Market insights

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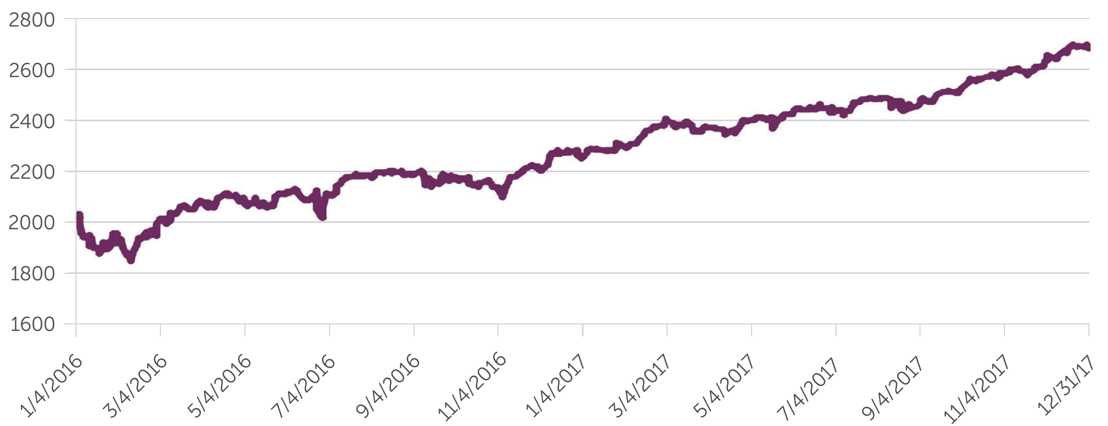
A market in transition

Key highlights:

- Markets have entered a transitional phase in which volatility swings are likely to become more common.
- If viewed via a scorecard, the positive side includes synchronized global growth, strong corporate earnings, solid GDP, and low unemployment. On the other hand, negatives include inflation fears, Fed rate hikes, trade protectionism, rising interest rates and a growing federal deficit.
- The outlook may appear to have more negatives than positives but we view this as part of the reason for an increase in volatility.

With early February reminding investors that volatility is never too far removed from financial markets, we may have entered a period of transition in financial markets in which swings are likely to be more common occurrences. This should not have been entirely unexpected as markets have been moving in a fairly static pattern for a long time (see Exhibit 1) and this shift may well be part of the return to a level of normalcy. In assessing the current economic picture, it may be helpful to think of the landscape through the lens of an economic scorecard, with both positives and negatives (see Exhibit 2).

Exhibit 1: For the last two years, stocks have been in a steady, upward trend



Source: Bloomberg, 12/31/17.

Exhibit 2: Economic scorecard

Positives	Negatives
Synchronized global economy	Fear of inflation
Strength in corporate earnings	Fed rate increases
Solid GDP growth	Rise of trade protectionism
Low unemployment rate	Prospect of rising interest rates
	Increasing federal deficit

For illustration purposes only.

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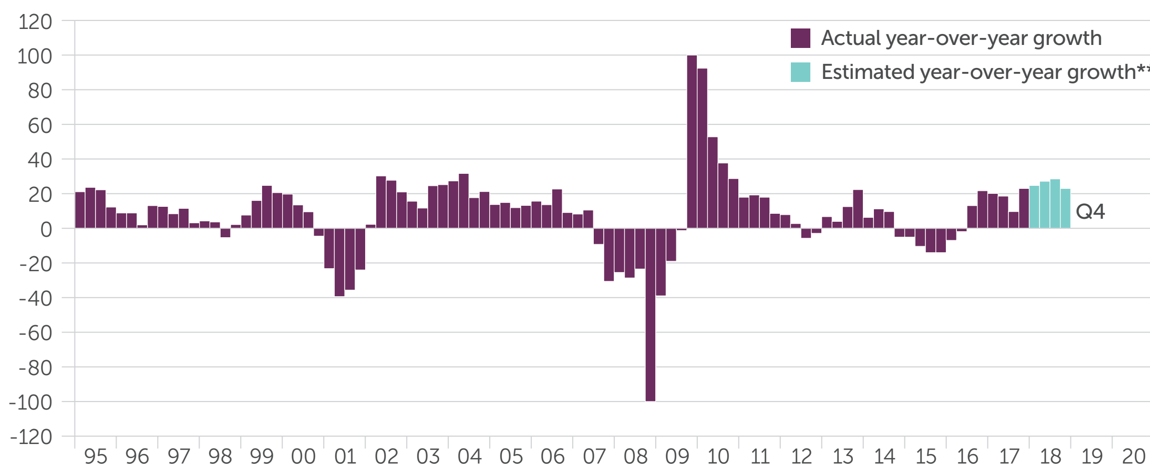
The positive side

Consider the left side of the scorecard. First, despite a significant market correction, a recovery soon followed the market sell-off in early February, with roughly two-thirds of value being restored in the ensuing weeks.[1] Both domestic and international equities have rebounded nicely with the S&P 500 Index and MSCI EAFE Index returning 1.83% and 0.30%, respectively, year to date.[2] Synchronized global growth has continued to provide support for the markets. Second, corporate earnings have been strong and industry estimates suggest this may continue to be a driver for the U.S. economy (see Exhibit 3). Third, GDP growth has been strong with the fourth quarter of last year registering an estimated 2.5%.[3] Finally, the U.S. unemployment rate is at its lowest level in decades which is positive news for wage growth and spending (see Exhibit 4).

Exhibit 3: Company earnings continue to show strength

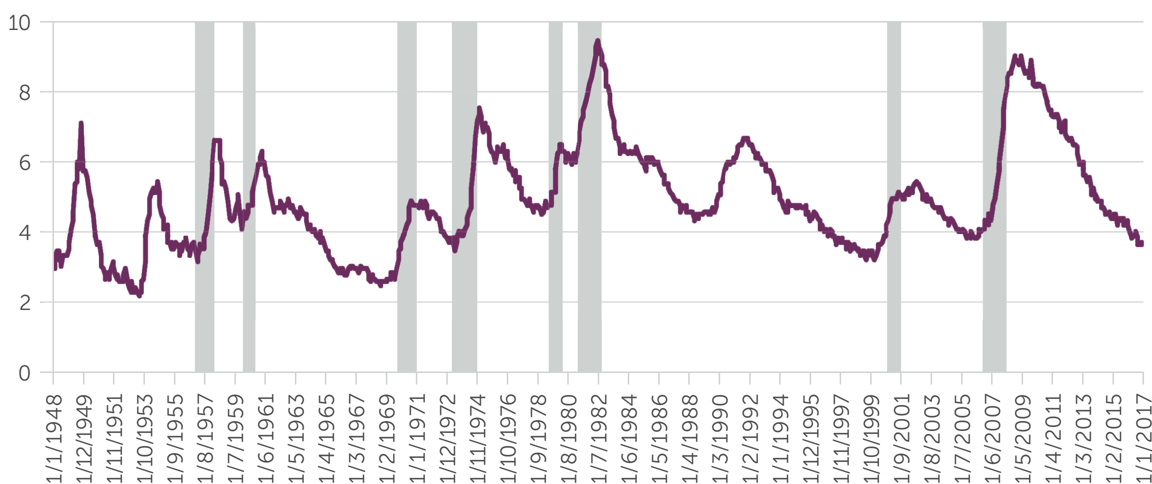
S&P 500 earnings per share growth* (yearly percent change)



* Yearly growth rates capped at +100% and -100% due to extreme values.
** Industry analysts' consensus expected earnings growth.
Source: Standard and Poor's, 3/2/18 and yardeni.com.

Exhibit 4: U.S. unemployment nearing lows last seen in the 1960s

Unemployment rates (percent)



Source: Federal Reserve Bank of St. Louis (FRED), 3/1/2018 and yardeni.com.
Note: Shaded areas denote recessions according to the National Bureau of Economic Research.

[1] Source: Bloomberg, 2/28/18.
[2] Source: Bloomberg, 2/28/18.
[3] Source: Bureau of Economic Analysis, U.S. Department of Commerce, 2/28/18.

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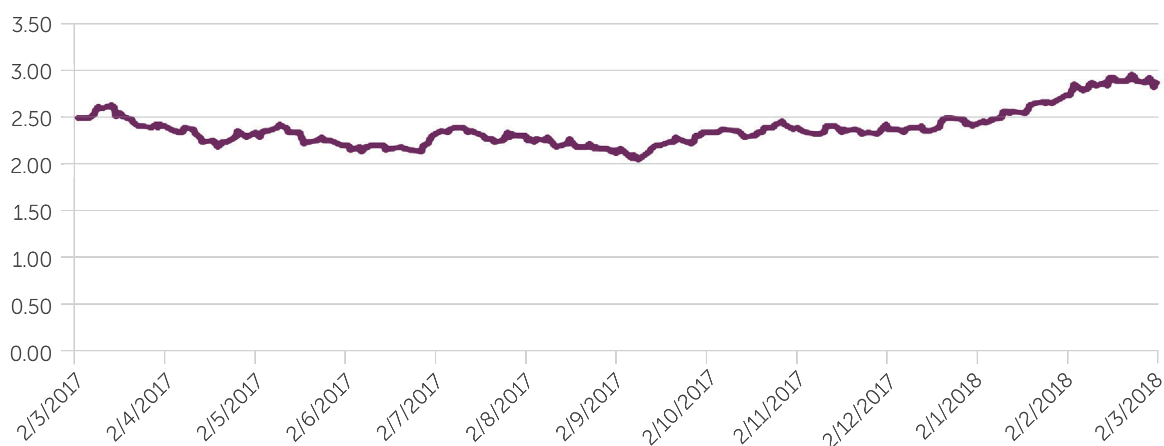
The negative side of the scorecard

Turning to the other side of the scorecard, we believe there are five items that investors should monitor as the year unfolds. First, for some time, market participants and the Fed had been concerned about the potential of deflation in the U.S. economy. With inflation starting to creep up in economic data, the focus has shifted from deflation to inflation which has created uncertainty in the market. Second, the Fed has now hinted, most recently via Chair Powell's testimony to Congress, that it may hike interest rates four times this year, instead of three, given the strong growth prospects of the economy and the threat of higher inflation. Third, trade protectionism, with President Trump introducing steel and aluminum tariffs, is now on the rise. Fourth, interest rates increased as we started the new year, although they then leveled off and actually have fallen recently (see Exhibit 5). Finally, largely due to the GOP tax cuts, the federal deficit has ballooned, with a commensurate tripling in the amount of U.S. Treasury debt that the market must absorb compared to fiscal year 2017.

Exhibit 5: Interest rates have leveled off recently

Ten-year U.S. Treasury over last 12 months



Source: Federal Reserve Bank of St. Louis, 3/2/18.
Data shown is the 10-Year U.S. Treasury constant maturity rate, daily, not seasonally adjusted.

What does it all mean?

The negatives may appear greater than the positives but that does not necessarily mean there is cause to be alarmed about the market in the near term. While greater caution is warranted, we believe solid corporate earnings should offset the "negatives". Although markets have entered a period of transition, bringing increased volatility, we think that this could be symptomatic of the shift to more normal financial markets rather than the end of the bull market.

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Glossary

The **Standard & Poor's 500 Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **MSCI EAFE (Europe, Australia, Far East) Index** is recognized as the preeminent benchmark in the U.S. to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America. Returns are in U.S. dollars.

Price/earnings (P/E) is the price of a stock divided by its earnings per share. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

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