—New Albany—
Investment Management

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Market Insight: A Douse of March Madness

March Madness: *"An undocumented form of mental illness, related vaguely to Mad Cow Disease, whose symptoms include severe cramps in the wrist and index finger of the hand that holds the TV remote, and beery smelling foam around the lips, crumbs on the upper body, and the repetitive muttering of the phrase, 'the brackets'."* (Author unknown)

For sure, March is an exciting month in college basketball. It brings out the best in some, and the 'not so best' in others. Emotions run hot, and unexpected outcomes are celebrated. The financial markets have also been experiencing a douse of March Madness as unexpected news and surprise announcements have driven bouts of angst and hysteria. Emotions are driving price action. Uncertainty over trade tariffs, the pace of rising interest rates, staffing changes at the White House, and some weaker economic news, have caused the markets to become skittish and volatility is elevated. Though these news bombs should not be ignored, it is important to view them in the context of the big picture.

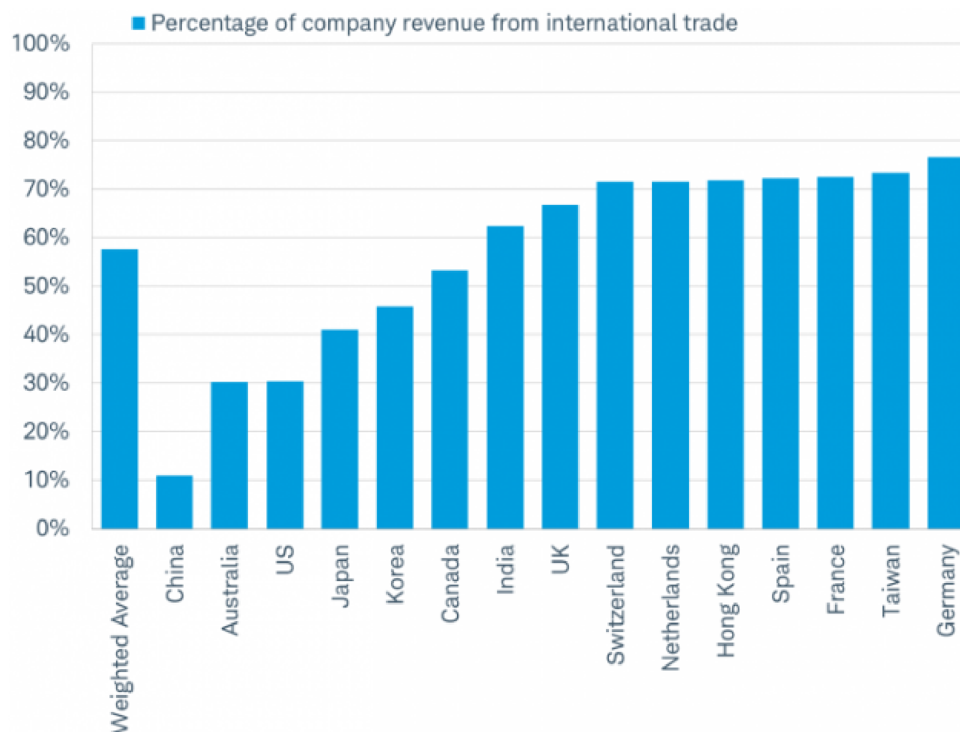
Future Growth Fiscally Dependent: The US is in the latter stages of economic expansion. This means the benefit of low interest rates has run its course and now Fiscal policy is the primary influence on expectations of future economic growth, earnings, and the direction of stock prices. Changes in fiscal policy are messy, unpredictable, and very slow to implement. Thus there is a lot of 'noise' that initially can jostle the markets in the short run, as investors process the potential outcome and impact. But over time, the focus returns to underlying fundamentals that drive stock prices: economic and earnings growth.

Tariffs & Trade Wars: The current hot topic is the US' repositioning on global trade. The recent announcement by President Trump of tariffs on steel and aluminum sent the markets scrambling as fears of global trade wars and inflation would ensue. But as the details of a much softer implementation became more apparent, the markets rebounded. However, concerns over retaliation have rekindled, sending the markets down again. The markets want clarity; and at this point there is none. Any changes in trade policy will likely drag on for months if not longer and thus will be an irritation/ headwind for the markets. What we do know on trade:

- The US has the world's largest trade deficit. This means we import more goods than export. A wider deficit means more dollars are controlled by foreign countries and they in turn control how those dollars are invested- either through capital expenditures or purchasing US Debt. Thus, the larger the deficit, more potentially disruptive it could be to our economy and, some argue, to our national security. Foreign control of domestic assets is a real issue.
- The US monthly trade deficit is -56.6 billion and the widest since 2008. The four largest trade deficits by country are with China 36.6 billion, the EU 13.6 b, Japan 5.7b and Canada 3.6b.
- Total world trade is equivalent to more than half of the world's economic output, so any changes to trade policies can cause significant ripples around the globe impacting many countries' growth, and the earnings of global companies.
- Emerging markets will have the most to lose from changes in trade laws because their economies depend most on exports. Thus, performance of emerging market stocks is more sensitive (volatile) to changes in global trade than developed market stocks,

- Companies in developed countries outside the U.S. have a greater percentage of international sales than U.S. companies. But, the European companies mostly trade with each other and thus may be more insulated from a trade war.
- Chinese companies have relatively little international trade exposure because a vast majority of sales are driven by domestic demand.

International Revenue by Country: The chart below shows the percent of revenue generated from international trade by country. Notice China has the least exposure of only about 12%, followed by Australia and the US with 30% of revenue generated from outside their country. Over half of business revenue is generated internationally and reinforces the importance of free trade on the global financial markets.

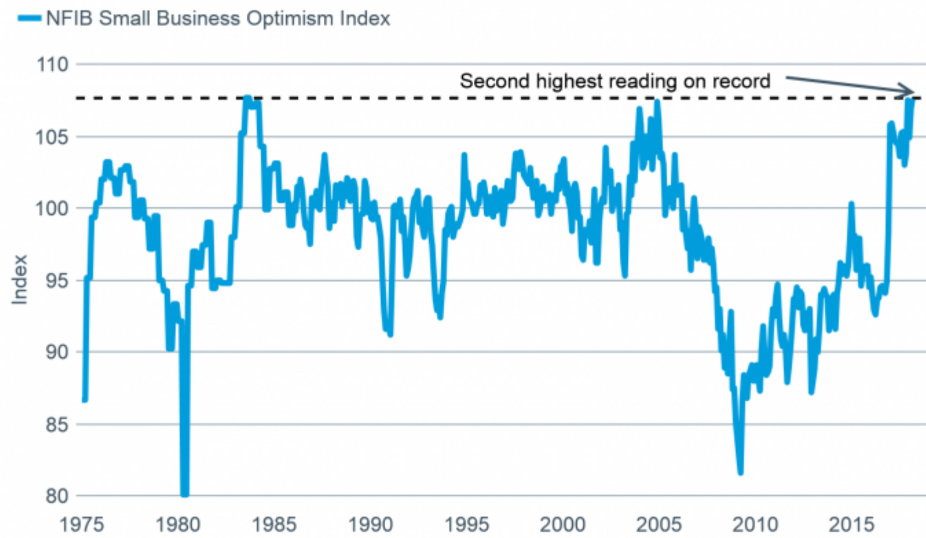


Source: Charles Schwab, Factset data as of 3/3/2018.

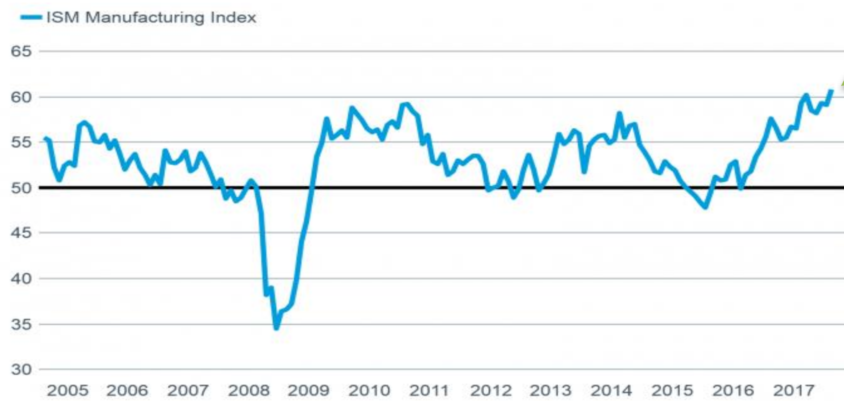
The proposed trade measures announced so far are not really that significant in the grand picture, but they do challenge the status quo. The big question is will this lead to retaliation from other countries and spiral into an all-out trade war.

The China Factor: The big concern is China because they are the US's largest trading partner and the largest holder of US debt. The proposed metal tariffs have little impact on China but the big concern is the "pending outcome of the Trump administration's review of China's alleged 'theft' of U.S. intellectual property rights." If China is found in violation, ''a far more significant series of tariffs, quotas, and investment restrictions on China could be proposed, and China could respond in kind." (Source: Charles Schwab). So any negative response from China could have a significant impact on the economy and financial markets.

Big Picture Still looks Supportive but … some mixed data. The underlying economy still looks quite solid; however recent soft retail sales data prompted 1st quarter GDP forecasts to be revised lower to 1.9%, down from 4% a month ago. But business spending remains very optimistic with the NFIB small business index at its highest level since 1983, and showing a record-high 'good time to expand' reading..



Also both the Institute of Supply Management (ISM) indices remain very strong, showing expansion.



The Labor Market Remains very strong; Inflation Good: Jobless claims are at their lowest level since 1969, and the labor participation rate jump to from 62.7% to 63%. At the same time, average hourly earnings, a key measure the Fed uses to gauge inflation, actually dipped to 2.6% and should calm fears of aggressive interest rate hikes.

Typical Late Cycle Volatility; Big Picture Still Supportive

World Growth Solid: The Organization for Economic Cooperation and Development (OECD) raised its 2018 and 2019 global growth forecasts to 3.9% and 4.0% respectively- the fastest growth rate since 2000. The table below shows the growth rate by year for each G20 country, with the green arrows indicating upward revisions in growth for the majority of countries.

Nearly every country got a GDP upgrade in the latest round of forecasts from the OECD

GDP growth

Year-on-year, %. Arrows indicate the direction of revisions since November 2017

	2017	2018	2019		2017	2018	2019
World	3.7	3.9	3.9	G20	3.8	4.1	4.0
Australia	2.3	3.0	3.0	Argentina	2.9	3.2 =	3.2 =
Canada	3.0	2.2	2.0	Brazil	1.0	2.2	2.4
Euro area	2.5	2.3	2.1	China	6.9	6.7	6.4 =
Germany	2.5	2.4	2.2	India[1]	6.6	7.2	7.5
France	2.0	2.2	1.9	Indonesia	5.1	5.3	5.4 =
Italy	1.5	1.5 =	1.3 =	Mexico	2.3	2.5	2.8
Japan	1.7	1.5	1.1	Russia	1.5	1.8	1.5 =
Korea	3.1	3.0 =	3.0 =	Saudi Arabia	-0.8	1.6 =	1.7 =
United Kingdom	1.7	1.3	1.1 =	South Africa	1.2	1.9	2.1
United States	2.3	2.9	2.8	Turkey	6.9	5.3	5.1

Source: OECD as of March 13, 2018. http://www.oecd.org/eco/outlook/Getting-stronger-but-tensions-are-rising-presentation-oecd-interim-economic-outlook-march-2018.pdf

In sum: Late Stages of an Economic Cycle has always been volatile and this current cycle is no different. The U.S. economy still looks healthy, Global growth continues to strengthen, inflation pressures remain modest, and earnings growth has been strong; all of which should allow the bull market to continue, albeit with increased volatility. In the short run, March Madness may provide more satisfaction on the basketball court than the than the financial markets; but long term, investors should ultimately be rewarded with a win. So hang tight and stay in the game!

Investment Strategy: Risk exposure remains at the upper end of target range because the fundamentals are still very supportive. However, with volatility expected to remain elevated, it is more of a stock pickers market where individual stock performance will vary widely. As such it is typically better to have good mutual funds (deliberate and unique stock selection) as compared to exchange traded index funds (a fixed basket of stocks) to reduce volatility and improve returns. With this backdrop, there has been some re-allocation of the portfolios away from ETF's and into select mutual funds.

These are my own thoughts. Please contact me with any questions or concerns.

Remember the many blessings of this day and enjoy the signs of Spring, new life!

Kind Regards,

Barbara

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