—New Albany—
Investment Management

May 8, 2018

Market Insight: Consolidations are Unpleasant but Healthy

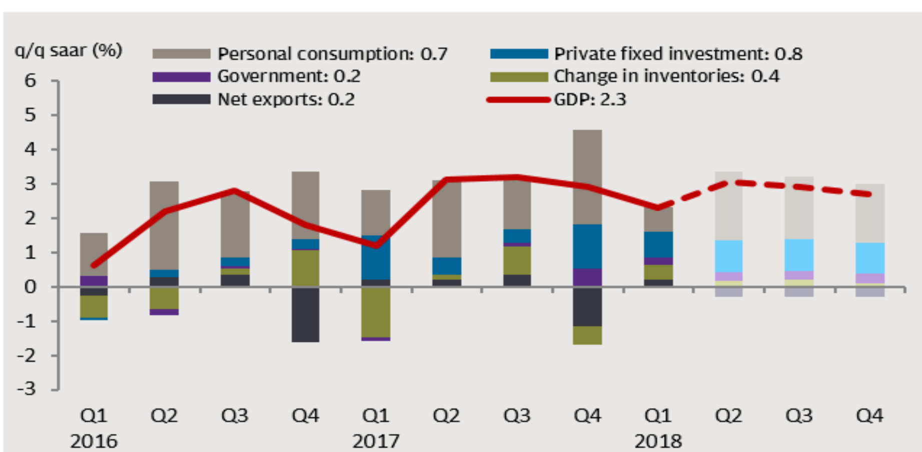
January seems like a long time ago when the markets were humming along in a slow steady ascent, setting a record of one of the longest stretches of market gains in over 90 years. Since then, it has been a tumultuous three months of high volatility and unpredictable gyrations that have challenged investors' fortitude and risk appetite. Market technicians would call this price action the 'Wave 4 countertrend of a Wave 5 Bull Cycle' (whatever that means). Market fundamentalist say we are in a period of 'consolidation'. Most investors would simply say it has been quite 'unpleasant'. The good news is that the market is returning to normal, the not so good news is that normalcy means there will be bouts of 'unpleasantness' such as the current period.

Opposing Forces: By definition, volatility indicates the market is uncertain over the future. Recently, slightly weaker economic numbers and rising interest rates have given investors reason to pause and question the potential impact on future growth and earnings. At the same time however, first quarter earnings have been nothing short of spectacular and are expected to be very strong throughout 2018. It is no wonder the price action is confusing, because investors are unsure which to focus on. These opposing factors have trapped the markets in a wide trading range for now, but eventually the market will break out and set a new trend based on the fundamentals.

Have the Fundamentals Changed? As an investor it is important to take note of the causes of volatility, not to knee jerk react, but to assess if the recent news has really changed the investing landscape. Have the long term fundamentals of growth and inflation dramatically changed to warrant a shift in strategy? Let's see what the charts are saying…

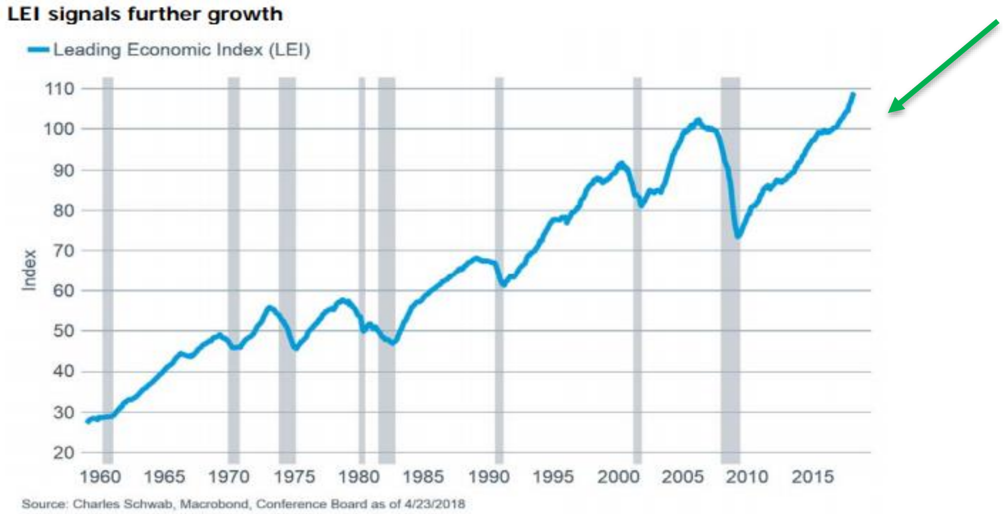
Economic growth slowed in Q1 but is expected to accelerate. The economy continues to chug along. First quarter GDP was a bit weaker than forecast, posting only 2.3% growth, but is expected to pick up in the second quarter to 3-4% growth as the effect of the tax cuts is fully absorbed into consumers' paychecks. The chart below displays GDP by quarter since 2016 and shows how the first quarter is usually slow then often rebounds in the ensuing quarters. Additionally, notice how each dip in growth is at a higher low indicating <u>the trending base growth rate is rising and confirms the economy is on solid footing.</u>

EXHIBIT 1: U.S. GROWTH EXPECTED TO PICK BACK UP IN 2018

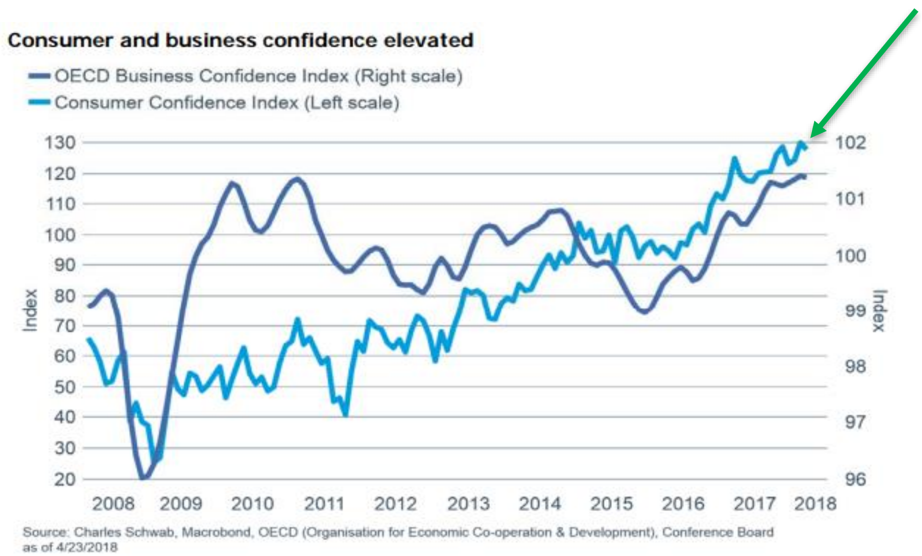


Source: BEA, Bloomberg; data through May 2, 2018. For illustrative purposes only.

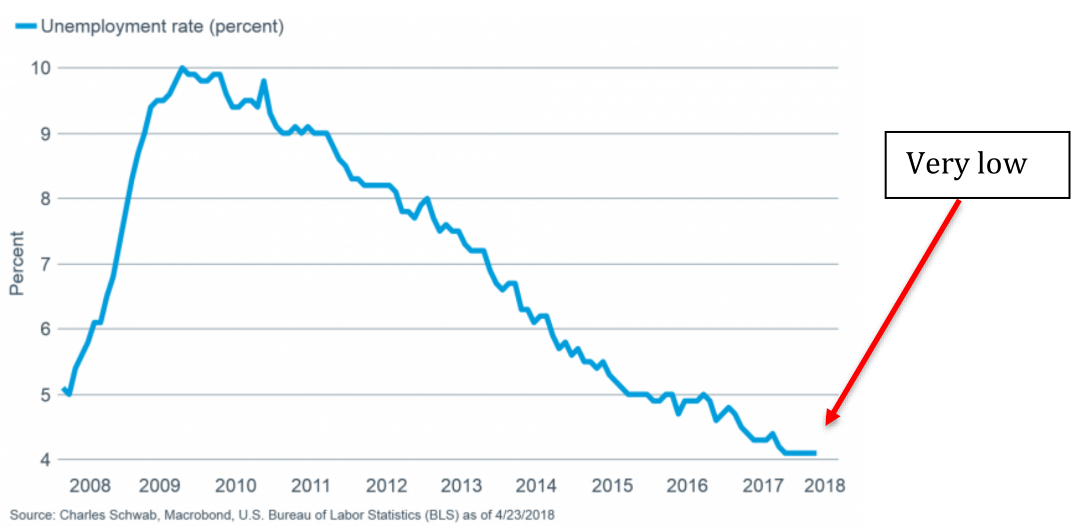
Leading Indicators point to solid growth ahead: Continued strength in the Index of Leading Economic Indicators- including industrial production, durable goods and housing data point to solid growth.



Consumer & Business Confidence, a good indication of future spending, continues to rise.



However, a tight Labor market (low unemployment) in the US is the main headwind for the future growth and could be a factor in accelerating inflation.



Inflationary Forces are building: The missing piece of this ten year expansion has been inflation, which had been exceptionally subdued until recently. Now, both labor and commodity prices are rising and have pushed key inflation indicators above the Fed's 2% target. The concern is the rise could prompt the Fed to be more aggressive in raising rates which would then pressure corporate earnings. One of the Fed's favorite indicators of inflation is the Employment Cost Index (ECI) which just posted new highs for this expansion at 2.7%.

Source JPMorgan

Oil prices are rising. This is Good News! What? Oil prices have more than doubled in two years, climbing $30 since the low of last summer and some investors are concerned this will hurt the economy. For those of us who lived through the oil price shock in the 1970's remember how inflation and interest rates rose so dramatically that it caused a recession. So why is rising oil prices a good thing today?

Source: Charles Schwab, Bloomberg data as of 4/23/2018.

Back in the 1970's rising oil prices were a result of a 'supply shock' where OPEC controlled the flow of oil globally. But this time is different because the rise in price is due to a rise is global demand, not a reduction in supply which means global economic growth is very solid. This is a good thing. In addition, rising oil prices benefit corporate earnings both in the US and globally. The energy sector is expected to see earnings rise over 70% in the 2nd Qtr from a year ago. Here in the US, oil production has doubled over the last decade and domestic energy companies stand to benefit nicely from rising prices.

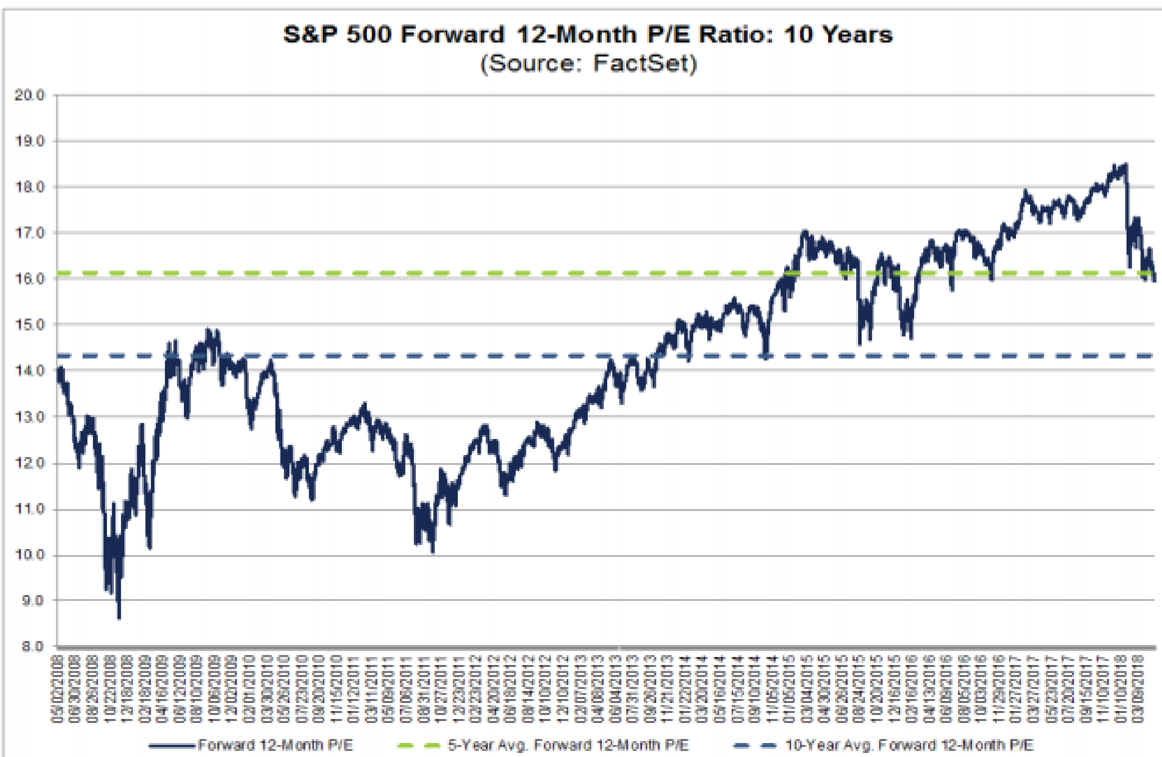
On the flip side, rising oil prices will hit the consumer at the pump; however, some of this rise will be offset by the tax cuts. As long as oil does not rise much above $70, rising prices are viewed as a net positive for the economy.

Spectacular Earnings Growth but the Market Ignores: According to FactSet…

- **1st Qtr 2018 earnings growth is coming in at 24.2%** (with 80% of the companies reporting so far). If this holds, it will mark the highest growth rate since Q3 2010. **This is remarkable!**

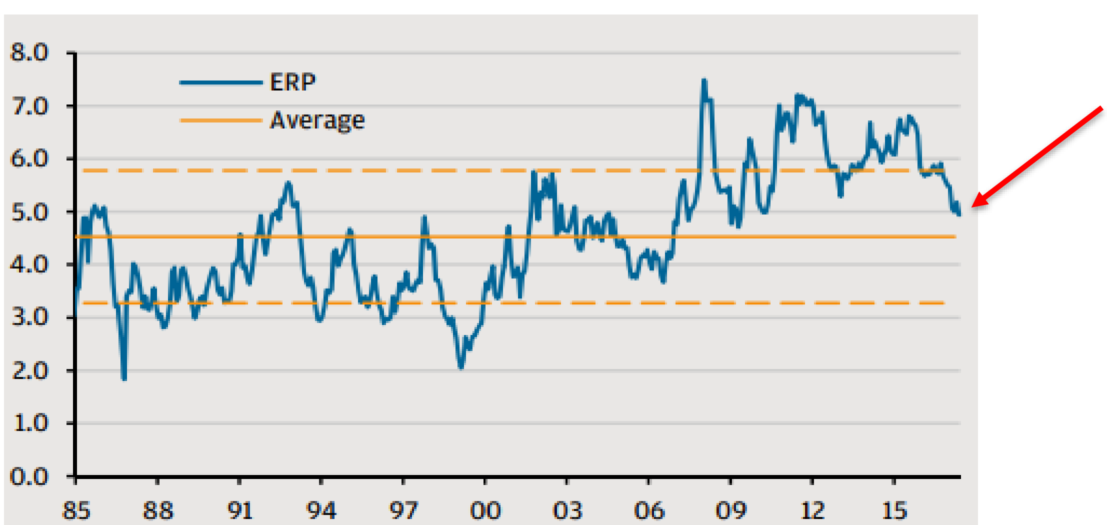
- **Double digit earning growth is projected for each quarter of 2018, with total 2018 growth forecasted of 19.5%. Now that's GOOD NEWS!**

Despite outstanding reported earnings, the market has traded down to sideways. The net result is the P/E ratio has declined from over 18 to 16. From a valuation standpoint, this is GOOD NEWS!



Offsetting great earnings are rising interest rates which are challenging stock valuations. Both short term and long term interest rates have been rising. When interest rates rise, it lowers the future valuation of all financial assets. Recently the 10yr Treasury note breached the 3%, a level not seen since 2014, and is causing investors to worry about stock valuation. The chart below shows the 10yr US Treasury Yield rising to 3%.

Stock valuations are actually cheaper today than a year ago (as measured by the P/E ratio) **but they are more expensive relative to interest rates**. One measure used to compare the relative value of stocks to bonds is the Equity Risk Premium (ERP) which calculates the expected excess return stocks will provide relative to investing in risk-free Treasury bonds. Typically, a high ERP indicates stocks are more attractive and a low ERP indicates bonds are a better value. The chart below shows the ERP has remained above 6% most of the time since 2008, meaning stocks have provided an extra 6% return over bonds. Since the Fed began to raise rates in 2016, the ERP has been falling, and now the ERP is near 5%, its lowest point in ten years. Though stocks are still attractive, they are not as attractive as before. History has shown when the ERP falls below 4%, the stock market struggles. But that would mean long rates would have to rise to near 4%, which is still a long way from the 2.95% level today.



Source: ThomsonReuters Datastream, J.P. Morgan Asset Management Multi Asset Solutions; data as of April 26, 2018.

Political winds are blowing again. According to Strategas Research, "we expect a continued rocky road between here and the midterm elections. Historically the average loss of House seats in the first midterm for a newly elected president has been 29... so that potential for turnover can help contribute to investor nervousness. The average maximum drawdown by the S&P 500 during midterm election years since 1950 has been 17%, with weakness concentrated in the first three-quarters of those years. But a positive caveat is that the average subsequent one-year performance from the trough of the drawdown has been +32%". Though the current political era is unlike none before, any election-related weakness could be followed by a rally thereafter.

In sum, there are indeed conflicting currents. Inflation and interest rates are rising, but for the right reasons. And political uncertainty is here to stay, so get used to it. None of these factors are in the 'red zone' that could derail the strong underlying momentum of growth in the economy. The charts are telling us the fundamentals are pointing to further solid growth but there are headwinds that will make it more challenging for the markets to move higher. This means the direction for stocks and interest rates should continue higher, but the pace will likely be arduous and at times frustrating.

Investment Strategy: We are maintaining a moderate pro-growth/risk tilt in the portfolios because the solid fundamentals should reassert themselves over the coming months. However, the current environment is not as supportive as it was in the 2016-2017 time frame and volatility is expected to remain elevated. Therefore, some repositioning into less volatile assets may be appropriate. At the same time, with interest rates expected to continue to rise, bond duration will remain short for the foreseeable future.

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

Kind Regards,

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