—New Albany—
Investment Management

February 2, 2018

Market Insight: Returning to Normal…Volatility

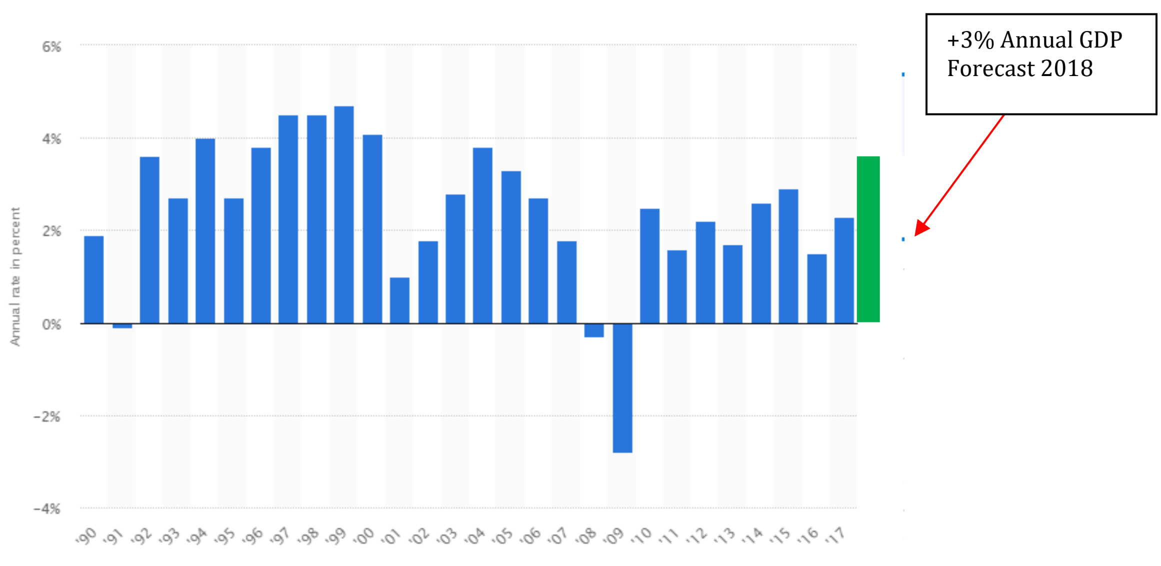
After a very strong start to the year, the US markets finally experienced its largest single day sell-off of 1.7% this week, something not seen since August of 2017. Globally, the MSCI world equity index which tracks shares in 47 countries, recorded its biggest weekly lost since November 2016, and has snapped its longest winning streak (10 weeks of gains) since 1999. Volatility as measured by the CBOE $VIX index spiked from an all-time low just three weeks ago to a five month high. Rising interest rates are cited as the cause. Suddenly the sanguine, tranquil investing landscape is looking a bit more challenging; but a broader perspective would conclude the market place is simply returning back to a more normal functioning free market. Without Central bank support, the markets are now much more subject to the flow of funds, interest rate fluctuations, fiscal policy changes and corporate news. **So higher volatility is likely here to stay.**

Many investors are wondering just how much further the bull market in global equities can run. Even with the sell-off, January price gains were remarkable, attaining returns that would be considered good for an entire year. So, as an investor, is it time to take profits or does the bull have more room to run? The answer to that questions lies in the market's expectation of the direction of future growth, inflation, earnings, and interest rates. The market tends to keep moving in one direction (in this case higher) until certain events change the expectation of the future.

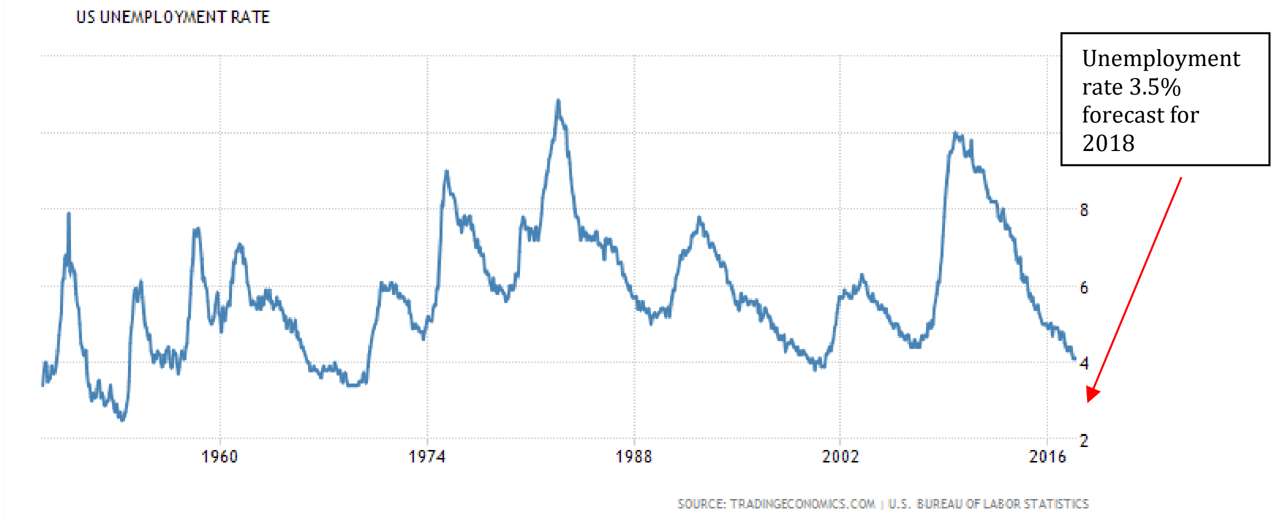
Let's take a look at the key factors and market expectation.

US Growth continues to accelerate with annualized growth expected to exceed 3% in 2018, the first time since 2005 and up from 2.3% in 2017, and 1.5% in 2016. Consumer and investment spending closed 2017 on a high note and are expected to continue to rise further this year due to falling unemployment and the enactment of the new tax law/ fiscal stimulus. The Atlanta Fed just upgraded their 1st Qtr GDP forecast to 5.4% a level not seen in many years.

Annual GDP Growth Rate 1990-2017 (source Statista)



The unemployment rate, currently at 4.1% is expected to drop to 3.5% by the end of this year, and will be at its lowest point since 1969. This low rate will support strong growth in 2018, however it could become a hindrance by 2019 as it will be hard to find more workers to support increasing growth.



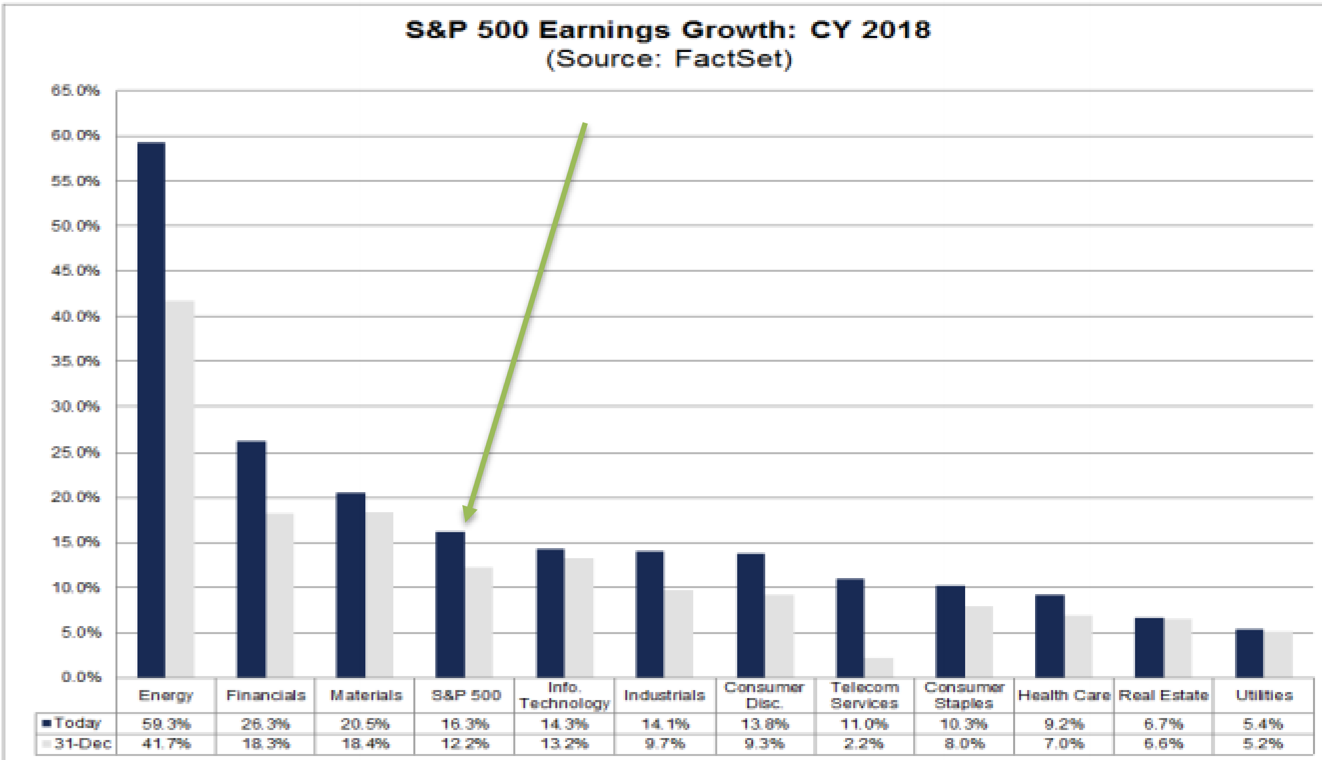
US Businesses are experiencing the most favorable domestic and global economic environment since the mid-2000s. Lower corporate tax rates combined with a weaker dollar allow US businesses to be more competitive globally. Domestically, lower tax rates allow companies to deduct investment spending from corporate tax payments which in turn lowers the cost of financing for capital spending projects like structures, drilling, data centers, and warehouses.

<u>Repatriated corporate earnings should benefit shareholders and the economy</u>**.** It is estimated the S&P 500 companies have stashed outside the US over $1 trillion of earnings to avoid the high tax rates. With the new lower corporate tax rates, companies are expected to bring back cash and deploy it in many ways such as dividends, share buybacks, wage increases and employee bonuses.

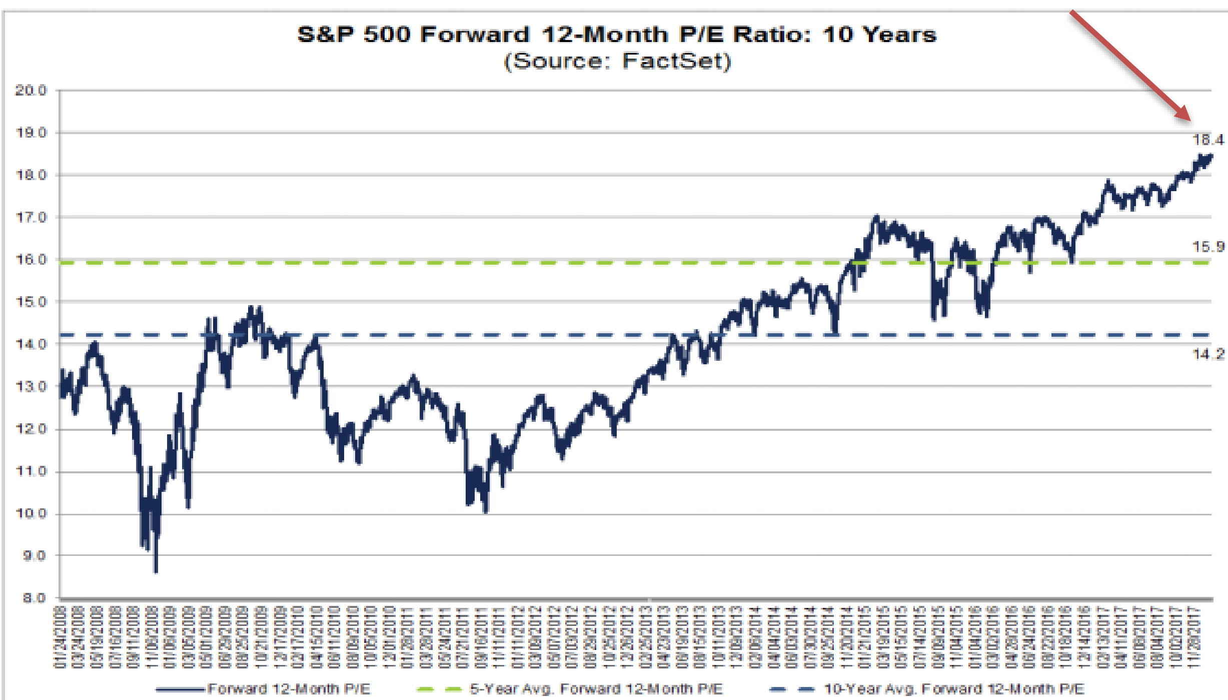
International economies continue to gain momentum with broad base strength seen across all major developed and emerging countries. China, India, Japan, and Europe are all experiencing accelerating growth both from their consumer and manufacturing sectors. Europe just posted 4th Qtr GDP of 2.7% (actually higher than the US) and the manufacturing index has climbed to the fastest pace since 2011.

Earnings growth very healthy: So far, of the 24% of companies that have released reports<u>, reported earnings have risen by 12%, and operating earnings (before special events) rose by 20% with broad base revenue growth of 7%, a level not seen since 2010</u>. A record high number of S&P 500 companies have beaten sales estimates for the 4th Qtr. Energy and Materials are leading the pack, followed by Technology, and Financial sectors. This rise in earnings is a big tailwind for stock prices.

For all of 2018, analysts are projecting S&P 500 earnings growth of 16.3% and revenue growth of 6.0%. (Factset)



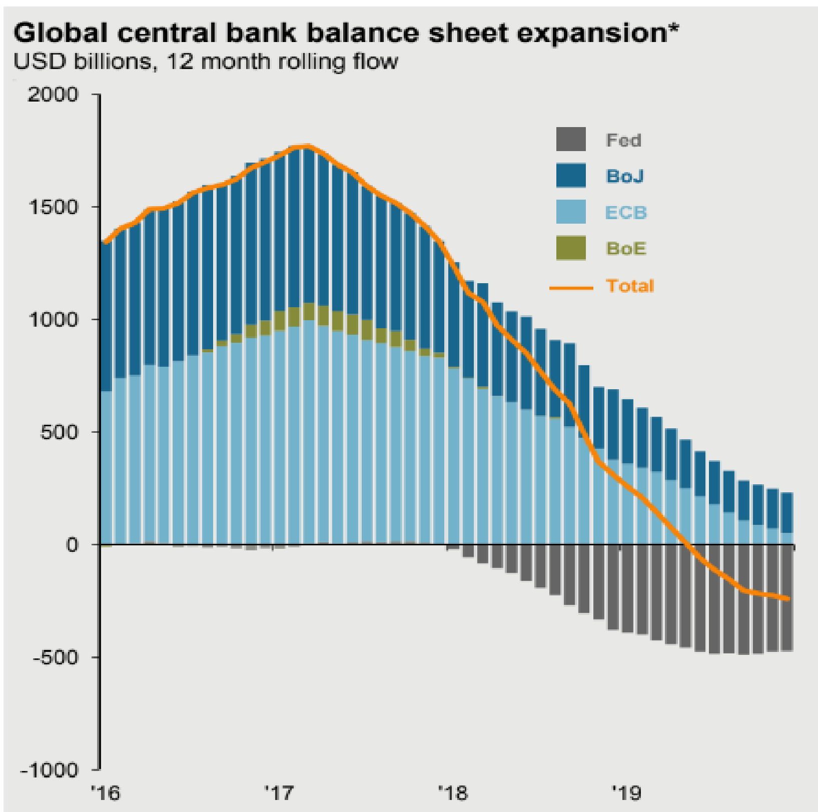
Valuation continues to creep higher: Warning! Forward P/E Ratio is 18.4, above the 10-Year average of 14.2, the 5-year average of 15.9, and 18.2 at December 31st. Since the start of the first quarter, the price of the index has increased by 6.1%, while the forward 12-month EPS estimate has increased by 4.8%. (Factset)



Inflation beginning to rise: Warning! A weak dollar (causes imports to be more expensive), rising oil prices, and rising wages are contributing to upward pressure on prices and are likely to push the consumer price index (CPI) above the Fed's 2% target rate. A little bit of inflation is OK, as it indicates a strengthening economy; and up until now, it has been one of the positive indicators the Fed has been hoping for. But if prices rise too much, it will pressure earnings and push interest rates higher.

Short Interest Rates rising. The Federal Reserve is expected to raise short term interest rates at least three and possibly four time this year, pushing the short term interbank borrowing rate up 75-100 bpts to 2%-2.25 %. This hike will impact some businesses' short borrowing cost; however, it will be welcomed by any consumer who has funds in a savings account or buys CD's. For almost a decade, consumers earned a negative real return (adjusted for inflation) on their cash and short term investments.

Long Term Interest Rates Rising in response to stronger economic data and withdrawal of Central Banks bond buying program. Warning! The Chart below shows the expansion of Central Banks balance sheets through 2017 (which reduced the supply of bonds and kept long term rates low), and then expected contraction beginning in 2018 by the Federal Reserve (gray bars). The reduction in bond buying will increase the supply of bonds and pressure long term rates higher.



Source: JP Morgan

<u>Tipping Point for Stocks:</u> The yield on the US 10yr Treasury has climbed to 2.8%, from 2.1% in 2017 and an all-time low of 1.2% in 2016. Again, a small rise in rates is a welcome sign of economic strength, but if rates rise too high, it becomes a headwind for both the economy and stocks. There is a great debate amongst bond gurus as to how high 10yr rates can rise before in really impedes economic growth and stocks. The estimates range from 3%-4%, so assume 3.5% is the magic number. That means interest rates still have a long way to go from the 2.8% level today.

In sum, a booming global economy and rising earnings are a huge positive for stocks in the near term. Confidence is high in that the US economy will continue to strengthen throughout 2018 as the effects of the new tax law slowly settles into the economy. And separately but very importantly, international economies are gaining momentum, which means there are multiple engines of growth. Thus the market is not just dependent on one sector or one economy for investment. This is all very good news and should allow stocks to continue to grind higher this year. However, with high expectations of growth, expensive valuations and rising interest rates, the market is subject (at risk) for disappointments. Thus volatility should continue to rise.

Investment Strategy: For stocks, risk positions remain at the upper end of targets range. For bonds, duration remains short term to avoid the impact of rising long term rates.

These are my thoughts on the current market environment and investment strategy. Please contact me with any questions or concerns.

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