"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

Spinning Wheel

"What goes up must come down
Spinnin' wheel got to go 'round
Talkin' 'bout your troubles it's a cryin' sin
Ride a painted pony let the spinnin' wheel spin

You got no money and you got no home
Spinnin' wheel all alone
Talkin' 'bout your troubles and you, you never learn
Ride a painted pony let the spinnin' wheel turn"

("Spinning Wheel", by Blood, Sweat & Tears)

Spring traditionally is a time of rebirth and renewal – the weather starts to turn, flowers begin to bloom, baseball fans fantasize once again, and romance is in the air. But as March slips into April in 2018, the markets decidedly are suffering from hay fever – sneezing, wheezing and, at times, crashing to the ground.

It is an interesting time – the global economy remains positive (though with some signs of slowing), unemployment in the US is very low and companies continue to add workers, wages are increasing slowly, interest rates remain low, inflation seemingly remains under control, and corporate revenues and earnings are solid. This should be a time for market optimism and bullishness – *"a young man's fancy turning lightly to thoughts of love*." And yet…

And yet the market seems determined to find things to worry about. First is the ongoing threat of a "trade war". Despite repeated lessons to the contrary, the markets (we believe) still over-react to Donald Trump's rhetoric. As we wrote just a few days ago:

> *May we suggest that "the market" take a deep breath regarding the actual risk of an impending trade war? It is a standard Donald Trump negotiation tactic… to stake out an extreme position and then work backward to an acceptable outcome…Investors should focus on where Trump ends up, not where he starts…We believe the actual outcome of the current trade saber-rattling (A "Trumpest in a Teapot"?) will be much less dramatic than the market seems to be pricing in right now.*

Second, the market seems fearful of a greater than expected economic slowdown, despite a relatively upbeat outlook expressed by the Federal Reserve when it announced its widely anticipated rate hike in mid-March. It is true that there was a downward revision to the Q4 2017 GDP growth rate from 2.6% to 2.5%. It is also true that inflation is not rising commensurate with the level of employment gains and general economic expansion. But the *Wall Street Journal* consensus forecast for overall 2018 US GDP remains a solid 2.9% as the full impact of the recent tax cuts hits the economy later this year. Globally it is a similar story, with the World Bank estimating global GDP at 3.1% (2.2% in Developed Economies and 4.5% in Developing Economies).

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There *are* two issues that we believe warrant investor attention. First, led by the US, global central banks either are or will eventually begin to withdraw liquidity from the marketplace as their respective local or regional economies pick up steam. We were told for years that all that global "quantitative easing" was "good" for risk assets. Are we now to believe that the withdrawal of that liquidity (even if well-signaled by the central banks) will somehow *not* be at least mildly repressive on those same risk assets? "*What goes up, must come down, spinning wheel, got to go 'round."*

The second issue warranting attention is the seemingly sudden fragility in the tech sector, which has been such a significant driver of market performance for the past 2-3 years. Despite sky-high valuations, investors who sold out of the so-called "FAANG" stocks (Facebook, Apple, Amazon, Netflix, and Google) before now were subsequently punished by a persistent and consistent rally in tech stocks. But, led by Facebook's trials and tribulations regarding personal data usage by third parties (and the corresponding threat of governmental intervention and/or regulation of social media more broadly), and perhaps marginally affected by President Trump's personal vendetta against Amazon (which we believe is more about negative coverage from the Jeff Bezos-owned *Washington Post* than it is about Amazon itself), those days may be ending (or at least slowing down). A more realistic perspective on valuations and potential multiples growth, should it persist, could have a longer-term impact on investor sentiment and therefore market performance.

With that backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

- Despite significant recent market volatility, the global economy remains solidly positive right now:
    - US Q4 2017 GDP estimates were lowered slightly from 2.6% to 2.5%, and current Q1 2018 estimates are also at 2.5% (down from earlier estimates). The consensus estimate for all of 2018 is 2.9% (source: *The Wall Street Journal*);
    - There is uncertainty regarding this forecast, however, as the ultimate impact of (a) the tax law changes, (b) any potential infrastructure deal that ends up on the President's desk, and (c) the outcome of ongoing trade negotiations could all dramatically change the economic outlook for the US over the remainder of the year. This uncertainty was a primary contributor to the quarter-end market sell-off and spike in volatility;
    - Both the US manufacturing and services sectors remain well in expansionary mode – the ISM manufacturing index came in at a strong 59.3 in March, and the non-manufacturing index came in at a robust 59.5; although both indicators were down slightly from previous months, anything above 50 is considered expansionary;
    - Inflation fears were a primary driver of market volatility at the end of January and the beginning of February, the result of higher reported wages and higher commodity prices (driven partially by a weak dollar). But it is hard to see what the fuss is about. Through February, US CPI was only 2.2%, slightly higher than January (2.1%) but still well within the Fed target ranges.
    - The consensus estimates are that the Fed will raise rates 2-3 more times in 2018, following the widely anticipated 25 bps hike in March. We believe the Fed will raise rates a total of three times this year, not four, as we do expect signs of a slowing (but not recessionary) economy later in the year;
    - Interest rates remain low, as the mild uptick in yields in the first 8-10 weeks of the year were erased at the end of March as panicky equity investors sought "safe haven" investments when volatility

spiked and stocks fell at quarter end. The yield curve remains very flat as the Fed raises rates on the short-end but the long end remains "tamped down" by steady demand, expectations for an eventually slowing economy, and moderate inflation trends. We continue to believe the yield curve will not invert (often times a harbinger of recession), and that rates will generally grind higher over the course of 2018;

- With essentially all of the S&P 500 companies having now reported for Q4 2017, corporate earnings were up close to 15% YoY, on an 8.3% increase in revenues. The earnings and revenue "beat rates" (i.e., actual performance coming in better than estimated) were 76.1% and 76.9%, respectively, both well above historical averages. While financial engineering in the form of share buybacks continues at a healthy pace, we remain especially pleased with the upward trending capital investment spending (sources: *Zachs Earnings Report, Thomson Reuters, and JP Morgan Asset Management)*;
- First quarter revenues and earnings in the US are expected to continue this impressive rally, as *Zachs Earnings Report* forecasts 15.9% YoY earnings growth on a 7.3% increase in revenue;
- The Eurozone Q4 2017 GDP annualized growth rate was a solid 2.4%, and 2.5% for all of 2017. Expectations for Q1 2018 are for an annualized growth rate of approximately 2.0%, and 2.2% for all of 2018 (source: *TradingEconomics*);
  - Manufacturing all across the Eurozone remains solidly expansionary, with the Markit manufacturing index falling slightly from 58.6 in February to 56.6 in March. Likewise, the Services index fell slightly from 56.2 in February to 55.0 in March (source: *TradingEconomics*);
  - Unemployment fell to 8.6% in January 2017, a 9-year low, and annualized inflation through February came in at 1.1%. Expected inflation for all of 2018 remains under 2.0%, another reason we simply do not see a major inflation spike in 2018 (despite market fears) (source: *TradingEconomics*);
  - ECB President Mario Draghi wants to taper his quantitative easing program, but remains frustrated by low inflation rates and a strengthening euro (or, perhaps more accurately, the continued weakness of the US dollar);
- Japan's GDP expanded 1.6% in 2017, and has now posted eight straight quarters of positive GDP growth. The consensus estimate for 2018 GDP growth is 2.2%, though some investors are concerned about the impact on exports from the recently strengthening yen, driven primarily by a "flight to quality" during the quarter-end market correction (source: *TradingEconomics*);
- China's (official) growth rate for 2017 was again stable at 6.9%, and (official) estimates for 2018 suggest a slight slowing to 6.4% – 6.5% (source: *TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy is growing, though an economic slow-down (not recession) is expected in the second half of 2018. Over the course of the first quarter, we've seen (a) slow declines in both the manufacturing and service sectors (though both remain solidly in expansionary territory); and (b) a downward trend in the Citigroup Economic Surprise Indicators, both in the US and in the G-10 countries (with the G-10 index actually falling into negative territory in recent weeks). A downward trend means that actual economic data is coming in below expectations and suggests a slowing economy.***
- ***The wild cards for global economic growth are the longer-term effects of (a) the recently enacted US tax law changes, which so far have been generally stimulative to short-term expansion; (b) any enactment of infrastructure spending in the US (we are doubtful), and (c) the ultimate***

outcome of current trade negotiations, which we do not view with much concern but which would be harmful to continued global growth if they escalate into an actual trade "war";

- ***Somewhat to our surprise, the US dollar remains weak, though it strengthened briefly during the quarter-end market downturn as investors sought "safe haven" investments. We believed that an expanding US economy and tightening of Fed policy would stabilize or strengthen the dollar, but investment flows, anticipation of an ultimately slowing economy, and negative real rates in other parts of the world continue to keep the dollar low;***
- ***Inflation is a question mark but counts as another area where we simply don't share the market's level of concern. Wages and dollar-based commodity prices have increased, but not dramatically, and we see few signs that they will do so unexpectedly in the months ahead.***
- ***Inflation may (probably will) rise over the course of 2018, but (we believe) not to levels that should impact economic expansion. The primary impact will be on Federal Reserve policy – should inflation rise more quickly than we expect, the Fed may be more aggressive in its rate hike response;***
- ***The primary risks to a perhaps slowing but generally positive economic outlook are (1) a hard line on trade policies from the Trump administration, which could trigger a global counter-response (and no one wins in a trade war, especially consumers); (2) geo-political events (specifically North Korea), though we view that risk as minimal unless, as with trade, there is a serious misstep by Trump in his upcoming Summit Meeting with North Korean dictator Kim Jong-un; and (3) that the Fed acts too soon in raising rates and chokes off the expansion (though New Chairman Powell's initial public commentary seems to minimize this risk);***
- ***We remain in somewhat "uncharted waters" from an economic policy perspective, as Trump seems intent on piling on fiscal stimulus in the midst of an already expanding economy – it is working, but the inflationary and deficit impacts may have detrimental longer-term affects;***
- ***Furthermore, we are witnessing a certain level of policy "cognitive dissonance" as this fiscal stimulus is being applied at the same time that the Fed is tightening monetary policy. Where this "push me – pull you" saga ends up remains somewhat of a mystery;***
- ***Despite recent market turbulence and investor fear, solid GDP, earnings, and revenue growth, combined with still low interest rates, make for a generally positive market environment, and we still think stocks will end the year higher than where they began (but perhaps not by as much as investors have become accustomed to over the past 3-4 years, and with far more volatility);***
- ***The quarter-end market declines brought valuations down to slightly more historically "normal" levels, but we still believe the market is not cheap, and investors need to recalibrate their longer horizon return expectations accordingly. You cannot change the fundamental law of investing – what you earn on an investments is a direct function of how much you pay for it;***
- ***Market volatility spiked for a variety of reasons in late January and early February, then again at the end of March as trade, inflation, and tech sector fears spooked investors. We do not view this with any sense of alarm; many investment strategies benefit from rising interest rates and "normal" market volatility, so investors should view this "return to normalcy" as a net positive, even if day-to-day fluctuations require recalibration of investor sentiment;***
- ***EM and EAFE markets continue to have better valuations than the US (though they are by no means cheap). The USD trend is the wild card for US investors – should dollar weakness continue, it will provide a nice currency tailwind to non-US returns for US investors;***

- ***The US yield curve remains fairly flat (there is currently less than 50 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates and technical investment flows compete with higher inflation expectations on the long-end of the curve, but we believe the risk of inversion is low. We do expect rates to "grind higher" over the course of 2018, barring further market corrections and a corresponding "flight to quality" response from investors;***
- ***At these rates and credit spreads, the public credit markets still look very expensive to us, though coupons are reasonably safe as corporate balance sheets are in good shape. Several of the "opportunistic credit" managers we follow have begun to "de-risk" their portfolios in anticipation of rates and/or spreads widening back out from current levels;***
- ***We also continue to believe that increased volatility and increased dispersion between individual security prices should result in better opportunities for active management;***
- ***Global commodity supply generally continues to exceed demand, but a weak dollar, should it continue, will benefit the real asset complex;***
- ***While we generally are constructive on the global economy and overall market performance, the public markets are not cheap. While we see little reason why the market cannot move higher over the next 3-6 months (though with the key difference of a return of more "normal" market volatility), we also believe that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.***

Contrary to *The Farmer's Almanac*, this past March both came in *and* went out like a lion. So, as the second quarter begins and winter gives way to spring, we encourage advisors and investors alike to undergo a seasonal "renewal" exercise, specifically a renewal and recalibration of their expectations regarding market volatility and long-term performance. Stay diversified, keep your investment horizon aligned with your long-term financial plan, and do your best to ignore the market's periodic *sneezing and wheezing.*

Warm Regards,

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President

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