Equity Market Update

As of March 31, 2018 / Volume 7, Issue 1 / FFTAM.COM

The stock market took investors on a wild roller coaster ride in the first quarter with not much return to show. In January, stocks zoomed to all-time highs as investor optimism over newly enacted tax cuts made its way through the markets. In February, stocks ended their historical run of 15 consecutive months without a decline on concerns about inflation and the potential for more Fed rate hikes. Selling intensified in March as traders fretted about a looming trade war between the US and China. Technology stocks also fell after a *New York Times* story revealed Facebook had allowed a third party to obtain personal information on 50 million of its users. With investor enthusiasm waning, the upcoming earnings season takes on heightened importance.

The S&P 500 declined 0.76% in the first quarter, its first quarterly decline since 2015. The index peaked on January 26th but was able to remain in positive territory until March 22nd. Volatility has been high since early February as trading sessions with moves of at least 1% in either direction becoming the norm. Technology and consumer discretionary were the only sectors to have positive performance.

The results were similar for the Dow Jones Industrial Average. It lost 1.96% in the first quarter. Large weights in Boeing, 3M and Caterpillar hurt the index as political spats over trade intensified.

The NASDAQ was the only large cap domestic index to experience a positive total return in the quarter. It gained 2.59%, despite falling almost 3% in March. Sharp gains in ecommerce, internet portals and semiconductors have enabled the NASDAQ to outperform the S&P 500 and Dow. However, like the S&P 500, the NASDAQ continues to get the lion share of gains from only a few companies.

Despite corporate tax relief finally going into effect, shares of mid and small-sized companies finished the quarter mixed. Both experienced strong rallies in March as trade war fears increased. The S&P 400 Mid-Cap Index decreased 0.77% in the first quarter, while the S&P 600 Small Cap Index gained 0.55%. The mixed results, along with their underperformance in 2017, makes midcap and small-cap stocks very attractive, especially since the tax cuts will lead to dramatically higher profits for these types of businesses.

The volatility that swept US stocks also hit international markets. The MSCI EAFE index declined 1.89% in March, while the MSCI Emerging Markets index slipped 2.00%. Improving economic results in Europe have lifted consumer and business confidence in the region to the highest levels in a decade. Broadening growth, further stimulus from the ECB and the Bank of Japan, and lower valuations versus US stocks make developed international investments attractive. Emerging economies are also benefitting from the broadening of global growth across different geographic regions, the weakness in the US Dollar, and lower valuations. Thus far in 2018, the MSCI EAFE index is down 1.58%, while the MSCI Emerging Markets index is up 1.24%.

All of last year, we wrote about the remarkable rally in growth stocks. For 2017, growth outperformed value by an astounding 1,657 basis points according to Russell. This marked the widest performance disparity between growth and value since 1999. Conditions did not let up in the first quarter with growth beating value yet again by 424 basis points. This trade did retrace some in March as technology stocks were hit. We have written for over a year that the disparity between growth and value is befuddling. Growth does well when economic success is scarce. With the global economy advancing in a synchronized fashion, coupled with the new corporate tax cuts, value should be doing much better. The only explanation appears to be that investors simply do not believe what they are seeing. Concerns about inflation and trade wars also do not help. Investor skepticism has plagued this market ever since the end of the financial crisis.

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As 2018 moves through its early stages, the improving global economic picture, along with the accommodative central banks, remain important ingredients for future stock market gains. The 45 largest economies in the world continue to expand at the same time. This has not happened since 2006-2007. The labor markets remain strong. Unemployment has been 4.1% for five consecutive months (the best since 2000), while the participation rate has improved. Weekly jobless claims have been below 300,000 for three years, the longest stretch since 1970. Wages are slowly improving and take-home pay has improved because of the tax cuts. The savings rate is still low at 3.4%, but the financial state of the consumer remains strong. Finally, the Citigroup Economic Surprise Index has moderated from its year-end highs, but it is still well into positive territory in the US. This is a good sign for further stock market gains; however, it also creates the possibility for volatility and disappointments as analysts boost their economic forecasts.

Accelerating global growth also opens the door for central banks to remove monetary stimulus. The Fed raised rates by 0.25% in March. They are also shrinking their balance sheet by $20 billion per month. During his first press conference as new Fed Chair, Jerome Powell said he is prepared to raise interest rates at the same gradual pace as his predecessor. The Fed dot plots signal they intend to raise interest rates three times in 2018 in 0.25% increments.

In our opinion, the words and actions from the major central banks, especially the Fed, will be an oversized factor in determining stock returns in 2018. Investors cling to these bankers' every word since we are living in unprecedented economic times. At no other point in recent history have we seen central banks signal monetary tightening through interest rate hikes and balance sheet reduction, while fiscal policy is signaling looser conditions with tax cuts, deficit spending, and talks of large infrastructure projects. Only time will tell if these competing views cancel each other out, or if one side wins over the other. Until then, this will likely create volatility in the capital markets. This means it is important to look at the levels in interest rates and the shape of the yield curve.

For three years, we have written about the high valuations in the stock market. Even though earnings have been much better than expected, the rally in stocks has exceeded earnings growth; thereby pushing up valuations. Currently, the S&P 500 trades at 16x EPS estimates for the next 12 months. This has dramatically improved since year-end as companies have released details about the impact of lower taxes. Regardless, we are still slightly above the long-term historical average of 15.7x. The trailing PE is 20.8, near the highest level for non-recessionary conditions in 13 years.

With interest rates still low compared to historical standards, stocks are attractive on a relative valuation basis. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here on the shoulders of continued earnings growth and improving economic conditions. With earnings season right around the corner, analysts are expecting S&P 500 earnings to rise 17% from levels one year ago—the best year-over-year showing since 2011. If this should come to fruition, it will significantly dampen the downside volatility we have experienced since early-February.

Once earnings season begins, we will be keeping a very close eye on the results from big technology companies. The five biggest components of the S&P 500 are all tech related—Apple, Microsoft, Amazon, Facebook and Alphabet (previously known as Google). Collectively, these five companies make up 15% of the entire index, which is more than any individual sector, excluding technology. As we saw in March, these companies size give them great influence over total returns, so when they decline, it is difficult for the rest of the market to absorb their losses while powering the overall market higher.

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Currently, economic data does not indicate a recession in the next 12 months; however, many indicators are signaling a transition from the mid-cycle to the late cycle—the possibility of peak profit margins; large cap stocks outperforming mid and small cap peers; full employment; the Fed in tightening mode; a flattening of the yield curve; tight corporate spreads in both investment grade and junk bonds versus US Treasuries; and a shrinking of the equity risk premium. When mixed in with above average stock valuations, the potential exists for higher levels of volatility; therefore, we expect stock returns to be more modest in 2018 when compared to the previous year.

Throughout the quarter, we communicated our investment strategy for the remainder of the economic cycle. The volatility currently in the marketplace solidifies our conviction in this plan. We have identified three outcomes that will lead to a change in our stock selection strategy. First, strong economic and earnings data should lead to both higher interest rates and stock prices. However, there is a point in which the higher interest rates will begin to have a negative effect on consumer spending and capex. Currently, we plan to slightly reduce our overweight to financials—a major benefactor of higher interest rates—when the yield on the 10-year US Treasury reaches 3%. This is because higher finance costs will begin to erode the consumer's appetite for mortgages and autos. Second, we plan to reduce our overweight in energy when our fixed income department eliminates their exposure to high yield bonds. Energy companies are a large percentage of non-investment grade credits, so this would signal higher finance costs and lower profits on the horizon for the sector. Finally, we plan to go underweight both financials and energy when our fixed income department extends duration in their bond portfolio. This move would signal they find bonds attractively priced, so we would want to underweight highly cyclical parts of the economy.

Until these conditions materialize, we will maintain our overweight position in financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare paired with an inline weight to consumer staples and underweights in utilities, telecom and REITs.

On the global scale, we reduced our overweight to US stocks by trimming US large cap in January. The proceeds were invested in developed international countries. We believe developed international economies are earlier in the economic cycle than the US. They also possess attractive relative valuations. Finally, we believe the ECB and the Bank of Japan will continue their quantitative easing programs for the duration of 2018. Despite the trim, we are still overweight US stocks, and we plan to maintain our overweight to mid and small-sized companies since they stand to benefit the most from corporate tax cuts and the reduction of regulations from President Trump. Finally, we have an inline weight to emerging markets.

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