This may change depending on what unfolds with the situation in Italy and with the outcome of current trade negotiations – negative turns of events in either area may slow down the planned steady tightening initiatives;

- Interest rates were "grinding higher" through April and May, with the 10-year Treasury rate breaking through the mental barrier level of 3.0%. There was then a significant reversal in late May back to yield levels not seen in several months because of the Italy-induced "flight to quality". We continue to believe rates generally will inch steadily higher, with periodic reversals during market disruptions;

- The US dollar, after weakening through the first quarter; strengthened through April and May, accelerating as the Italian situation unfolded. We believe the dollar will continue to strengthen through 2018, as the US economy, interest rates, investment flows, and inflation all pick up steam (source: *TradingEconomics*);

- With almost all US S&P 500 companies having reported, first quarter earnings were up a whopping 24.2% year-over-year, on an 8.5% increase in revenues. While this is very positive, expectations are for stabilizing or slightly decelerating earnings as we move through the remainder of 2018 (source: *Zachs Earnings Report*);

Economic & Market Outlook:

- The global economy continues to expand, though there are distinct signs of slowing. Further economic slow-down (though not a recession) is expected in the second half of 2018. The consensus expectation is that the US will not see a recession until later in 2019 or perhaps even 2020 (barring exogenous events);

- We remain in somewhat "uncharted waters" from an economic policy perspective, as heavy fiscal stimulus in the US battles against tightening monetary policy. So far, fiscal stimulus appears to be winning the tug-of-war, but the longer term impact on deficits and inflation remain unknown. We believe this is at least a contributing factor to ongoing market uncertainty and volatility;

- Despite market turbulence and investor uncertainty, solid GDP growth and solid earnings and revenue growth make for a generally positive market environment, and we still think stocks can end the year higher than where they began. However, decelerating earnings growth and rising interest rates may combine to push valuations down and volatility up;

- Market volatility will also be affected by ongoing geopolitical uncertainties regarding trade negotiations, Italy, the Middle East, the Korean peninsula, and now Spain, which recently ousted market-friendly Prime Minister Mariano Rajoy on corruption charges, and replaced him with Socialist Pedro Sanchez;

- EM and EAFE markets continue to have better valuations than the US, but the strengthening US dollar and a "risk off" mentality has hit EM hard recently via significant investment outflow. We still like EM and EAFE as longer-term positions, but investors may be headed into increased volatility;

- The US yield curve remains flat (there is currently ~50 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates and technical investment flows compete with higher inflation expectations on the long-end of the curve, but we believe the risk of inversion is low. We do expect rates to "grind higher" over the course of 2018, barring further market corrections and a corresponding "flight to quality" response from investors

"Sell in May and go away" has always been one of our least favorite market clichés – it strikes us as lazy-minded. The fact that is has "worked" in the past seems to us to be the poster child for the expression *post hoc, ergo propter hoc* (i.e., just because B followed A does not mean that A caused B).

But as we head into the summer of 2018, that advice sure looks tempting, as market conditions look to be challenging for the next couple of months, to say the least. Ultimately, however, we believe the more prudent approach, as almost always, is to remain calm, stay diversified, keep your investment time horizon aligned with your long-term financial objectives, and pay attention.

Sincerely,
The Corbenic Partners Team

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